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LOAN PARTICIPATIONS: ARE THEY "SECURITIES"?

DENNIS SCHOLL*
RONALD L. WEAVER**

I. INTRODUCTION

Recent developments in the law governing loan participation agreements among banks are of great consequence to the legal, banking, general financial and corporate borrowing communities. They especially affect everyday efforts of small and medium sized banks and other banks with limited lending ability to serve the financial needs of larger bank customers.

Banks use loan participation to retain and service large customers primarily on a sole basis, to develop corresponding banking relationships and to obtain potentially profitable loans which they would not have an opportunity to make on an individual basis. Typically, when a bank borrower applies for a loan which the bank is unable to make due to statutory lending limitations on loan amounts to customers, the bank will seek out additional banks to join together and each lend a portion in order to accumulate the amount necessary to meet the customer's needs. The original bank becomes the "lead" bank and will negotiate the terms of the loan with the borrower. An information packet is presented to the participating banks who usually evaluate the borrower and the terms before deciding whether to proceed, and if so, in what amount. The banks that elect to proceed either execute individual loan agreements with the borrower or enter into a participation agreement with the lead bank. In the latter case, only one note is signed between the lead bank and the borrower. There is no substantive difference between the two methods as far as reviewing whether they fall under the ambit of securities laws.6

Of special significance on a practical level is the case law developing around the attempted characterization of loan participation agreements as securities. The question of whether a loan participation agreement falls under the ambit of securities laws has been addressed by the courts in various jurisdictions. In the case of Tcherepnin v. Knight, 389 U.S. 332 (1967), the Supreme Court of the United States held that a loan participation agreement did not satisfy the definition of a security as set forth in the Securities Act of 1933.

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agreements as securities within the meaning of the Securities Exchange Act of 1934 and other federal and state securities laws. The substantial consequences such a characterization has on the banking industry, including potential business dislocation, rescission, fines and even criminal penalties make necessary a careful but practical analysis of the question—when, if ever, are loan participations securities?

As this article will show (and the accompanying chart graphically demonstrates) there is an emerging doctrine from the courts that a loan participation agreement generally is not treated as a security unless it has a preponderance of the following characteristics:

1. an unfixed interest rate on the loan or an equity kicker built into the return on the loan,
2. an unsecured or minimally secured loan,
3. a borrower without accessible or preservable cash flow or net worth with which to repay the loan,
4. a lead bank which has:
   (a) sole or primary and virtually exclusive access to borrower information, and

4. See Chart at pp. 224-25, infra.
5. These characteristics are used to distinguish between investments, which generally are covered by the 1934 Act, and commercial transactions, which generally do not fall under the scope of the act.
6. This feature reflects the distinction between capital at risk and the nature of a loan transaction. A fixed interest rate negates the risk factor inherent in a true capital investment. See, e.g., Union Planters Nat’l Bank v. Commercial Credit Business Loans, Inc., 651 F.2d 1174, 1184-85 (6th Cir.) (fixed rate of return in the form of interest does not satisfy the “reasonable expectation of profits” prong of the “modified Howey” test) (see infra notes 29-38, 51-56 and accompanying text), cert. denied, 102 S. Ct. 972 (1981). See also infra note 71 and accompanying text. An “equity kicker” is a term of art in the banking business and involves a loan arrangement under which a bank lends money at a lower rate of interest and makes up the difference by taking a share of the borrower’s profits from the project for which the loan was made.
7. Reliable accessible collateral is a traditional feature of a loan. It is therefore contraindicative of a capital investment in a security. See infra notes 66-71 and accompanying text.
8. However, as one court noted, even a commercially risky loan is not the same as an investment risk without other factors. Lincoln Nat’l Bank v. Herber, 604 F.2d 1038, 1043 (7th Cir. 1979).
9. When a participant bank chooses not to exercise its right to investigate the borrower he is not entitled to the protection of the securities laws when the borrower defaults. See Hirsch v. du Pont, 553 F.2d 750, 763 (2d Cir. 1977). However, when the information is not available to a participating lender the lead bank may have a greater obligation to inform the participant. The failure to meet this obligation may make a court more likely to view the transaction as a security. Whether a security is involved or not depends upon the economic realities of the transaction in light of congressional intent. United Housing Found., Inc. v.
LOAN PARTICIPATIONS

(b) primary or exclusive control of loan administration and enforcement upon default.\textsuperscript{10}

5. a lead lender which has greater sophistication in lending than the participant,\textsuperscript{11} and

6. a purpose involving a new, unique or speculative venture rather than a relatively risk-free venture.\textsuperscript{12}

