EQUITY PARTICIPATION BY THE INSTITUTIONAL LENDER: THE SECURITY STATUS ISSUE

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I. INTRODUCTION

This article will examine and analyze the various approaches utilized by courts in resolving the question of whether a particular type of note, the equity participation financing arrangement, should be considered as a security or as an investment. An important factor weighed by the courts which is peculiar to an equity participation financing arrangement is that the lender often shares in the profits of the venture in addition to or instead of receiving a fixed rate of interest.[1]

This article does not deal with the security status of note transactions in which the lender obtains true equity participation in the real estate venture as a joint venturer, partner, or similar investor. In such a financing arrangement, the loan made for the venture and the equity participation usually will be viewed as two separate and distinct transactions. Thus, the loan transaction will not be subject to the added factor examined in this article.

II. DEFINING THE PROBLEM

Over the last few years, changes in the economy have caused traditional long-term lenders to become increasingly disenchanted with long-term fixed rate mortgages.[2] As a result, many permanent lenders have

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1. *See* MADISON & DWYER, THE LAW OF REAL ESTATE FINANCING, ¶ 3.04[18] at 3-49 (1981). The separate transaction by which the lender obtains an equity participation interest as a joint venturer or partner is unlikely to come within federal securities jurisdiction because, as a partner, the lender will take active participation in the control and management of the venture. *See, e.g.*, Slevin v. Pedersen Assocs., Inc., 540 F. Supp. 437 (S.D.N.Y. 1982); Williamson v. Tucker, 645 F.2d 404 (5th Cir. 1981), *cert. denied*, 454 U.S. 987 (1981). Furthermore, it is doubtful that the institutional lender could overcome the difficult burden of proving a situation of forced reliance.

2. A recent Brookings Institute study of real value investment income earned by permanent lenders on fixed rate, long-term mortgages during the last thirty years, reflects that the average

begun to demand some type of equity participation or kicker.[3]

An *equity kicker* is a method by which the lender shares a percentage of the income derived from the real estate venture in addition to the fixed interest rate.[4] The equity participation can take one of two forms. The first is a true equity participation by the lender as a joint venturer, partner, or similar position as an investor. The second is a form of financing arrangement in which the lender receives a share of the earnings or income from the property.[5]

The employment of an equity participation arrangement in the note transaction poses several important problems.[6] One arises because the lender's equity participation is based, in part, upon representations and projections furnished by the borrower concerning the expected yield of the venture. A later inquiry may help to determine whether fraud was involved. Should litigation result from this inquiry, the lender may attempt to invoke the protections afforded by federal securities laws. The

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contract interest rate was 9.34 percent for loans from 1970 through 1975; however, after full repayment by 1979 (on the assumption that declining tax shelter benefits would prompt refinancing after 10 years), the average real interest earned was only 1.73 percent. Downs, *Real Interest Rates Short-Change Lenders*, NAT'L REAL EST. INV., 26, Oct. 1980. MADISON & DWYER, *supra* note 1, ¶ 3.04[18], at 3-49 (1981); *See also* Downs & Gilberto, *How Inflation Erodes the Income of Fixed-Rate Lenders*, 11 REAL EST. REV. 43 (1981).

3. The taking of an equity position in the real estate venture is based upon the lender's assumption that the property's net income will vary directly with the rate of inflation, thus keeping the lender's real yield approximately constant. In addition, lenders have protected themselves against the uncertainty of future price rises by offering loans with interest rates that vary in accordance with some indicator sensitive to inflation, as in variable rate mortgages. They have also protected themselves by developing loans that require the interest rates to be renegotiated at frequent enough intervals to quickly catch up with changing conditions, as in renegotiable rate or rollover mortgages. All of these forms of investment shift most of the risks of unanticipated inflation from lenders to borrowers. *See* Downs, *The Triple Revolution in Real Estate Financing*, 13 REAL EST. REV. 18, 19 (1983).

4. MADISON & DWYER, *supra* note 1, ¶ 3.04[18], at 3-16. *See also*, Wiggin, *How Equity Financing Works*, 11 REAL EST. REV. 2, 22 (1981).

5. In addition, some lenders are employing a device called the *convertible mortgage* whereby the lender obtains, in addition to a fixed rate of interest and perhaps additional interest in the form of an equity kicker, the additional right of converting the mortgage indebtedness into equity at some future date. MADISON & DWYER, *supra* note 1, ¶ 3.04[3] [c], at 3-20. *See also*, *Special Report: The Participating Convertible Loan*, MORTGAGE & REAL EST. EXECUTIVES REP. 1, 3 (Dec. 15, 1981).

6. Some courts have raised the question of whether the substance of a particular equity participation loan transaction reveals the intent to evade the usury laws. *See generally*, Annot., 16 A.L.R.3d 475 (1967). In general, compensation to the lender in the form of a share of income, earnings, or profits will be categorized as interest unless there is a substantial risk of nonpayment of capital or the full legal interest, a risk that a prudent person would not incur in order to merely receive the legal interest. *Id.* at 486-87. *See also*, MADISON & DWYER, *supra* note 1, ¶ 5.05[8], at 5-38. The judicial reasoning and specific formulations of the cases analyzing the usury problem in equity participation notes may be of some aid in determining the security status issue in the same context. *See infra* text accompanying notes 64-67.

lender's objective in pursuing this tactic would be to obtain relief under the antifraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934.[7] By focusing the inquiry on whether fraud (as defined in the federal securities laws) has occurred, the parties seeking a remedy under these acts can avail themselves of the federal antifraud provisions.[8]

A variety of fact patterns involving note transactions have been presented to the courts. Invariably, the plaintiff in these cases attempted to invoke the remedies of the securities acts. The results reached by these courts have been relatively consistent.[9] Generally, a note given by a bank or other institutional lender is held not to be a security within the meaning of the federal securities laws.[10] Thus, in a typical lending transaction, notes do not have security status and are not governed by federal securities laws. The appellate courts, however, have not been presented with the security status issue in an equity participation note transaction in which the institutional lender receives a share of income from the venture in addition to or in lieu of a fixed rate of interest.

