1976

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Bank Loan Participations as Securities: Notes, Investment Contracts, and the Commercial/Investment Dichotomy

In a recent article, bannered Banks vs. Banks, the Wall Street Journal reported a number of pending lawsuits which major American banks claim threaten their continued use of certain syndicated loans in large international transactions by raising the possibility that the banks organizing these loans will be held liable for losses suffered by other banks participating in the loans.¹ The suits reported involve participation loans, identical in substance to loan participations commonly used in domestic banking. In such loans, a participant bank purchases a portion of a loan made by a lead bank and receives a certificate entitling it to a corresponding share of the installments of principal and interest repaid to the lead bank.²

An important question presented in these pending lawsuits is whether the participations are securities within the meaning of federal securities laws, principally the Securities Act of 1933³ and the Securities Exchange Act of 1934.⁴ In view of the greater possibility under the federal statutes than under common law of a lead bank

¹. Mathews, Banks vs. Banks, WALL STREET J., Sept. 14, 1976, at 1, col. 6 [hereinafter cited as Banks vs. Banks]. The article reports that much of the developing world's industrial growth has been financed by American banks acting through group loans. Seven suits have been filed in federal courts in New York, Philadelphia, and Texas, alleging a failure to disclose material information in the sale of a group loan organized by European-American Banking Corp. to finance E.M.J. Colocotronis, a Greek shipping firm which proved to be in unsound financial condition. A total of about $19 million in damages is being claimed by seven disgruntled loan participants. Id.

². A Primer on Loan Participation, 10 THE BANKERS LETTER OF THE LAW, Sept. 1976, at 5 [hereinafter cited as Primer on Participation]. The terms "group loan," "syndicate," and "participation" are often loosely used. The European-American Banking Corp. loan described in the Wall Street Journal report was a true participation loan; the co-lenders purchased a share of the large loan negotiated with the borrower by the lead bank, and received participation certificates evidencing their right to share in the loan repayments received by the lead bank. In a true syndicate loan, each bank separately negotiates with the borrower and receives a promissory note for its contribution to the loan. See Banks vs. Banks, supra note 1, at 1, col. 6.


being held liable for fraud in the purchase or sale of a security, the answer is important to all banks engaged in these transactions.

Although the few writers who have considered the question have relied on *Lehigh Valley Trust Co. v. Central National Bank* to conclude that the participant's interests are securities, significant developments in the definitional law of the securities acts in the last five years necessitate a reexamination of *Lehigh Valley* and a reconsideration of the status of these loan participations. The purpose of this comment is to determine whether bank loan participations should be classified as securities under the federal laws. To do so requires a review of recent judicial interpretations of the federal securities acts, particularly the courts' construction of the statutory terms "note" and "investment contract," and the judicial creation of a "commercial/investment dichotomy" to determine whether interests are securities under the federal laws.

I. INTRODUCTION

A. Loan Participation

The term "participation" is commonly, and often carelessly, used to describe multi- or interbank loan transactions. A true loan participation occurs when a lending bank, the "lead" bank, sells an undivided fractional interest in a loan and any collateral securing it to one or more "participating" banks. The participant has no legal relationship with the borrower; the participation certificate,

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6. 409 F.2d 989 (5th Cir. 1969). *Lehigh Valley* is the first reported case in which a bank loan participation agreement was held to be a security. Other cases have implied that participations could be securities. See, e.g., NBI Mortgage Inv. Corp. v. Chemical Bank, [Current Binder] CCH Fed. Sec. L. Rep. ¶ 95,632 (S.D.N.Y. June 25, 1976); Crowell v. Pittsburgh & L.E.R.R., 373 F. Supp. 1303 (E.D. Pa. 1974) (complicated transaction which closely resembled a participation held to be a security).