Generally, the courts have attempted to distinguish the promissory note which is being participated in from the participation transaction itself in determining if a security is present. Under this analysis, the focus is on the transaction and the general rule is that the transaction may be considered a security even if the note itself is not.\textsuperscript{13} This is in contrast to early literal readings of the 1934 Act which focused on the underlying promissory notes to determine whether securities were involved.\textsuperscript{14}

In examining participation transactions, recent rulings have considered the economics and practicalities of the banking process and

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Forman, 421 U.S. 837, 848-49 (1975). If the economic reality is that a participant bank is damaged by a lead bank's omission of material information to which the participant is entitled then the transaction or participation is one which may fall within the intent of the 1934 Act. \textit{See}, e.g., Lehigh Valley Trust Co. v. Central Nat'l Bank, 409 F.2d 989 (5th Cir. 1969). But see United American Bank v. Gunter, 620 F.2d 1108, 1119 (5th Cir. 1980) (borrower financial statement not forwarded to plaintiff participant by lead bank until two months after agreement to participate. In the absence of misrepresentation the court declined to find the omission to be a security law violation, even if the participation agreement could have been considered a security).

10. The fourth prong of the \textit{Howey} test for identifying a security is that the expected profits be derived from the managerial or entrepreneurial efforts of others. \textit{See infra} notes 30-32, 57-63 and accompanying text. There are two aspects to this prong. First, a partner who has the legal right to assert some voice in managerial matters but chooses not to cannot claim to have relied on the efforts of others to satisfy the test. \textit{See}, e.g., Elson v. Geiger, 506 F. Supp. 238, 243 (E.D. Mich. 1980). Second, the lead bank's administration of a fixed interest loan without involvement in the profits of the business' entrepreneurial effort will not satisfy the test either. \textit{See}, e.g., American Fletcher Mortgage Co. v. U.S. Steel Credit Corp., Inc., 635 F.2d 1247, 1254-55 (7th Cir. 1980), \textit{cert. denied}, 451 U.S. 911 (1981). This Court stated that the interest the participant earned, which was fixed at a certain rate above prime, "did not derive from the Mortgage Company's entrepreneurial services within the meaning of \textit{Forman} but from the underlying notes." \textit{Id.} at 1255.

11. \textit{See infra} text accompanying note 65.


13. \textit{See}, e.g., American Fletcher Mortgage Co. v. U.S. Steel Credit Corp., 635 F.2d 1247. (The court did not dispute the parties agreement that "a participation may be a security even though the underlying note is not." \textit{Id.} at 1253). \textit{See also} Commercial Discount Corp. v. Lincoln First Commercial Corp., 445 F. Supp. 1263 (S.D.N.Y. 1978). "It is quite logical, and is moreover well established, that a participation in a loan may be a security, even though the underlying loan is not." \textit{Id.} at 1267.

14. Lehigh Valley Trust Co. v. Central Nat'l Bank, 409 F.2d at 992.
\end{flushleft}
concentrated primarily on the characteristics of the loan, the lender and the borrower. Decisions of the last five years have almost uniformly determined that loan participation agreements not having a preponderance of the characteristics listed above are not securities.\textsuperscript{15} However, no court has unequivocally stated that a loan participation may never be a security. Indeed, certain recent holdings, while in the minority, raise the possibility that a federal securities law violation can be committed by a lead bank in connection with the participation of loans.\textsuperscript{16} Therefore, the gauging of legal duties in such agreements requires concentration not so much on rarefied securities law concepts as on the factual circumstances under which one bank agrees to participate in part of a loan to another. The resulting application of the above described risk factors is the litmus test for the existence of a security and hence the finding of a securities law violation.

II. IMPLICATIONS OF A FEDERAL SECURITIES LAW VIOLATION

The uncertain state of the economy, increasing bankruptcies, bad loans and resulting litigation about the status of loan participation as securities create grave practical consequences in the event of a determination that there has been a securities law violation. The potential for damages in the event of a violation is substantial.

The Supreme Court has established that the definition of a security for 1933 Act\textsuperscript{17} purposes is virtually identical to that for 1934 Act purposes.\textsuperscript{18} As a result, a loan participation transaction and the potential for subsequent securities litigation impacts duties and penalties under both acts. Registration requirements and anti-


\textsuperscript{17} Tcherepnin v. Knight, 389 U.S. at 335-36 ("The Securities Act of 1933 . . . contains a definition of security virtually identical to that contained in the 1934 Act") (footnote and citation omitted).

fraud rules under state and federal laws arise to create substantial differences in compliance and exposure once the definitional threshold is crossed and a loan participation is found to be a security.

Registration expense, increased offering memoranda obligations, the consequences of private actions under Rule 10b-5 and possibly section 17(a) of the 1933 Act and other disclosure requirements are expensive results that buyers of bank loans will have passed on to them unless the definition of "securities" is confined to true investments rather than typical commercial transactions.