III. AN EXERCISE IN STATUTORY CONSTRUCTION

The issue of whether equity participation notes are securities is not easily resolved. Various approaches have been taken by the courts in construing the meaning and scope of the word "security" under the 1933 and 1934 Acts.

The 1933 Act provides that, unless the context otherwise requires, "[t]he term 'security' means any note. . . ."[11] The Act further provides

7. Securities Act of 1933, §§ 12(2)-19(a); 15 U.S.C. §§ 77(a)-(b)(b)(b) (1982); Securities Exchange Act of 1934, § 2; 15 U.S.C. § 78(b) (1981); 17 C.F.R. § 240-10b-5c (1983).

8. The federal antifraud provisions provide definite advantages over state remedies. It is generally easier to recover for securities fraud under the remedial provisions in the federal securities law arsenal as compared with remedies provided by state commercial law, contract law, blue sky law, corporation law or common law fraud actions. *See* 1 A. BROMBERG, SECURITIES FRAUD & COMMODITIES FRAUD, §§ 2.7(1)-(2) (1983). *See also*, Sonnenschein, *Federal Securities Law Coverage of Note Transactions: The Antifraud Provisions*, 35 BUS. LAW. 1567, 1567-68 (1980).

In addition, the federal antifraud provisions allow the payee to seek solvent defendants from among other parties to the transaction such as the borrower's accountants. *See* Chemical Bank v. Arthur Andersen & Co., 552 F. Supp. 439 (S.D.N.Y. 1983).

9. *See generally*, Annot., 39 A.L.R. FED. 357 (1978); Lipton & Katz, *"Notes" Are (Are Not?) Always Securities — A Review*, 29 BUS. LAW. 861 (1974); Lipton & Katz, *"Notes" Are Not Always Securities*, 30 BUS. LAW. 763 (1975); Comment, *Notes as Securities Under the Securities Act of 1933 and the Securities Exchange Act of 1934*, 36 MD. L. REV. 233 (1976); Comment, *Commercial Notes and Definition of 'Security' Under the Securities Exchange Act of 1934: A Note Is a Note Is a Note?*, 52 NEB. L. REV. 478 (1973); Sonnenschein, *supra* note 8.

10. Sonnenschein, *supra* note 8, at 1579-82.

11. Securities Act of 1933 § 2(1), 15 U.S.C. § 77b(1) (1981).

that "[a]ny note . . . which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, and which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof," is exempt from the 1933 Act's registration requirements.[12] This exemption, however, does not apply to the Act's antifraud provisions.[13] The 1934 Act provides that unless the context otherwise requires, "[t]he term security means any note . . . but shall not include currency or any note . . . which has a maturity at the time of issuance of not exceeding nine months."[14] Hence, read literally, the statutes provide that all notes are securities for the purposes of § 17(a), which is the antifraud provision of the 1933 Act. Additionally, all notes with maturity of greater than nine months are securities for the purposes of § 10(b), the antifraud provision of the 1934 Act,[15] "unless the context otherwise requires."[16]

Notwithstanding this plain statutory language and its literal application to any note, the courts have consistently held that not every note is a security.[17] The rationale behind these decisions, however, has been anything but consistent. The courts differ as to the degree of recourse in the statutory language and as to when it is appropriate to analyze the economic realities of a given transaction. These differences, examined below, are reflected in three approaches used by courts in determining

12. Securities Act of 1933 § 3(a)(3), 15 U.S.C. § 77c(a)(3) (1976). In Release No. 33-4412, the SEC outlined the criteria which short-term notes must meet in order to be eligible for the registration exemption of § 3(a)(3) of the 1933 Act. The notes must be: (1) prime quality negotiable commercial paper (2) of a type not ordinarily purchased by the general public, that is (3) paper issued to facilitate well-recognized types of current operational business requirements and (4) of a type eligible for discounting by Federal Reserve banks. Securities and Exchange Commission Release No. 33-4412, 26 Fed. Reg. 9158-9159 (1961). This release has been given some weight by the courts in determining security status of notes (as factors that underscore the commercial-investment dichotomy of notes). *See, e.g.*, SEC v. Continental Commodities Corp., 497 F.2d 516, 525 (5th Cir. 1974); Zeller v. Bogue Elec. Mfg. Corp., 476 F.2d 795 (2d Cir. 1973).

13. Exchange Nat'l Bank of Chicago v. Touche Ross & Co., 544 F.2d 1126, 1132 (2d Cir. 1976).

14. Securities Exchange Act of 1934 § 3(a)(10), 15 U.S.C. § 78c(a)(10) (1982). This calculation is made "exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited." *Id.*

15. *See Chemical Bank*, 552 F. Supp. at 445.

16. The definitional sections of both Acts are introduced by the language "[w]hen used in this [sub]chapter, unless the context otherwise requires . . . ." Securities Exchange Act of 1934 § 3(a)(10), 15 U.S.C. § 78c(a) (1982); Securities Act of 1933 § 3(a)(3), 15 U.S.C. § 77b (1981).