7. See notes 41-139 and accompanying text infra.

8. See notes 41-108 and accompanying text infra.


11. Id. See generally Armstrong, The Developing Law of Participation Agreements, 23 Bus. Law. 689 (1968) [hereinafter cited as Armstrong]. The participant may have no personal relationship with the borrower, since loans are often participated to meet a customer's
issued by the lead bank, evidences the participant's rights in the borrower's payments of principal and interest, and in any collateral held or obtained by the lead bank. A number of reasons support the practice of buying and selling participations. Participations spread the risk associated with a loan; they permit a bank to service the needs of a customer at times when it could not otherwise satisfy those needs with its own funds; and they provide a source of income for banks whose funds exceed loan demand.

Loan participations are not exclusively interbank transactions; banks frequently participate in loans where the lead lender is a finance company. A major source of loan participations is the correspondent banking system, in which "country" respondents maintain a service relationship with "city" correspondents. A participation sold by a rural bank to the city correspondent is an "upstream" needs without exposing him to competing banks. A lead bank may therefore not wish the borrower to meet the participant. The borrower has no direct relationship to the participant; he may not even know that participations have been sold in his loan. Id.

12. This comment is concerned with participation loans of this nature, which can be distinguished from multi-bank or syndicate loans where each bank loans money directly to the borrower, obtains a separate note for its share, and an "agent" bank is appointed to administer the loan. See generally Stivers, An Analysis of the Techniques Utilized to Meet the Loan Participation Needs of a Correspondent Bank, 53 J. COM. BANK LENDING, DEC. 1970, at 34-35 [hereinafter cited as Stivers]. Although the agent bank may hold all the notes, receive and transmit disbursements and repayments, and represent the lending banks in dealing with the borrower, each bank has an independent legal relationship to the borrower in the multi-bank or syndicate loans. Armstrong, supra note 11, at 689-90.

13. In one study, over half of the banks surveyed had at some time participated in loans made by commercial finance companies. See Konrad, Participations with Finance Companies, 50 J. COM. BANK LENDING, April 1968, at 37. This commonly occurs when the prospective borrower is currently too great a financial risk for the bank to extend the loan itself, but shows promise of developing into an acceptable customer. In these circumstances, the loan is referred to a commercial finance company more experienced in administering high risk loans, and the bank participates in the loan extended by the finance company. The transaction often originates with the finance company. The combination of high interest rates of the finance company and low interest rates of the bank results in a lower overall rate to the borrower than if the finance company had extended the loan itself. The finance company and bank share the risk and the practice constitutes a source of referrals for both. The bank may retain the borrower's deposit account and may eventually gain the borrower as a prime loan customer; at the same time, the transaction insulates the borrower from contact with other banks. Id. See also Stone & Dorgan, A Different Approach to Commercial Finance Company/Bank Participation Loans, 59 J. COM. BANK LENDING, Sept. 1976, at 23.

participation and one originating with the city bank as lead is characterized as "downstream." In general, the available capital and the most attractive loan opportunities are located in the money-center cities. The "country" areas suffer chronically from capital shortages or sharp fluctuations in capital supply. Accordingly, country respondents often seek to sell two types of participations. An overline participation is offered for sale when the bank lacks funds to meet a loan request, or when granting the loan would violate the bank's legal lending limits. Liquidity participations are offered when the lender seeks to improve its cash position for its own policy reasons, or in response to criticism by a governmental regulatory body. In either case, the lead lender is enabled through participations to satisfy the credit needs of its customers without the risk of exposing them to competing lenders or losing their deposit accounts.

Not all participations are upstream. Downstream participations afford the country respondents an opportunity to share in attractive loan assets otherwise foreclosed to them, and provide an avenue for employing funds when local loan demand is low. Although participations are often bought and sold in a specific loan, a lead may form and sell interests in a pool of loan assets. Whether the banks involved are correspondents or not, the practice of participating loans has proven to be an effective means of transferring funds between areas of capital surplus and deficit. Many rural areas, because they are primarily agricultural, suffer capital imbalance because of severe seasonal fluctuations in availability of funds and loan demand and are generally capital poor in relation to their financing needs. Rapidly developing regions, such as California and Colorado, may also be capital poor. For these areas particularly, participated