Subjecting loan participations to the anti-fraud provisions of the 1934 Act and their primary progeny, Rule 10b-5, also carries grave consequences including stricter disclosure requirements for lead lenders. Further, characterizing loan participations as securities regulated by the 1934 Act and Rule 10b-5 may give dissatisfied participants access to the federal courts to air their grievances. These types of commercial grievances can and usually should be adequately adjudicated in state courts on common law doctrines of fraud, deceit, misrepresentation and breach of contract. The difficult standards of proof and reluctance of courts to impose liability for negligent nondisclosure or erroneous disclosure reflect the well-considered policy against allowing all but the most serious claims of omissions and misrepresentations to be challenged under the 1934 Act. This is supported by recent Supreme Court decisions denying implied rights of private action in numerous federal statutory provisions.

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23. Bellah v. First Nat'l Bank, 495 F.2d 1109, 1114 (5th Cir. 1974).
25. See, e.g., Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11 (1979) (no implied right of private action under § 206 of Investment Advisors Act of 1940); Touche Ross v. Redington, 442 U.S. 560 (1979) (no implied right of private action under § 17(a) of 1934 Securities Exchange Act); Chrysler Corp. v. Brown, 441 U.S. 281 (1979) (no implied right of private action under the Freedom of Information Act to enjoin agency disclosure). But see Cannon v. University of Chicago, 441 U.S. 677 (1979) (implied right of action under Title IX of Education Amendments Act of 1972). One commentator set forth an apt understanding of the Supreme Court's antipathy toward over-extension of the securities laws by stating: "There can be little doubt about the intensity of the Court's concern over the expansion of securities liability and its determination to curb [that expansion]." 1 A. BROMBERG & L.
Similarly, application of the antifraud provisions to an industry already governed by a substantial regulatory scheme would create an unnecessary overlap in federal review. The highly regulated banking industry already contains established statutory safeguards for both depositors and shareholders. To expose banks to another layer of SEC requirements with regard to an everyday commercial transaction would impose substantial expenses and increase the risks of breaches of confidentiality in the banking system.

III. WHAT CONSTITUTES A "SECURITY" IN THE CONTEXT OF A LOAN PARTICIPATION

Despite the recent decisions which suggest that typical loan participations are not securities, several basic issues remain unsettled. Even the proper definition of a "security" remains less than certain.

The definitional section of the 1934 Act states that:

When used in this title, unless the context otherwise requires . . . (10) [t]he term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security or in general, any instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificates for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill or exchange or banker's acceptance which has a maturity at the time of issuance of days of grade, or any renewal thereof the maturity of which is likewise limited.26

While this definition appears sufficiently broad to include loan participation agreements, a literal reading is not determinative if, as the statute notes, "the context otherwise requires."27 In fact, in determining the scope of the term "security," the Supreme Court has thoughtfully insisted that "application [of the securities law]
turns on the economic realities underlying the transaction.\(^\text{28}\) The Court has gone so far as to say that:

\[
\text{[C]ourts will construe the details of an act in conformity with its}
\text{dominating general purpose, will read the text in the light of con-}
\text{text and will interpret the text so far as the meaning of the words}
\text{fairly permits so as to carry out in particular cases the generally}
\text{expressed legislative policy.}\(^\text{29}\)
\]

Considering the "economic realities" involves measuring the loan participation by the four standards of the accepted current judicial outline of the elements of a security set forth in \textit{Securities and Exchange Commission v. W.J. Howey Co.}\(^\text{30}\) As modified by the \textit{United Housing, Inc. v. Forman} decision,\(^\text{31}\) the Howey test defines a security as (1) the presence of an investment (2) in a common venture (3) premised on a reasonable expectation of profits (4) to be derived from the entrepreneurial or managerial efforts of others.\(^\text{32}\)

Although simply stated, the Supreme Court has offered little guidance on how the modified \textit{Howey} test is to be applied. District and circuit courts have not always agreed in their application of it,\(^\text{33}\) especially in a commercial context where both parties have a