17. *See, e.g., Exchange Nat'l Bank*, 544 F.2d at 1132; Great W. Bank & Trust v. Kotz, 532 F.2d 1252 (9th Cir. 1976); C.N.S. Enter. v. G. & G. Enter., 508 F.2d 1354 (7th Cir. 1975), *cert. denied*, 423 U.S. 825 (1975); McClure v. First Nat'l Bank of Lubbock, 497 F.2d 490 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975).

security status: the *anti-literalist*, the *economic reality*, and the *literalist*.[18]

IV. THE JUDICIAL APPROACHES

A. The Anti-Literalist and Economic Reality Approaches

One approach taken by the federal courts to determine security status of the instrument when analyzing note transactions is to reject any literal interpretation of the definitional sections of the Acts. Courts instead examine the economic realities of the transaction.[19] Under this functional approach, courts simply look to certain judicially established criteria which define a security without attempting to fit the particular instrument or transaction into one of the statute's classifications. This anti-literalist approach has had the effect, in some cases, of yielding results which conflict with the language of the Acts.[20] This functional approach to defining the scope and meaning of the term "security" is based upon the United States Supreme Court's consistent decisions holding that, in determining whether an instrument is a security, the "emphasis should be on economic reality rather than on the form of the transaction and the letter of the statute."[21]

The anti-literalist approach places secondary importance on the literal wording of the statute. Several different tests have been formulated by the courts under this anti-literalist approach in an attempt to establish criteria that will distinguish securities from nonsecurities. While the particular form of these tests varies from circuit to circuit, the majority of circuits employ the same fundamental approach by setting forth a presumption against the note as a security and deeming it to be a security only when the transaction sufficiently displays the attributes of an investment contract.

18. Sonnenschein, *supra* note 8, at 1568, 1571-78. Under the anti-literalist approach, the courts totally reject any literal interpretation of the definitional sections of the Acts and find it appropriate to examine the economic realities of the transaction to determine what is a security. On the other hand, the literalist approach utilizes total recourse to the statutory language and resorts to the economic realities to find what is not a security.

19. American Fletcher Mortgage Co. v. U.S. Steel Credit Corp., 635 F.2d 1247, 1253 (7th Cir. 1980), *cert. denied*, 451 U.S. 911 (1981).

20. *Id.* at 1253-54. The court stated that a loan participation is not a security unless the participation is an investment in a common venture entered into for profits, such profits coming from the work of others. The court found that the listing of loan participations as securities in the Act was intended by Congress to be literally construed: the list included in the Act is merely a list of potential securities; Wolf v. Banco Nacional de Mexico, 549 F. Supp. 841, 843-44 (N.D. Cal. 1982) (the court stated that the Act is not to be read literally).

21. United Hous. Found., Inc. v. Forman, 421 U.S. 837, 851-52 (1975) (citing Tcherepnin v. Knight, 389 U.S. 332, 336 (1964)).

1. The Howey Test—An Investment Contract Analysis

Some courts utilizing the anti-literalist approach have contrasted a particular note transaction with the requirements set forth by the Supreme Court in *SEC v. W.J. Howey*.[22] In *Howey*, investors purchased plots in an orange grove and leased the land back to the seller under a service contract in which the seller agreed to cultivate the crops, market the crops, and remit the net proceeds to the investor. The Court labeled the arrangement an investment contract, which it defined as an "investment of money in a common enterprise with profits to come solely from the efforts of others."[23] The Court described this as a flexible definition designed to "meet the countless and variable schemes devised by those who seek the use of money of others on the promise of profits."[24]

The reliance by these courts upon the *Howey* investment contract test in analyzing note transactions for security status was further encouraged by the Supreme Court in *United Housing Foundation, Inc. v. Forman*.[25] In *Forman*, the Court stated:

> [The *Howey* test] embodies the essential attributes that run through all the Court's decisions defining a security. The touchstone is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.[26]

The application of the *Howey* investment contract criteria to debt instruments, as compared with investment contracts, produces particular difficulties. Specifically, these difficulties arise in relation to the criteria of *common enterprise, expectation of profits*, and *reliance on the managerial skills of others.*

For example, it is not clear whether the usual one-on-one transactional relationship between the lender-payee and the borrower-maker in the note transaction satisfies the common enterprise language of *Howey*. In fact, there has even been considerable debate among the circuits as to whether a horizontal or vertical commonality is required to satisfy the

22. 328 U.S. 293 (1946). *See* United Am. Bank v. Gunter, 620 F.2d 1108 (5th Cir. 1980); Canadian Imperial Bank of Commerce Trust Co. v. Fingland, 615 F.2d 465 (7th Cir. 1980); National Bank of Commerce v. All Am. Assurance Co., 583 F.2d 1295 (5th Cir. 1978); Burrus, Cootes & Burrus v. MacKethan, 537 F.2d 1262 (4th Cir. 1976), *cert. denied*, 434 U.S. 826 (1977).

23. *Howey*, 328 U.S. at 301.

24. *Id.* at 299.

25. 421 U.S. 837 (1975).

26. *Forman*, 421 U.S. at 852. Until *Forman*, the Supreme Court previously had before it only cases involving purported investment contracts. It was not until Marine Bank v. Weaver, 455 U.S. 551 (1982), that the Court was confronted with a debt instrument that was plainly not an investment contract. One court has found significant the fact that in deciding *Weaver*, the Court did not rely on the *Howey* test. *See Wolf*, 549 F. Supp. at 846.

common enterprise requirement.[27] The horizontal commonality approach ties the fortunes of each investor, in a pool of investors, to the success of the overall venture and requires multiple investors and a pooling or sharing of funds.[28] On the other hand, the vertical commonality approach requires only that the investor and the party seeking the investment be involved in some common venture. The vertical commonality approach does not require that other investors be involved in the venture. As the Fifth Circuit explained, a one-on-one relationship is sufficient as long as the "fortunes of the investor are interwoven with and dependent upon the effort and success of those seeking the investment."[29] Hence, whether the particular note transaction satisfies the common enterprise element of *Howey* may depend upon whether the note transaction is analyzed under a vertical or horizontal commonality approach.[30]