15. Stivers, supra note 12, at 40.
16. See notes 23 & 24 and accompanying text infra.
17. Stivers, supra note 12, at 31-34. Since any bank may lack sufficient funds to meet loan requests, country banks have also assisted city banks in times of capital shortages. Correspondents, supra note 14, at 42.
21. Id. See also Correspondents, supra note 14, at 40.
22. Correspondents, supra note 14, at 40, 42.
23. See 1964 Report, supra note 14, at 3-4; Stivers, supra note 12, at 35-38; Correspondents, supra note 14, at 42, 46, 50.
24. 1964 Report, supra note 14, at 4; Stivers, supra note 12, at 35-38; Correspondents, supra note 14, at 42, 46, 50.
loans provide a valuable capital resource. Participated loans, however, are subject to all the ordinary commercial risks associated with loans. Since the participation is a nonrecourse sale of a share in the loan asset, the lead and participants share pro rata in any loss if a default occurs.

B. The Importance of Being a Security

A participant which suffers a loss as a result of fraud in connection with the purchase or sale of a loan participation would generally find greater protection under the federal securities acts than under the common law. A private action for damages under the antifraud sections of the securities acts, particularly rule 10b-5 promulgated under the Exchange Act, would be more advantageous than a common law action primarily because the federal action, by the terms of rule 10b-5, reaches factual omissions and half-truths as well as actual misrepresentations. The major element to be proven

25. A sale of a participation is frequently offered on a nonrecourse basis, because the sale would otherwise closely resemble an interbank loan, with attendant problems under the banking laws. ROBERT MORRIS ASSOCIATES, GUIDELINES FOR UPSTREAM DOWNSTREAM CORRESPONDENT BANK LOAN PARTICIPATIONS 8 (1975); Correspondents, supra note 14, at 42.

26. 1 A. BROMBERG, SECURITIES LAW: FRAUD-SEC RULE 10b-5, §§ 2.7(1)-(2) (1975) [hereinafter cited as BROMBERG].


28. 17 C.F.R. § 240.10b-5 (1976) provides:

   (a) To employ any device, scheme, or artifice to defraud,
   (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
   (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

   in connection with the purchase or sale of any security.


29. See note 28 supra. See also Bangs, Rule 10b-5 and the South Dakota Lawyer, 14 S.D.L. REV. 56, 79 (1969) (rule 10b-5 “is proving to be the most prolific source of litigation since Henry Ford invented the flivver”). Under the common law, fraud consists only of active misrepresentations. It ordinarily imposes no duty on an actor to voluntarily disclose material
is that the omitted or misleading information was "material," that is, "a reasonable man would attach importance . . . to the information in determining his choice of action in the transaction." 30

Moreover, the common law fraud requirements of scienter, reliance and causation are relaxed or even abrogated under rule 10b-5. Scienter, the "mental state embracing intent to deceive, manipulate, or defraud," 31 seemed to have been virtually eliminated as an element by the federal courts, 32 until the Supreme Court recently held that some proof of scienter on the part of the defendant was necessary to maintain a rule 10b-5 action. 33 Proof of reliance by the plaintiff on the fraudulent statement, essential to a common law action for misrepresentation, is not a significant obstacle in a federal action when an omission of material fact is alleged. 34 Proof of causation remains undisputably essential to a federal securities fraud action, but doubt exists about how proximate the causation must be. 35 Finally, a federal action under the securities acts possesses attractive procedural features. 36 Indeed, the classification of partici-

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32. See, e.g., SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 854 (2d Cir. 1968), cert. denied, 404 U.S. 1005 (1971); 2 Bromberg, supra note 26, at § 8.6(1).
33. Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976). The case involved the alleged negligence of a corporation's auditors who failed to uncover fraud by the corporate management. Although the opinion does not discuss the degree or nature of the scienter that is required, the Court held that the plaintiff could not maintain the action solely on a theory of negligent omission, without any allegation of scienter. Id. at 194-214. 34. 2 Bromberg, supra note 26, at § 8.6(1).
35. 6 L. Loss, SECURITIES REGULATION 3880-83 (1969); 2 Bromberg, supra note 26, at § 8.7(1).
Comments as securities might determine whether or not certain injured participants may have any expectations of recovery of their losses from participations sold to them without full disclosure of significant facts.\footnote{37}