\begin{itemize}
\item \text{28. United Housing Foundation Inc. v. Forman, 421 U.S. at 848-51, reh'g denied, 423 U.S. 884 (1975); Tcherepnin v. Knight, 389 U.S. at 336 (1967); SEC v. W.J. Howey Co., 328 U.S. 293 (1946).}
\item \text{29. SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 350-51 (1943). See also Tcherepnin}
\item \text{v. Knight, 389 U.S. 332 (1967).}
\item \text{30. 328 U.S. 293 (1946) (hereinafter referred to in text as \textit{Howey}).}
\item \text{31. 421 U.S. 837.}
\item \text{32. \textit{Id.} at 852.}
\item \text{33. The Third, Fifth, Seventh and Tenth Circuits generally utilize an "investment-com-}
\text{mercial" test. The test centers around judicial concern that the securities laws regulate}
\text{investment transactions, but not commercial transactions. Consequently, the focus of the test}
\text{is whether a given transaction is commercial or investment in nature. See, e.g., McGovern}
\text{Plaza Joint Venture v. First of Denver Mortgage Investors, 562 F.2d 645, 647 (10th Cir.}
\text{1977); C.N.S. Enterprises, Inc. v. G. & G. Enterprises, Inc., 508 F.2d 1354, 1358-59 (7th}
\text{Cir.), cert. denied 423 U.S. 825 (1975); Lino v. City Investing Co., 487 F.2d 1358 (7th}
\text{Cir. 1973).}
\item \text{The Sixth and Ninth Circuits employ a risk capital analysis. This analysis is concerned}
\text{with whether the transaction involves "risk capital" and, to that end, considers six factors.}
\text{The six factors are time, collateralization, form of obligation, circumstances of issuance,}
\text{contemplated use of the funds, and the relationship between the amount borrowed and the size}
\text{of the borrower's business. See, e.g., Union Planters Nat'l Bank v. Commercial Credit Busi-}
\text{ness Loans, Inc., 651 F.2d at 1181-82 (6th Cir), cert. denied 102 S. Ct. 972 (1981); Amfac}
\text{Mortgage Corp. v. Arizona Mall of Tempe, Inc., 583 F.2d 426, 431-32 (9th Cir. 1978).}
\item \text{The Second Circuit uses a more literal approach. That approach is, at least, strongly}
\text{related to a list of exceptions to the general literal rule. The exceptions include: notes deliv-}
\end{itemize}
high level of business and economic sophistication. Twice in recent months the Supreme Court has denied certiorari in cases seeking a determination of whether loan participations are securities. In April, 1981 the Court refused such consideration in a loan participation case in which the Seventh Circuit used an “investment-commercial” analysis to find that a loan participation was not a security. The Court also denied certiorari in a case from the Sixth Circuit in which the appellant sought to apply a “risk capital” analysis to a commercial loan participation in an unsuccessful attempt to find the existence of a security. Based upon the Supreme Court’s reluctance to review this issue, an examination of lower court decisions remains the only way to uncover the development of any consistency in the applications of the Howey test in this area. There are dozens of such state and federal interpretations thus far, with the primary ones being reviewed herein.

IV. APPLICATION OF THE HOWEY TEST

A. Presence of an Investment

Although all four factors of the Howey test are generally considered together, a court’s finding of this first and most important factor, the presence of an investment, is often dispositive of the issue. Consideration of this Howey component, however, is the most difficult, for as one court expressed it:

[In one sense every lender of money is an investor since he places his money at risk in anticipation of a profit in the form of interest earned in consumer financing, notes secured by mortgages on homes, notes evidencing “character” loans to bank customers, short-term notes secured by liens on small businesses or their assets, and short-term notes secured by assignment of accounts receivable. See, e.g., Exchange National Bank of Chicago v. Touche Ross & Co., 544 F.2d at 1138.

One commentator recently reviewed the application of Howey in the context of the sale of a business and whether such a transaction fell within the ambit of the securities laws. He too found a wide divergence in the courts at the district and circuit levels. Seldin, When a Stock is Not a Security: The “Sale of Business Doctrine” Under The Federal Securities Laws, 37 BUS. LAW. 637 (1981).


35. See discussion of the “investment-commercial” analysis infra at note 33.

36. 635 F.2d at 1254.

37. 651 F.2d 1174. See supra note 33 for a review of the factors used by the Sixth Circuit in applying their risk capital analysis.

38. See chart on pp. 224-25 for an analysis of the leading cases and their distinguishing factors.

39. See supra text accompanying note 33.
est. Also in a broad sense every investor lends his money to a borrower who uses it for a price and is expected to return it one day.\textsuperscript{40}

Only an examination of the context in which the transaction took place aids a court in determining whether the bank was providing money for a low-risk commercial lending transaction or funding a higher-risk capital investment scheme. Attached hereto is a chart\textsuperscript{41} which uses the eight factors characterizing this context to evaluate the seminal 1969 Lehigh Valley case,\textsuperscript{42} and determine whether the loan participation in question was a "security." The eight analyzed factors are: (1) powers of the participant; (2) loan collateral; (3) loan duration; (4) type of return on the loan; (5) description of the participant; (6) characterization of the transaction by the parties; (7) intended use of the borrowed funds; and, (8) creditworthiness of the borrower.