In addition, courts have continually struggled with the problem of adequately defining the expectation of profit requirement in the context of note transactions.[31] In a sense, every lender is an investor because he places his money at risk in anticipation of profit in the form of interest. The difficulty in applying the *Howey* test to conventional loans arises because the investor-payee is "attracted solely by the prospects of a return on his investment."[32] Since that type of investment lacks the "touchstone . . . [of] the presence of an investment in a common venture premised on a reasonable expectation of profit," the common enterprise element is lacking.[33] Additionally, the return on most conventional loans is set by a fixed rate of interest and is earned regardless of the profitability of the enterprise. Because the lender's profit margin is independent of the profits of the enterprise, the transaction does not involve an investment of money with the expectation of profits dependent upon the efforts of another. This is because the profits are earned from

27. *See, e.g.*, Merrill Lynch, Pierce, Fenner & Smith, Inc., v. Curran, 456 U.S. 353 (1982); Brodt v. Bache & Co., 595 F.2d 459 (9th Cir. 1978); SEC v. Koscot Interplanetary, Inc., 497 F.2d 473 (5th Cir. 1974); Miller v. Central Chinchilla Group, 494 F.2d 414 (8th Cir. 1974); Milnarik v. M-S Commodities, Inc., 457 F.2d 274 (7th Cir. 1972), *cert. denied*, 409 U.S. 887 (1972).

28. Hirk v. Agri-Research Council, Inc., 561 F.2d 96 (7th Cir. 1977).

29. *Continental Commodities Corp.*, 497 F.2d at 522 (quoting SEC v. Glen W. Turner Enter., Inc., 474 F.2d 476, 482 n.7 (9th Cir. 1973), *cert. denied*, 414 U.S. 821 (1973)).

30. However, situations involving numerous payees, bank loan syndications, or participations "have increasingly been held to be outside the coverage of the antifraud provisions" of the federal securities laws. Sonnenschein, *supra* note 8, at 1591. The loan participation, however, may be a security under the *Howey* test even though the underlying note is not. *American Fletcher Mortgage Co.*, 635 F.2d at 1253.

31. *See, e.g.*, Meason v. Bank of Miami, 652 F.2d 542 (5th Cir. 1981), *cert. denied*, 455 U.S. 939 (1982); *Wolf*, 549 F. Supp. at 846-47.

32. *Wolf*, 549 F. Supp. at 846 (quoting *Forman*, 421 U.S. at 852).

33. *Id.* (quoting *Forman*, 421 U.S. at 852).

the lender's money, and there is no return generated "above or of a different nature than that found in a [typical] commercial lending transaction."[34] Thus, the elements of the *Howey* test are absent from the conventional loan transaction. In contrast to these traditional loan transactions, a portion of the return obtained through equity participation notes will not be fixed, but will be dependent upon the earnings of the venture and the management efforts of the borrower. It has yet to be determined what mix of fixed and nonfixed return will satisfy the expectation of profit requirement of *Howey*.

Another area of difficulty in the context of equity participation note transactions is determining the existence of "reliance on the efforts of others" by the investor. The key element in determining whether an investment is a security under the *Howey* test is whether there is, in fact, investor dependence on the entrepreneurial and managerial skills of another for the success of the venture.[35] If the investor obtains managerial control over the investment and, thus, the corresponding right to inspect the business records, the requisite investor dependence on others is lacking and the transaction does not involve a security because the investor has the ability to inform himself as to the condition of the venture and to promote its success.[36]

In the equity participation note transaction, the superior bargaining position of the institutional lender allows it to negotiate the terms of the note. As a result, the institutional lender will probably obtain a covenant to permit it to inspect the income producing property and its business records at such times as it may request, and will likely dictate the terms of any leasing of the property. If the lender should subsequently discover a change in the financial condition of the venture, it usually will be able to negotiate new terms and restrictions and obtain at least some control over the venture. Hence, the superior bargaining position of the lender, coupled with its degree of involvement in the venture, presents a novel question as to whether an equity participation financing arrangement falls within the coverage of the federal securities law, as analyzed under the *Howey* test.[37]

34. *United Am. Bank*, 620 F.2d at 1117 (quoting *National Bank of Commerce*, 583 F.2d at 1301). The concept of a fixed return in deciding whether a particular note transaction is covered by the definition of a security has not restricted some courts. *See, e.g.*, El Khadem v. Equity Sec. Corp., 494 F.2d 1224, 1229 (9th Cir. 1974), *cert. denied*, 419 U.S. 900 (1974), *see infra* note 44 and accompanying text (applying the *risk capital* analysis).

35. *See Forman*, 421 U.S. at 852. *See also* Aldrich v. McCulloch Properties, Inc., 627 F.2d 1036 (10th Cir. 1980).

36. *See, e.g.*, Gordon v. Terry, 684 F.2d 736 (11th Cir. 1982), *cert. denied*, 103 S. Ct. 1188 (1983); *Williamson*, 645 F.2d at 404.

37. Considerable case law has been devoted to interpreting the work "solely" under the

2. *The Commercial-Investment Test—Creating a Dichotomy*

In response to the general shortcomings of the *Howey* investment contract analysis, as applied to most note transactions, several circuits have developed the *commercial-investment dichotomy test*.[38] This test is premised on the view that the securities laws evidence the concern of Congress regarding the practices associated with investment transactions, and that the securities laws were not designed "to regulate commercial transactions that have no impact on the securities markets."[39] Utilizing this dichotomy approach, courts have held that regardless of maturity, a note is a security only if it evidences an investment transaction. If the note merely reflects a commercial loan transaction, the provisions of the securities laws do not apply.[40]

Difficulties arise, however, in attempting to establish a precise line of

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Howey test and to unraveling the extent of investor participation which will prevent an investment contract from qualifying as a security. *See, e.g.*, Villeneuve v. Advanced Business Concepts Corp., 698 F.2d 1121 (11th Cir. 1983); *Glenn W. Turner Enter. Inc.*, 474 F.2d 476.