**II. THE PRESENT STATE OF THE LAW**

At present there appear to be two theories for concluding that a loan participation is a security under the federal securities acts. First, the participation may be included in the language, "any note . . . or any certificate of interest or participation in . . . the foregoing,"\footnote{38} under the Exchange Act. Under this approach, if the note

\footnote{37. Furthermore, if a participation should be held subject to the registration provisions of the Securities Act of 1933, § 5, 15 U.S.C. § 77e (1970), its sale without registration could be automatically rescinded within one year. \textit{Id.} §§ 77i(1), 77m. However, most participations would almost certainly be exempt from registration as private offerings, assuming that only a limited number of banks or similarly sophisticated financial institutions were solicited. \textit{Id.} § 77d(2). According to a recent report, the Securities and Exchange Commission (SEC) has taken no action to compel the registration of participations. \textit{See also Banks vs. Banks, supra note 1, at 1, col. 6.}

\footnote{38. Section 3(a)(10) of the Exchange Act provides:
(a) When used in this title, \textit{unless the context otherwise requires—}

(10) \textit{The 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 certificate 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 of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited. 15 U.S.C. § 78c(a)(10) (1970) (emphasis added).}

Section 2(1) of the Securities Act provides that

(1) The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing. 15 U.S.C. § 77b(1) (1970).}

Distinctions have been noted between the definitions in the two acts, but the Supreme
given by the borrower to the lead bank is a security under the Act, then a participation sold in the note would also be a security. Second, the sale of a participation may be an "investment contract" under the securities acts, and thus a security regardless of the status of the underlying note.39

A. "Any Note" and the Commercial/Investment Dichotomy

Both securities acts provide that unless the context otherwise requires any certificate of interest or participation in any note is a security.40 A loan participation undoubtedly falls within the literal meaning of these words, and the Fifth Circuit Court of Appeals concluded as much in Lehigh Valley Trust Co. v. Central National Bank.41 Lehigh Valley involved a 10b-5 action alleging material omissions and misleading disclosures. Appellant, Central National Bank, was deeply committed in loans to Martin Von Zamft and various corporations controlled by him, when one of the corporations, Larso Construction, approached it for additional credit. Satisfaction of half of this request caused Central’s commitment to Larso to equal ten percent of its assets, and it was precluded by state law from meeting the balance of the loan itself. To protect its enormous interest, Central attempted what the court characterized as the "ultimate bailout"—it offered the overline portion of the Larso loan request for participation.42 Lehigh Valley participated in the loan; it was informed that the Larso loan was secured by stock and personal guarantees, but was not told of other factors which made the loan a significant risk.43

39. Each of the securities acts includes "investment contract" in its definition of "security." For the pertinent language of the acts see note 38 supra.
40. See note 38 supra.
41. 409 F.2d 989 (5th Cir. 1969).
42. Id. at 991.
43. Lehigh Valley was not informed that the corporation whose stock secured the Larso loan was already in reorganization proceedings under the Bankruptcy Act; that Von Zamft, the prime guarantor, was then in default to Central on personal obligations; that bank examiners had criticized the security on some of the other loans; that other banks were then foreclosing on their collateral for other loans; and that Von Zamft’s empire in general was suffering serious financial problems. Id. at 990-91.
Central contended on appeal that it was not liable since the Exchange Act and rule 10b-5 did not apply where no “security” was involved. The court looked to the definition of “security” in the Exchange Act, and observed that the language “any note” had been “literally read by the judiciary to the extent that almost all notes are held to be securities”; this plainly included within the language of the Act Larso’s note to Central. Recognizing that Central was charged not with the sale of the note but with the sale of a participation in the note, the court was influenced by the strict interpretation given to “any note,” and determined that it must read the rest of the statute literally. The Fifth Circuit concluded that the Lehigh Valley participation was a certificate of interest or participation in a note within the coverage of the Exchange Act, and hence was a security; it therefore permitted Lehigh Valley’s cause of action against Central under rule 10b-5 of the Act.