A typical commercial loan involves well-collateralized notes from creditworthy borrowers for relatively nonspeculative purposes. Usually the loan participant has full access to borrower information and the right to monitor loan enforcement, regardless of whether the right is exercised or not. This creates a sophisticated commercial environment in which few cases have determined that a security is present.\textsuperscript{43} Of the twelve representative cases listed in the chart, only in two did the court find loan participations to be "securities;" in ten cases, the courts did not make such a finding.\textsuperscript{44} In the two cases in which the courts found securities to be present, participants were denied meaningful access to information because of geographic isolation\textsuperscript{45} and the significant managerial and administrative rights over loan collateral, terms of the loan and foreclosure resided only in the lead lender.\textsuperscript{46}

\textsuperscript{40} C.N.S. Enterprises, Inc. v. G. & G. Enterprises, Inc., 508 F.2d at 1359.
\textsuperscript{41} See chart at pp. 224-25, infra.
\textsuperscript{42} Lehigh Valley Trust Co. v. Central National Bank, 409 F.2d 989.
\textsuperscript{43} See Great Western Bank and Trust v. Kotz, 532 F.2d at 1260 (Wright, J. concurring) (Judge Wright's survey of the then-existing case law revealed only one instance, Young v. Seaboard Corp., 360 F. Supp. 490 (D. Utah 1973), where a federal court had ruled that a note given by a borrower to a bank in a commercial loan transaction was a security). Id. at 1260 n.1.
\textsuperscript{44} See chart at pp. 224-25, infra.
\textsuperscript{45} Lehigh Valley Trust Co. v. Central National Bank, 409 F.2d at 993.
\textsuperscript{46} Commercial Discount Corp. v. Lincoln First Commercial Corp., 445 F. Supp. at 1265, 1268.
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<th>TYPE OF RETURN</th>
<th>DESCRIPTION OF PARTICIPANT</th>
<th>LABEL FOR TRANSACTION USED BY PARTIES</th>
<th>INTENDED USE OF FUNDS</th>
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<td>American Fletcher Mortgage Co., Inc. v. U.S. Steel Credit Corp.</td>
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<tr>
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<td>Residential construction</td>
<td>Loan fully insured; construction fully insured</td>
<td></td>
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<tr>
<td>SAMUEL T. ISAAC &amp; ASSOCIATES</td>
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<tr>
<td>UNITED CALIFORNIA BANK</td>
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<td>6 months</td>
<td>Fixed**</td>
<td>Sophisticated: Bank</td>
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<td>Finance current operations</td>
<td>Perceived as a low-risk borrower, but was in dire financial straits</td>
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<td>V TH FINANCIAL CORPORATION</td>
<td>NO</td>
<td>Very limited access to information</td>
<td>Pro-rata interest in accounts receivable</td>
<td>5 years</td>
<td>Fixed**</td>
<td>Sophisticated: Bank</td>
<td>Loan</td>
<td>Finance current operations</td>
<td>Represented by lead as successful business, but was in dire financial straits</td>
</tr>
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<td>Not identified</td>
<td>Fixed**</td>
<td>Sophisticated: Bank</td>
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<td>Borrower refused by other banks in area</td>
</tr>
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<td>MANCHESTER BANK v. CONNECTICUT BANK AND TRUST CO.</td>
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<td>COMMERCIAL DISCOUNT CORP. v. LINCOLN FIRST COMMERCIAL CORP.</td>
<td>YES</td>
<td>Very limited conduct audits only</td>
<td>None</td>
<td>Revolving</td>
<td>Fixed**</td>
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<td>Not identified</td>
</tr>
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<td>YES</td>
<td>Very limited: no way to independently verify lead's representations</td>
<td>Shares of corporate stock of borrower</td>
<td>Not identified</td>
<td>Fixed**</td>
<td>Sophisticated: Bank</td>
<td>Loan</td>
<td>Not identified</td>
<td>Represented by lead as successful business, but was in dire financial straits</td>
</tr>
</tbody>
</table>


** "Fixed" refers to a rate pegged to and floating with a recognized prime rate index.
B. Common Venture

The second prong of the Howey test involves the presence of a common venture. The question of commonality remains unsettled and the courts are divided as to whether a horizontal or vertical relationship satisfies the common venture requirement of Howey. Courts which find that horizontal relationships are sufficient to create common ventures rely upon the fact that an individual investor has pooled the monies of several investors in one enterprise. Other courts find that vertical relationships are common ventures any time the profitability of one investor's funds are dependent upon the expertise of another, i.e., the promoter. Although both determinants of whether there is a common venture have merit, most courts have given little weight to this factor and determine on the security status of a loan participation without delving into a common venture analysis.50

C. A Reasonable Expectation of Profits

Typical judicial examination of the factor requiring a reasonable expectation of profits has centered on the form of profit being derived in the loan participation. While the fixed rates of return in a typical commercial loan are literally "profits," many courts have justifiably recognized that such a literal interpretation could render meaningless any distinction between commercial and investment transactions and require the application of the securities laws to any transaction which has the potential for any form of return.51