The factor of the superior bargaining position of the institutional lender is also considered by some courts to undermine securities law coverage of note transactions under the commercial-investment dichotomy test. *See infra* text accompanying note 51.

38. *See National Bank of Commerce*, 583 F.2d at 1301; *Great W. Bank*, 532 F.2d at 1256-57. *See also* Sonnenschein, *supra* note 8, at 1588.

39. *American Fletcher Mortgage Co.*, 635 F.2d at 1254. The premise that the securities laws were intended to protect investors but were not meant to impose burdensome obligations on those engaged in ordinary commercial or consumer transactions is based on the language of the United State Supreme Court decisions and on the legislative histories of the 1933 and 1934 Acts. *See, e.g., Great W. Bank*, 532 F.2d at 1256; *C.N.S. Enter.*, 508 F.2d at 1359. For example, a Senate Report on the Bill which, with changes, was to become the 1933 Act stated:

> The aim is to prevent further exploitation of the public by the sale of unsound, fraudulent and worthless securities through misrepresentation; to place adequate and true information before the investor; to protect honest enterprises, seeking capital by honest presentation, against the competition afforded by dishonest securities offered to the public through crooked promotions; to restore the confidence of the prospective investor and his ability to select sound securities; to bring into productive channels of the industry and development capital which is grown timid to the point of hoarding; and to aid in providing employment and restoring buying and consuming power.

S. REP. NO. 47, 73d Cong., 1st Sess., to accompany S. 875, April 27, 1933. *See also* H.R. REP. NO. 85, 73d Cong., 1st Sess., to accompany H.R. 5480, May 4, 1933; 77 CONG. REC. 2983 (1933).

40. *See, e.g., American Fletcher Mortgage Co.*, 635 F.2d at 1254; *National Bank of Commerce*, 583 F.2d at 1298; *Great W. Bank*, 532 F.2d at 1256-57; *C.N.S. Enter.*, 508 F.2d at 1359; *McClure*, 497 F.2d at 493-95.

Possible bases for the application of the commercial-investment dichotomy include: (1) the purpose of the Act to protect investors; (2) the "unless the context otherwise requires" language; (3) the practical considerations of subjecting commercial notes to the registration requirements of the federal acts; (4) the fear of the resulting litigation flooding the federal courts if commercial notes were included; and, (5) the intent that commercial loan transactions should find recourse in state rather than federal courts. *See* Bellah v. First Nat'l Bank of Hereford, 495 F.2d 1109 (5th Cir. 1974); Zabriskie v. Lewis, 507 F.2d 546, 551 (10th Cir. 1974).

demarcation between investment and commercial transactions.[41] While the extremes of each have been conceptually identified,[42] the delineation between the two is not always clear.[43] As the Seventh Circuit has noted:

> 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. 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.[44]

In the absence of further congressional indication of intent, the gray area in between must thus be subjected to a case-by-case treatment.

a. *Framing the Commercial-Investment Dichotomy*

Different factors have been articulated by the courts in their attempts to distinguish commercial transactions from investment transactions.[45] Courts generally consider nine factors when making this distinction.

(1) *The length of time in which the note proceeds are held.* It is generally recognized that the longer funds are held, the greater the risk of loss. As the risk of loss increases, the courts become more inclined to

41. *See, e.g., Exchange Nat'l Bank*, 544 F.2d at 1132; *Great W. Bank*, 532 F.2d 1252; *C.N.S. Enter.*, 508 F.2d 1354; *Wolf*, 549 F. Supp. 841. *See also* Sonnenschein, *supra* note 8, at 1589.

42. Common stock is plainly a security, whereas consumer loans and short-term commercial paper are not. *See C.N.S. Enter.*, 508 F.2d at 1359; *Wolf*, 549 F. Supp. at 848.

43. *See, e.g., Great W. Bank*, 532 F.2d at 1258; *C.N.S. Enter.*, 508 F.2d at 1359, 1362 n.14; Robbins v. First Am. Bank, 514 F. Supp. 1183 (N.D. Ill. 1981).

44. *C.N.S. Enter.*, 508 F.2d at 1359.

45. The Ninth Circuit, for example, has approached the framing of the commercial-investment dichotomy by focusing on the risk elements of the transaction, analyzing the nature and degree of risk accompanying the transaction to the party providing the funds: the greater the risk, the stronger the indication of an investment transaction. *See Great W. Bank*, 532 F.2d at 1256; *El Khardem*, 494 F.2d at 1229. The inquiry under this approach is whether the funding party invested risk capital subject to the entrepreneurial and managerial efforts of the borrower, thus transmuting the *Howey* expectation of profit test into a risk capital test, and focusing the inquiry retrospectively on what the investor stands to lose rather than prospectively on what he expects to gain. *Id.* at 1229; Amfac Mortgage Corp. v. Arizona Mall of Tempe, Inc., 583 F.2d 426, 431-32 (9th Cir. 1978). *See also Forman*, 421 U.S. at 857 n.24 (The Supreme Court reserved judgment on the appropriateness of the risk capital approach to dispose of the particular case before it because governmental regulations made the subject transaction virtually risk-free to the investor).

The Third and Tenth Circuits have not fully articulated specific criteria in an attempt to frame the dichotomy. *See* McGovern Plaza Joint Venture v. First of Denver Mortgage Investors, 562 F.2d 645 (10th Cir. 1977); Lino v. City Investing Co., 487 F.2d 689 (3d Cir. 1973). *See also* Sonnenschein, *supra* note 8, at 1589 n.95.