Since the Lehigh Valley decision, it has been accepted that an interbank loan participation may be a security. But developments in the last few years make questionable the continued vitality of Lehigh Valley. At least insofar as its holding was based on a literal reading of the statute, as was its dictum that nearly all notes are securities, it is no longer undisputable precedent. Rejecting the literal approach, courts have held that not all notes are securities.

Lehigh Valley shortly preceded, and may have precipitated, a wave of securities litigation in which the courts have struggled with the statutory language in order to deny federal jurisdiction over many transactions involving notes. The judiciary’s negative reaction to

44. Id. at 991-92.
45. Id. at 992.
46. Id. The court also was persuaded by its perception of a Supreme Court policy of broadly reading the definition of security, and of construing the antifraud provisions of the Exchange Act expansively. See SEC v. National Sec., Inc., 393 U.S. 453 (1969); Tcherepnin v. Knight, 389 U.S. 332, 338 (1967).
47. 409 F.2d at 992.
49. See United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 849 n.14 (1975) (“with the exception of the Second Circuit, every Court of Appeals recently to consider the issue has rejected the literal approach”). Of course, some notes are still held to be securities. See notes 55-108 and accompanying text infra.
50. See, e.g., Exchange Nat’l Bank v. Touche Ross & Co., 544 F.2d 1126 (2d Cir. 1976); Great W. Bank & Trust v. Kotz, 532 F.2d 1252 (9th Cir. 1976); Zabriskie v. Lewis, 507 F.2d 546 (10th Cir. 1974); SEC v. Continental Commodities Corp., 497 F.2d 516 (5th Cir. 1974);
the proposition that Congress intended the securities acts to provide every maker, payee, or transferee of every note a federal forum and cause of action may seem reasonable. Nevertheless, the relevant definitional language of the two acts appears to be unambiguous in meaning, and the exemption and exclusion provided for certain notes are narrow. Courts were thus confronted with the question of how Congress, by writing definitions of sweeping scope for securities, and providing only narrow exceptions, could not intend for almost all notes to be regarded as securities. An answer was found

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51. The Securities Act defines "security" as being, inter alia, "any interest or instrument commonly known as a 'security.'" 15 U.S.C. § 77b(1) (1970) (emphasis added). The Exchange Act includes within its coverage "any instrument commonly known as a 'security.'" 15 U.S.C. § 78c(a)(10) (1970) (emphasis added). A House report on the Securities Act stated that the definition of "security" was "in sufficiently broad and general terms so as to include ... the many types of instruments that in our commercial world fall within the ordinary concept of a security." H.R. Rep. No. 85, 73d Cong., 1st Sess. 11 (1933) (emphasis added). However, the acts were also intended to apply to certain novel or unusual types of interests and transactions. See notes 109-39 and accompanying text infra.

52. Section 3(a)(10) of the Exchange Act provides that a security within its coverage "shall not include ... any note ... which has a maturity at the time of the issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited." 15 U.S.C. § 78c(a)(10) (1970). Therefore, a note meeting the criteria should not be subject to any term of the Exchange Act.

Section 3(a)(3) of the Securities Act states that unless expressly provided the Act shall not apply to the following kinds of securities:

(3) Any note, draft, bill of exchange, or banker's acceptance 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 the maturity of which is likewise limited.

15 U.S.C. § 77c(a)(3) (1970). Section 17, the antifraud section of the Act, provides that the exemption shall not apply to it. 15 U.S.C. § 77q(c) (1970). The notes described in § 3(a)(3) of the Securities Act, therefore, are exempt from the Act's registration requirements, but not its antifraud terms. Because nine month and shorter maturity notes are totally removed from the Exchange Act under its definition of a security, the Exchange Act's removal of these notes is referred to herein as an exclusion; because § 3(a)(3) of the Securities Act operates only to remove nine month and shorter maturity notes from the Act's registration requirements, and not its antifraud provisions, its removal is referred to as an exemption.