The more closely a loan participation resembles a low-risk, fixed-return commercial transaction, the more likely that it will not be found to be a security. Applying this standard, notes issued in a low-risk, fixed-return commercial transaction have generally been found to be outside the parameters of the securities laws.52 For ex-

47. See e.g., Curran v. Merrill Lynch, Pierce, Fenner and Smith, 622 F.2d 216 (6th Cir. 1980) (horizontal relationship sufficient). But see e.g., SEC v. Continental Commodities Corp., 497 F.2d 516 (5th Cir. 1974) (vertical relationship sufficient).
48. See e.g., Curran v. Merrill Lynch, Pierce, Fenner and Smith, 622 F.2d 216, 222.
49. See e.g., SEC v. Continental Commodities Corp., 497 F.2d at 522.
51. See e.g., Canadian Imperial Bank of Commerce Trust Co. v. Fingland, 615 F.2d 465, 470 (7th Cir. 1980); Great Western Bank and Trust v. Kotz, 532 F.2d at 1258-59; Bellah v. First Nat'l Bank, 495 F.2d at 1114.
52. See, cases cited supra note 13.
ample, in *Marine Bank v. Weaver*, the United States Supreme Court recently held that a six-year certificate of deposit issued by a federally regulated bank was not a security within the meaning of the 1934 Act. The Court gave two main reasons for its decision: first, certificates of deposit pay a fixed rate of interest which is in no way dependent on the profits of the issuer. Second, the 1934 Act is not necessary to protect bank depositors since they already are adequately protected by the Federal Deposit Insurance Corporation (FDIC) and other federal banking laws.

Before one relies entirely on the form of profit generated to determine if a security exists, it is important to note that the securities laws provide for the regulation of instruments that yield a fixed rate of return. The Supreme Court, however, has further defined profits under the *Howey* test, so that “[b]y profits, the Court has meant either capital appreciation resulting from the development of the initial investment . . . or a participation in earnings resulting from the use of investors’ funds.” Where banks advance funds in a typical commercial lending transaction and generate a predetermined rate of return subject not to the borrower’s rate of profit but to the prevailing prime rate of interest, the courts generally find that such a transaction does not evidence a security and is not subject to the regulation of the state or federal securities laws.

**D. Profits Derived from the Entrepreneurial Efforts of Others**

The final *Howey* test element requires that the profits obtained by a lender through the advance of funds be derived from the managerial or entrepreneurial efforts of others. Under this part of the *Howey* test, a loan participation is not a security so long as the participant has a meaningful and proportionate voice in the financial management and monitoring of the loan. Courts have also reached this conclusion when loan participants obtain certain loan monitoring rights inherent in a typical participation agreement. For example, the rights to demand foreclosure of the loan to

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55. United Housing Foundation, Inc. v. Forman, 421 U.S. at 852.

56. See cases cited supra note 15.

57. See e.g., Great Western Bank and Trust v. Kotz, 532 F.2d at 1259; Elson v. Geiger, 506 F. Supp. at 243.
prevent alterations in the collateral and to veto modification of the terms of the obligation have been held to be sufficient of a managerial rights that the loan participations in question were not securities.\textsuperscript{58} However, even when such oversight powers are not obtained by the participants and the lead lender exclusively manages the loan, several courts find that a retention of the routine duties of loan administration by the lead lender does not change this result.\textsuperscript{59} This theory considers the economic reality of loan participation notes and concludes that by the very nature of participations, maximum efficiency results from centering administrative duties in one bank.\textsuperscript{60}

Even in a case where the lead lender held sole responsibility for administering a $49 million construction loan, participated in by four other banks, the court noted that such centering of administrative responsibilities did not necessarily mean that the participants had the legal right to look to the administrative efforts of the lead lender for their interest income.\textsuperscript{61} The court recognized instead that the sophisticated participant bank investor looks to the entrepreneurial efforts of the borrower for its profit, not to the efforts of the lead lender to perform ministerial functions with respect to the loan.\textsuperscript{62} As such, the participants had no right to damages from the lead lender under the federal securities laws.\textsuperscript{63}

V. GUIDELINES FOR STRUCTURING LOAN PARTICIPATIONS THAT ARE NOT SECURITIES

Courts consistently try to exclude most commercial (as distinct from investment) transactions from the reach of the securities regulations. One reason for such judicial antipathy to commercially sophisticated plaintiffs in the area of federal securities laws is the realization that traditional commercial transactions involve fewer risks of loss than investment transactions and usually are adequately regulated by other state and federal laws. Few enterprises are more regulated than commercial lending in such areas as to

\textsuperscript{58} See e.g., American Fletcher Mortgage Co. v. U.S. Steel Credit Corp., 635 F.2d at 1254; Provident Nat'l Bank v. Frankford Trust Co., 468 F. Supp. at 455.