The Fifth and Seventh Circuits find an analysis of the purpose or motive of the transaction helpful in drawing the commercial-investment line. *See, e.g., Bellah*, 495 F.2d 1109; *McClure*, 497 F.2d at 493-94; Lincoln Nat'l Bank v. Herber, 604 F.2d 1038, 1042 (7th Cir. 1979); *C.N.S. Enter.*, 508 F.2d 1354.

classify the transaction as an investment.[46]

(2) *The existence and extent of collateralization.* There is typically an inverse relationship between the amount of collateral securing the loan and the lender's dependence upon the entrepreneurial or managerial efforts of the borrower for the repayment of the loan. A greater risk is created by unsecured loans than by secured loans. If the lender holds no security, then repayment of the loan is more dependent upon the entrepreneurial or managerial efforts of the borrower. If the loan is secured, then the lender is not as dependent upon the borrower's efforts since he can always look to the collateral in the event of nonpayment.[47]

(3) *The form of the obligation and how the transaction is characterized by the parties.* Where the parties are referred to in the documents as borrower and lender, or indicate that the parties were dealing with securities or that they believed that the securities laws would govern the transaction, there may be some indicia of an *investment* transaction.[48]

The United States Supreme Court in *Forman*[49] held that the name given to an instrument is not dispositive as to whether it is a security. However, the Court went on to say that the name of the instrument may be a factor in deciding whether the instrument is a security. The Court stated that the name given to the instrument may be important since the "purchaser . . . may justifiably assume that the federal securities laws apply" if the instrument is characterized by a name traditionally thought to fall under the protection of the federal securities laws.[50]

(4) *Whether the obligations were issued to a single party or to a large class of investors.*[51]

(5) *The relative bargaining power of the parties.* This factor was

46. *See, e.g., Amfac Mortgage Corp.*, 583 F.2d at 432; *Great W. Bank*, 532 F.2d at 1257, ("The most important factor is *time*."). Demand or short-term notes are almost always held not to be a security unless payment is dependent upon the success of a risky enterprise, or the parties contemplate the successes of a risky enterprise, or the parties contemplate an indefinite extension of the note. *Id.* at 1257-58. It is largely left to the courts, however, to determine how short is too short a maturity. *See Wolf*, 549 F. Supp. at 849.

With the average commercial loan for apartments, shopping centers, and office buildings lasting from 23 to 28 years, and for hotels and motels lasting 15 years, most equity participation notes will have a long-term maturity. *See* MADISON & DWYER, *supra* note 1, ¶ 3.04 at 3-21. The long-term note status, however, may be affected by a call provision presently being utilized by some life insurance companies. *Id.; Great W. Bank*, 532 F.2d at 1258.

47. *See, e.g., Amfac Mortgage Corp.*, 583 F.2d at 433; *Great W. Bank*, 532 F.2d at 1258; *El Khadem*, 494 F.2d at 1228.

48. *See, e.g., Amfac Mortgage Corp.*, 583 F.2d at 432-33; *Great W. Bank*, 532 F.2d at 1258.

49. *Forman*, 421 U.S. at 850.

50. *Id.*

51. *See, e.g., Great W. Bank*, 532 F.2d at 1258; *McClure*, 497 F.2d at 493. *See generally* Fitzgibbon, *What Is A Security? - A Redefinition Based on Eligibility To Participate In the Financial Markets*, 64 MINN. L. REV. 893 (1980). This element of pooling-of-investors has

raised by Judge Wright in his concurring opinion in *Great Western Bank & Trust v. Kotz.*[52] For example, where an institutional lender is involved and the lender is advocating that federal security laws govern the transaction, coverage under the securities laws has generally been denied. The superior bargaining position of the lender, its ability to compel wide-ranging disclosures and verification of information, as well as its ability to obtain control over the borrower's business, have all been factors in these decisions.[53]

The counterargument is that "while banks are in a favorable position to obtain disclosure, the target of § 10(b) of the 1934 Act and § 17(a) of the 1933 Act is fraud, which a bank's ability to obtain disclosure cannot always prevent."[54] The factor of the lender's ongoing control over the borrower's business obtained as a result of his superior bargaining position may alone, however, undermine the existence of a security in the equity participation note context.

(6) *Whether the provider of the funds is in the business of lending funds in such transactions.*[55]

(7) *The contemplated use of the note proceeds.* The use of proceeds for capital expenditures might be viewed as evidence of an investment transaction. On the other hand, if the proceeds are used for working capital, for current operations, or for discharging or refinancing an existing debt, less risk is involved. Such funds generate a faster return than do funds used for capital expenditures,[56] and the project may be classified as a commercial transaction.

(8) *The relationship between the amount borrowed and the size of the borrower's business.* The greater the amount borrowed in proportion to the borrower's net worth, the less cushion there is to protect the lender

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been the subject of much debate among the circuits. *See supra* notes 26-30 and accompanying text.

In addition, this class-of-investors criteria has been articulated by the SEC in its Release No. 4412, detailing the position of the Commission on exemption from registration under the 1934 Act, but relied upon by some courts in approaching the commercial-investment dichotomy. *See supra* note 12; *National Bank of Commerce*, 583 F.2d at 1302.

52. *Great W. Bank*, 532 F.2d at 1262 (Wright, J. concurring).

53. *Id. See also* Sonnenschein, *supra* note 8, at 1599.

54. *Exchange Nat'l Bank*, 544 F.2d at 1137.