If instruments used in every private loan transaction qualified as securities under the federal statutes, our jurisdiction could be invoked with respect to any claim of fraud in connection with the issuance of a check or note, no matter how small the transaction. We do not view this as the type of situation that prompted the enactment of the federal securities laws. . . .
in the statutes’ preface to their definitions, which provides for application of the laws “unless the context otherwise requires”; the judiciary has largely relied on this language to fashion an approach for excluding transactions from the scope of the federal securities laws.\textsuperscript{54}

Like the \textit{Lehigh Valley} court, other federal courts had originally construed the acts’ references to “any note” literally in those cases they had considered.\textsuperscript{55} Doubts concerning the viability of the literal approach first appeared in \textit{Movielab, Inc. v. Berkey Photo, Inc.},\textsuperscript{56} where the district court refrained from applying a strictly literal approach, although it held that a definition which purports to include “any note” must in effect apply to some notes. In the court’s view, if some notes were securities, the ones at issue clearly were;\textsuperscript{57} the implication, however, was that some notes were not securities.

The trend away from a literal application of the securities acts’ definitions developed with \textit{Sanders v. John Nuveen & Co.},\textsuperscript{58} a class action against a broker-dealer for fraud connected with the sale of short-term commercial paper.\textsuperscript{59} The case is significant; al-

\begin{itemize}
  \item There is no ambiguity in the language of §10(b). Nor does a literal reading of the language defeat or hamper Congress’ apparent purpose.
  \item Try as we may, we fail to detect in the 1934 Act any grant of discretionary power to the court to construe the term “security” as including certain types of notes but not others. Congress apparently decided that it would pass a sweeping prohibition rather than attempt to draw such distinctions. We are bound by that decision.
  \item Indeed, the \textit{Lehigh Valley} decision has been criticized for failing to take into account the language, “unless the context otherwise requires” found in § 3(a)(10) of the Exchange Act, 15 U.S.C. § 78c(a)(10) (1970).
  \item 452 F.2d 662 (2d Cir. 1971).
  \item \textit{Id.} at 663. The court was persuaded in \textit{Movielab} that the transaction before it involved a security; one publicly held company had purchased the assets of another in exchange for installment notes running for twenty years, in the total principal amount of $10,500,000. The appellant had argued that Congress could not have intended to open the federal courts to every transaction, however small, involving a note. The court, however, was impressed by the size of the notes and their exceptionally long term.
  \item 463 F.2d 1075 (7th Cir. 1972).
  \item Commercial paper is unsecured, short-term corporate promissory notes, payable to bearer, and supposedly issued only by well-known companies with financial positions beyond question, for the purpose of financing current transactions of a definite seasonal or periodic
\end{itemize}
though the Seventh Circuit held that "any note" means every note, it did not apply the patently unambiguous final clause of the Exchange Act's definitions, which provides that any note with a maturity not over nine months is not a security.\(^\text{60}\) The court found the clause contradictory when compared to the Securities Act, which considers such notes securities, but exempts them from its registration provisions.\(^\text{61}\) A note would be excluded from the Exchange Act and thus immune to a fraud action under that Act, although it remained subject to an action for fraud under the Securities Act. The \textit{John Nuveen} court felt this incongruity required it to construe the meaning of the Exchange Act's exclusion. There being no legislative history or other interpretive aids to assist in the construction of the exclusion,\(^\text{62}\) the court relied on the legislative history of the Securities Act's registration exemption to interpret and limit the Exchange Act's exclusion.\(^\text{63}\) Only well-secured, prime quality commercial paper, issued to finance current business transactions and of a type not ordinarily issued to the general public, were determined to fall within the provisions of the Securities Act's exemption.\(^\text{64}\) Notes meeting the criteria are commercial paper, are exempt


\(^\text{61}\) See note 52 supra.


\(^\text{63}\) 463 F.2d at 1078-80.