\textsuperscript{60} See cases cited supra note 15.


\textsuperscript{62} Id.

\textsuperscript{63} Id.
LOAN PARTICIPATIONS

whom loans can be made, loan amounts, loan ratios and collateral, especially after the federal laws enacted in 1978 concerning these matters. 64

Another traditional feature of a commercial transaction is the advance of money for a short period of time. The longer funds are held or used by another, the greater the risk of loss and the more likely it is that the transaction will be characterized as an investment under the Howey test. 65

Another commercial characteristic is the existence of substantial collateral for the advance of funds. While a secured lender may look to the collateral in the event of the borrower's inability to repay the loan, an unsecured investor is generally more dependent upon the ability and efforts of others to generate a profit. The profit in a loan participation emanates from the borrower, not the lead lender, as it is the borrower who will post the collateral and generate the funds to repay the debt and the profit on it. The lead lender in a participation is typically an administrator as well as a participant and has little or no effect on the profitability and repayment of the loan. If it oversees or exercises control over the borrower's everyday affairs, a different result will obtain. 66

To the extent that a participant's advance of funds is secured by collateral available to (and preferably assigned on a pro-rata basis to) the participant, the transaction is less likely to be a security. 67

The character of the collateral is especially important. The more valuable, reliable, liquid and accessible the collateral, the lower the risk that a court will find a Howey type investment. Collateral deemed adequate for this purpose in loan participation cases include: first mortgages shared pro-rata by the participant; 68 an attachable bank account with a required minimum balance; 69 a pro-

69. In Great Western Bank and Trust v. Kotz, 532 F.2d at 1258, the bank and the bor-
rata interest in the borrower's accounts receivable;"\textsuperscript{70} and labor, performance and material payment bonds coupled with a pro-rata interest in a first mortgage.\textsuperscript{71} There are certainly other factors to be considered and should a preponderance of other factors heretofore discussed be absent even pro-rata participation in these forms of collateral is not a certain safeguard against characterization of the participation as a security.

Another indicator of a commercial rather than an investment transaction is a fixed rate of return for the use of the funds. In this context "fixed" returns include rates related to recognized indices of the prime lending rate.\textsuperscript{72} In contrast, "equity kickers" and other participations in which lenders shared in borrower profits based upon the success of the borrower's venture more closely resemble investments typically treated as securities by the courts.\textsuperscript{73}

The intended use of the funds also bears on a commercial characterization of the transactions. Borrowing for a stable and identified purpose is considered synonymous with commercial loans\textsuperscript{74} and the less the risk involved in the intended use, the less the likelihood of treatment as an investment and therefore a security.

The duties of the participant and the diligent exercise of those duties may actually have the effect of reducing his opportunities for a remedy under the federal securities laws. When a loan participant exercises any type of duty under a participation, he may be deemed to have stopped relying on the managerial or entrepreneurial skills of the lead lender and as such may not meet the \textit{Howey} test.\textsuperscript{75} The greater the participant's access to information about the borrower and the more extensive the participant's control over loan collateral, loan terms and loan foreclosure, the less likely that the participation will be a security under the \textit{Howey} test. This assumes, however, that there exists a preponderance of the other factors which militate against finding the exis-

\textsuperscript{70} See, e.g., Union Planters Nat'l Bank v Commercial Credit Business Loans, Inc., 651 F.2d at 1182.

\textsuperscript{71} See, e.g., Provident Nat'l Bank v. Frankford Trust Co., 468 F. Supp. at 450, 455.


\textsuperscript{73} See supra note 6 for an explanation of "equity kickers."

\textsuperscript{74} See, e.g., American Fletcher Mortgage Co. v. U.S. Steel Credit Corp., 635 F.2d at 1254.

\textsuperscript{75} See supra notes 57-63 and accompanying text.
tence of a security.

If the participation is structured so that the participant bank has access to information about the borrower before advancing funds, the courts generally do not find a security present and in turn do not invoke the federal security laws to protect sophisticated lenders who did not choose to exercise their rights. However, geographic and informational isolation have been found to require special efforts by the lead bank to inform the participant about the borrower's financial status.