55. *See, e.g., Great W. Bank*, 532 F.2d at 1260-62; *McClure*, 497 F.2d at 495 ("A commercial bank's business is lending money not trading in securities."); *Wolf*, 549 F. Supp. at 850-51. The justification given for this factor is that Congress, in enacting certain banking regulations, explicitly distinguished the investment from the lending activities of national banks, 12 U.S.C. §§ 24, 301, and state banks which are members of the Federal Reserve, 12 U.S.C. § 335. *Great W. Bank*, 532 F.2d at 1261.

56. *See, e.g., Great W. Bank*, 532 F.2d at 1258; *McClure*, 497 F.2d at 494; *Continental Commodities Corp.*, 497 F.2d at 525-27.

from default in the event of business failure. Therefore, there is greater risk to the lender. As the risk to the lender increases, the indications of an investment contract grow stronger.[57]

(9) *The purpose or motive of the transaction.*[58] An *investment motive* is related to the hope of realizing return "commensurate with the success" of the business enterprise.[59] The United States Supreme Court gave this factor controlling weight in *Forman*[60] where it held that the shares were not securities because the tenants bought the shares in order to acquire housing, and not in order to participate in the profits of the cooperative.

Only those note transactions which display these judicially formulated attributes are classified as securities under the federal securities laws.[61] These factors, however, are not exclusive, nor is any one dispositive. The courts, recognizing the need for flexibility due to the infinite variability of note transactions, have rejected any attempt to define the elements of an investment which might be applied from case to case.[62]

b. *Broadening the Risk Analysis*

Although the above mentioned factors will offer some guidance in deciding whether a given equity participation note is a security, consideration should also be given to risk elements which are peculiar to an equity participation note and which may support a finding of an investment transaction. In both the equity participation transaction and the ordinary fixed note financing arrangement, the lender assumes the risk of nonrepayment of principal. However, in the ordinary financing arrangement, the lender's profit expectation is not subjected to a significant risk since a guaranteed rate of return has been agreed upon regardless of the venture's profitability. In contrast, the equity participation lender exposes itself to the risk of not realizing its share of profits, which are based on the performance of the venture. Thus, the equity participation lender faces the risk of losing its profit from the equity kicker, depending upon the borrower's skill and efforts in managing the venture. Hence, in attempting to apply a risk analysis approach to frame the commercial-

57. *See, e.g.*, *Great W. Bank*, 532 F.2d at 1258; *C.N.S. Enter.*, 508 F.2d at 1361.

58. *See, e.g.*, *Lincoln Nat'l Bank*, 604 F.2d at 1038, 1042-43; *C.N.S. Enter.*, 508 F.2d at 1361; *McClure*, 497 F.2d at 493-94.

59. *See* Sonnenschein, *supra* note 8, at 1590.

60. *Forman*, 421 U.S. 837.

61. *See Chemical Bank*, 552 F. Supp. at 445. *See also* Sonnenschein, *supra* note 8, at 1588.

62. *Great W. Bank*, 532 F.2d at 1258 (quoting *C.N.S. Enter.*, 508 F.2d at 1359; "We do not hold that application of any single factor discussed above compels us to affirm the judgment of the district court. Nor do we intimate that in a different case there would be no other factors to consider.").

investment dichotomy in an equity participation note transaction, consideration must be given to the lender's assumption of a different and distinct risk associated with the kicker.[63] The risk factors which have been promulgated by the courts in attempting to frame the dichotomy have not addressed this distinction, and consequently provide an inadequate analysis.

To analyze the degree of risk assumed by the lender, courts have looked to the hazard to which a lender's funds have been exposed. In making this analysis, it is helpful to examine cases which have considered the hazard question in the context of equity participation notes. Such an examination will help determine whether the interest charged in such transactions was usurious.[64]

To resolve the usury issue courts have applied the so-called interest contingency rule. This rule provides that when payment of full legal interest is subject to a contingency, so that the lender's profit is wholly or partially exposed to a hazard, the interest contingently payable need not be limited to the legal rate.[65] The interest contingency rule also requires that the parties act in good faith and without intent to avoid a usury statute.[66] However, in order for this rule to apply, the hazard to which the lender's capital is exposed must be over and above the risk accompanying the extension of a normal loan of that kind.[67] The interest contingency rule treats the lender and the debt instrument differently when a high degree of risk is involved. This rationale may in the future be adopted by courts attempting to resolve whether an equity participation note is covered under the federal securities laws.[68]

Through the investment contract approach, *Howey* examined the relevancy of federal securities law with regard to the equity participation note. The investment contract approach focuses upon what amount of compensation is dependent upon the efforts of the borrower and whether the amount is sufficient to transform a commercial note transaction into

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63. Obviously, in the hierarchy of risks assumed by the lender (risk of its capital and risk of its profit in the form of fixed interest and/or contingent compensation), the degree of risk associated with the nonpayment of profit is less in degree relative to the risk of nonrepayment of capital.

64. As recognized by the Supreme Court in *Forman*, 421 U.S. at 857 n.24, there are different kinds of risks, and the distinction must be made between investment risks and the ordinary commercial risk incident to a loan transaction.

65. *See, e.g.*, Thomassen v. Carr, 250 Cal. App. 2d 341, 58 Cal. Rptr. 297 (1967). *See generally* MADISON & DWYER, *supra* note 1, ¶ 5.05[8].

66. *Thomassen*, 250 Cal. App. 2d at 346, 58 Cal. Rptr. at 301.