\(^\text{64}\) The exemption found at § 3(a)(3) of the Securities Act of 1933, 15 U.S.C. § 77c(a)(3) (1970), was written for commercial paper. The original draft of the Act contained no such exemption; it was included principally at the urging of the Federal Reserve Board during congressional committee hearings on the bill. \textit{Commercial Paper}, supra note 59, at 381-82. The Federal Reserve Board felt that the Securities Act was "not intended to apply . . . to short-time paper issued for the purpose of obtaining funds for current transactions in commerce, industry, or agriculture and purchased by banks and corporations as a means of employing temporarily idle funds." Letter from Chester Morrill, Secretary of the Federal Reserve Board, to Senator Duncan V. Fletcher, April 3, 1933, in \textit{Hearings on S.875 Before the Senate Comm. on Banking and Currency}, 73d Cong., 1st Sess. 120 (1933). This commercial paper was described in the hearings as having "a record of safety only second to Government bonds." \textit{Id.} at 94-96.

The SEC has interpreted the Securities Act exemption as applying only to prime quality negotiable commercial paper, not ordinarily purchased by the general public, issued to facilitate well-recognized types of current operational business requirements, and eligible for discounting by Federal Reserve banks. SEC Securities Act Release No. 33-4412 (Sept. 20, 1961) 17 C.F.R. § 231.4412 (1961). The "prime quality" nature of the paper, and its supposed safety, supports the exemption. The current transactions requirement refers to the theore-
from registration under the Securities Act, and, in the *John Nuveen* court's view, are what the exclusion of the Exchange Act was intended to exclude from the coverage of that Act. All other notes, according to the court, are investment securities and subject to the provisions of both acts. Since the notes at issue in *John Nuveen* were offered to the public at large, were not prime, and did not finance current transactions, they were the kind of security "in regard to which the securities acts were intended to offer protection against fraud, misrepresentation and non-disclosure."

A new philosophy for dealing with notes had been suggested by *John Nuveen*, and became a statement of law in *Lino v. City Investing Co.* The Third Circuit ruled in *Lino* that the securities acts were never intended to apply to a suit by the maker of notes given in payment for the right to operate a business franchise. The Court of appeals rested its decision squarely on the precatory introduction to the definitions of both acts which states that the definitions apply
tically self-liquidating nature of commercial paper; the operation financed should pay its return in time to meet the maturity date of the paper. Schweitzer, *Commercial Paper and the Securities Act of 1933: A Role for Registration*, 63 Geo. L.J. 1245, 1246-48 (1975). It has been argued that much commercial paper was not self-liquidating in 1933 and is not today; that paper is not tied to specific current transactions, but is used as a general capital source by continual "rolling over," that is, reissuing the paper as it matures, and paying off the first note with the proceeds of the next. *Id.* at 1248-49.

65. The court stated:

In other words, when Congress spoke of notes with a maturity not exceeding nine months, it meant commercial paper, not investment securities. When a prospective borrower approaches a bank for a loan and gives his note in consideration for it, the bank has purchased commercial paper. But a person who seeks to invest his money and receives a note in return for it has not purchased commercial paper in the usual sense. He has purchased a security investment.

463 F.2d at 1080 (footnotes omitted).

66. *Id.* at 1079. The Second Circuit concurred with this holding in *Zeller v. Bogue Elec. Mfg. Corp.*, 476 F.2d 796 (2d Cir.), cert. denied, 414 U.S. 908 (1973), a derivative action by stockholders of a subsidiary of Bogue. The plaintiffs alleged that Bogue had looted the subsidiary by forcing it to loan money to its parent in exchange for notes which were alleged to be securities. The court held that a maturity of less than nine months did not foreclose a 10b-5 action on a note unless the note fit the commercial paper criteria; it reasoned that the securities acts were intended to protect investors and should be read accordingly. *Id.* at 800.

67. 487 F.2d 689 (3d Cir. 1973).