VI. Conclusion

If the loan being participated is of a speculative nature or if the banking entity acting as a participant lacks information and the ability to obtain such information or the right to provide input regarding the structuring of the loan, possible securities laws ramifications should be considered. This inherent risk factor with its potential for large amounts of exposure to the requirements of the 1934 Act creates a disturbance in normal commercial interbank dealings and is an expensive, usually unwarranted, intrusion into the commercial banking system. At least insofar as loan participations are concerned, the specter of the securities laws and the uncertainty surrounding them makes free enterprise less free and does so with little or no benefit to the investing public for whom the securities laws were intended. A bank's strong bargaining position usually will permit it to gain access to information necessary to make a judgment regarding a participation. If such information is unavailable, a bank typically will not enter into the transaction. Application of the securities laws in a failed loan participation context is typically inequitable and creates the potential of giving one sophisticated investor an unexpected and undeserved windfall at the expense of another in the event a loan in which they have agreed to share the risk goes into default. To that extent, the public that invested in the victim bank is done a totally unjustifiable disservice. As one court stated rather acerbically, "[t]he securities laws were not enacted to protect sophisticated businessmen from their own errors of judgment."

It is not in contravention to the public policy surrounding the securities laws to find that a loan participation is usually not a "se-

76. Hirsch v. du Pont, 553 F.2d at 762-63.
77. Lehigh Valley Trust Co. v. Central Nat'l Bank, 409 F.2d 989.
78. Hirsch v. du Pont, 553 F.2d at 763.
curity." It is, in fact, necessary to make such a finding, and in the best interest of the public to do so in the typical commercial loan context for three reasons. First, consider the consequences in the few cases where the lead lender maintains exclusive control over the information and decision-making regarding a speculative loan. In such circumstances, treatment of the participation interest as a security would generally be appropriate. But that case has the potential to be wrongly decided if in a few months or years there is a general swing back to the standards applied before the Lehigh Valley case when no loan participations were considered securities. Such a result is possible if unjustifiable dislocations of bank dealings are not confined to the cases where the securities laws have a place.

Second, the public interest is best served by even-handed and practical application of the securities laws only where they are needed so that their duties and penalties are not needlessly diluted or enforcement withheld.

Finally, there is, of course, a strong public interest in assuring that purchasers of investments receive full and fair disclosure of material facts. However, this laudible goal does not require banks to be forced to needlessly curtail the economically necessary, large financings of today's marketplace that, due to their size, occur only through loan participations. The minimal benefit from application of the securities laws is not worth the expense of extra documentation and delays resulting from the imposition of these additional securities laws requirements in the typical commercial loan participation. A conclusion that a loan participation is not a security requires an interpretation of the word "security" through two federal statutory schemes which are not always consistent with each other: the securities laws and the banking laws. In order to provide for a peaceful co-existence between these two frameworks in the area of loan participations, there must exist an opportunity for the banking industry to depend on and conform to not only the banking laws but a consistent interpretation of the securities laws through additional, more precise regulations.

It has been implied that the proposed Federal Securities Code (FSC) eliminates the treatment of substantially all loan participations as securities.79 One section of the FSC describes one of the

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79. Participaton interests offered by a lead bank under loan agreements entered into with borrowers in normal lending transactions are excluded securities if the note is issued under the loan agreement in a mercantile rather than an investment transaction and if the securities are not required to be offered pursuant to offering
exclusions to the definition of security by stating that the definition of "security" does not include . . . a note or evidence of indebtedness issued in a primarily mercantile or consumer, rather than investment, transaction. The FSC Standard, while potentially dispositive of the loan participation as a security issue, stands unenacted and there is no sign of such an enactment in the near future. As such, the SEC should enact a "safe harbor" rule which provides for the exclusion of loan participations as securities if certain safeguards are complied with. Under such a proposed rule, a loan participation or similar certificate of indebtedness which met the following standards would not be considered to fall within the ambit of federal securities laws if:

1. the participant has reasonable access to information about and input to enforcement of the participated loan against the borrower (whether participant exercises the rights or not);
2. the borrower is reasonably creditworthy by local credit standards; and
3. the participated loan is reasonably secured by local credit standards.

As with the currently existing "safe harbor" rules promulgated by the SEC, strict compliance with each section of the rule would be required to obtain the exemption. The establishment of such a rule would provide banks with the opportunity to avoid the uncertainty and risk involved with possible exposure to damages from a securities law violation. While a decision from the Supreme Court that loan participations which meet certain minimum criteria similar to those proposed above would help solidify the current trend of the law toward the determination that generally loan participations are not securities, the Supreme Court has recently been reluctant to grant certiorari in these types of cases. Therefore, the

statements . . . because offered otherwise than to institutional investors . . .

81. Such a rule could be similar in form and effect as that issued for private placements as in the recently enacted Regulation D and more specifically Rule 506, the progeny of Rule 146. 47 Fed. Reg. 11266 (1982) (to be codified at 17 C.F.R. § 230.506).
82. See 1 Fed. Sec. L. Rep. (CCH) ¶ 2850, at 2929-3 (1975) for a discussion of possible safe harbor provisions.
establishment of a "safe harbor" rule for loan participants would appear to resolve a large part of the existing controversy within this area of the law.