67. *Id.*

68. In *Thomassen*, an investment risk was found by the court notwithstanding a degree of control by the lender in the borrower's business. *Thomassen*, 250 Cal. App. 2d at 348, 58 Cal. Rptr. at 302.

an investment transaction.[69] Each note transaction ultimately must be subjected to a case-by-case treatment under the multifactor anti-literalist approach.[70]

B. A Literalist Approach—Application of a "Context" Exclusion

Due to the limitations of the multifactor anti-literalist approaches, the Second Circuit in *Exchange National Bank v. Touche Ross & Co.*[71] developed the so-called literalist approach to determine whether a particular instrument should be classified as a security.[72]

The Second Circuit rejected the anti-literalist approach for determining the status of the transaction since that approach began with a presumption against coverage under federal securities laws. The literalist approach on the other hand, views the issue in a different light.[73] Under this approach, the courts presume that notes are covered under the securities laws. This presumption stems from a literal reading of the definitional sections of the Acts.[74] The party who asserts that a note within the literal language of the Acts is not a security has the burden of showing that the note should not be covered under the securities laws. This is accomplished by comparing the particular note transactions to a set of transactions that are clearly considered not to be securities.[75] If the particular transaction that is being analyzed bears a "strong family resemblance" to any of these examples, the presumption of coverage is overcome and the transaction is excluded.[76] All ambiguous cases are resolved in favor of coverage under the securities laws.[77] In *Exchange National Bank*, Judge Friendly enumerated examples of note transactions

69. There also remains the problem of defining the factors and in determining how much weight to attach under the circumstances of the particular case to the presence or absence of the articulated factors. *See Wolf*, 549 F. Supp. at 849-50.

70. It has been argued that this necessity of a case-by-case treatment mitigates the analytical viability of the anti-literalist approaches. *See Exchange Nat'l Bank*, 544 F.2d at 1136.

71. *Id.* at 1132.

72. Judge Friendly articulated the literalist approach in *Exchange Nat'l Bank* notwithstanding the Supreme Court's statements in *Forman*, 421 U.S. at 848-51, rejecting the literalist approach in favor of one that emphasizes the economic realities of a given transaction. *Exchange Nat'l Bank*, 544 F.2d at 1137. The Second Circuit's position is that the economic realities approach governs only the catch-all phrase "investment contract" in cases involving unusual or unique instruments. *See* Golden v. Garafalo, 678 F.2d 1139, 1144-46 (2d Cir. 1982); *Chemical Bank*, 552 F. Supp. at 449-50.

73. *Exchange Nat'l Bank*, 544 F.2d at 1132 n.14. *See also* Sonnenschein, *supra* note 8, at 1588.

74. *Exchange Nat'l Bank*, 544 F.2d at 1137.

75. *Id.* at 1137-38.

76. *Id.* at 1138.

77. *Id.*

that are excluded from coverage under the Act.[78]

In the typical equity participation note transaction, the note will usually have a maturity greater than nine months and does not bear resemblance to these examples. Hence, the equity participation note will presumptively be a security under the literalist approach, although it remains to be considered whether such a result is consistent with the intended purpose of the Act.[79]

V. CONCLUSION

Various judicial approaches have been utilized by federal courts to determine whether to classify a note transaction as a security. The element peculiar to equity participation financing arrangement, that is, the lender's sharing in the ventures profitability in addition to or in lieu of a fixed rate of interest, lends strong support to the finding that the transaction is a security.

An examination of the economic realities of the equity participation financing transaction suggests that the transaction should be an investment. The lender contributes funds to the borrower's enterprise with an expectation of a financial return depending upon the entrepreneurial or managerial efforts of the borrower. However, courts will have to make their decisions on a case-by-case basis, and consider the extent of lender participation, the degree of risk to which the lender's projected return is

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78. *Id.* These include:

> [T]he note delivered in consumer financing, the note secured by a mortgage on a home, the short-term note secured by a lien on a small business or some of its assets, the note evidencing a "character" loan to a bank customer, short-term notes secured by an assignment of accounts receivable, or a note which simply formalizes an open-account debt incurred in the ordinary course of business (particulary if, as in the case of the customer of a broker, it is collateralized). When a note does not bear a strong family resemblance to these examples and has a maturity exceeding nine months, § 10(b) of the 1934 Act should generally be held to apply.
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> *Id.* at 1138.

A common feature of the examples enumerated by the court is that they generally involve relatively few persons.

Variations of the Second Circuit's formulation of the literalist approach have also been suggested. *See, e.g., Wolf*, 540 F. Supp. at 850-52. *See also* Sonnenschein, *supra* note 8, at 1605-09.

79. Any approach to resolving the security status issue in the context of an equity participation financing arrangement should be applied within the purpose of the securities laws. As stated by the Supreme Court in *Forman*:

> The primary purpose of the Acts of 1933 and 1934 was to eliminate serious abuses in a largely unregulated securities market. The focus of the Acts is on the capital market of the enterprise system: the sale of securities to raise capital for profit-making purposes, the exchanges on which securities are traded, and the need for regulation to prevent fraud and to protect the interest of investors.

Forman, 421 U.S. at 849.

subjected, and the amount of contingent compensation that is sufficient to transform the transaction into an investment transaction.

In addition, the presumption of coverage under the Securities Laws based upon the "any note" language of the Acts remains. This is due to the long-term equity participation financing transaction's failure to resemble any of the examples enumerated by Judge Friendly in formulating the literalist approach.

Alternatively, other factors, such as the intent behind the enactment of the Securities Acts, might be considered for the purpose of holding that the equity participation note falls outside the protection of the Securities Acts. Courts which focus on the applicability of the act to such notes must address the question of whether federal securities laws were intended to extend to such a note transaction. In resolving this question, the courts must consider the lender's superior bargaining power and the existence of traditional remedies provided under contract and commercial laws.

In summary, it should be recognized that no mechanical formula can or should be established to resolve the issue of whether the Securities Acts are applicable to every arrangement in which the equity participation note is used. This necessary uncertainty is due to the infinite variety of business transactions in which notes are given. Each transaction must, therefore, be treated individually and determined by the facts presented using the analysis techniques discussed in this paper.