68. *Id.* at 694-96. Section 10(b) of the Exchange Act proscribes the use of "manipulative or deceptive devices" in the "purchase or sale" of securities, and authorizes the SEC to promulgate attendant regulations. 15 U.S.C. § 78j(b) (1970). Rule 10b-5, promulgated under § 10(b) of the Act, combines the purchase or sale feature of the Exchange Act's § 10(b), with the broad antifraud language of § 17(a) of the Securities Act, 15 U.S.C. § 77q(a) (1970), which only reaches fraud in the sale of securities. For the text of the rule see note 28 *supra*.
“unless the context otherwise requires.” It found lacking in common sense the plaintiff’s proposition that his “security” had been purchased and paid for with a business franchise. Furthermore, the Third Circuit could not accept the logical extension of the plaintiff’s proposition—that every consumer buying an article on credit has sold a security to the retailer. Although the statutory language does literally support that result, the court noted that nowhere in the statutes or their legislative history is there any express reference to consumer transactions. Since the court also determined that certain characteristics generally applicable to securities transactions were absent, it concluded that no security was involved due to the “commercial context” of the transaction at issue. In the court’s view, Congress had specifically instructed the courts through its precatory language that some transactions would fall outside the spirit and intention of the law; in Lino, the commercial context of the transaction would require the conclusion that the transaction was without the acts’ broad coverage.

69. The court reasoned that the commercial context of this case requires a holding that the transaction did not involve a “purchase” of securities. These were personal promissory notes issued by a private party. There was no public offering of the notes, and the issuer was the person claiming to be defrauded. The notes were not procured for speculation or investment, and there is no indication that [the payee] was soliciting venture capital from Lino.

487 F.2d at 694-95.

70. Id. at 695.

71. See note 69 supra.

72. 487 F.2d at 694-96.

73. Id. at 695. The court relied on the Supreme Court’s observation in Holy Trinity Church v. United States, 143 U.S. 457 (1892) that “a thing may be within the letter of the statute and yet not within the statute, because not within its spirit, nor within the intention of its makers.” Id. at 458-59. Curiously, the court did not acknowledge a frequently cited authority which seems particularly to support its conclusion—SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344 (1943), in which the Supreme Court, interpreting § 2(1) of the Securities Act, stated that the rules of statutory construction long have been subordinated to the doctrine that courts will construe the details of an act in conformity with its dominating general purpose, will read text in the light of context and will interpret the text so far as the meaning of the words fairly permits so as to carry out in particular cases the generally expressed legislative policy. Id. at 350-51. In this context, the generally expressed legislative policy was the protection of investors. See Message of President Roosevelt to Congress, Mar. 29, 1933, in S. Rep. No. 47, 73d Cong., 1st Sess. 6 (1933); Message of President Roosevelt to Congress, Feb. 8, 1934, S. Rep. No. 792, 73d Cong., 2d Sess. 1 (1934). The Senate report on the Securities Act notes that the “purpose of this bill is to protect the investing public and honest business. The basic policy is that of informing the investor of the facts concerning securities . . . and providing protection against fraud and misrepresentation.” S. Rep. No. 47, 73d Cong., 1st Sess. 1 (1933) (emphasis added).
Although a few district courts had previously held that certain notes were not securities,74 Lino represents the first appellate court determination that a note came under the language, “unless the context otherwise requires.” It was also the first significant judicial attempt to articulate a theory for future decisions by listing the factors determinative of a “securities context.” Other courts quickly followed Lino’s lead.75 In Bellah v. First National Bank,76 the nine month maturity exclusion of the Exchange Act was held to apply to plaintiffs’ notes because they were “commercial,” not investment in context. The Bellah court emphasized that in extending the loan, the bank merely intended to aid the plaintiffs in the operation of their business, not “to profit from the successful operation of [the] enterprise.”77 The court stated as a general conclusion that “notes issued in the context of a commercial loan transaction fall beyond the purview of the [Exchange] Act.”78 McClure v. First National

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76. 495 F.2d 1109 (5th Cir. 1974).

77. Id. at 1113. The Bellah court apparently coined the phrase “commercial-investment dichotomy,” by which the doctrine of the duality of notes has come to be referred. See id. at 1112 n.3.

78. Id. at 1114. The court also reasoned that to construe such notes as securities would necessitate requiring their registration, which would “inevitably wreak havoc on the commercial paper market.” Id. This argument seems to be a makeweight, or rather a naïve position in view of the Securities Act’s exemption relative to private offerings, which would almost certainly apply to a transaction between a single borrower and a single bank. See Securities Act of 1933, § 4(2), 15 U.S.C. § 77d(2) (1970). The court in Bellah was doubtful that construing the note as a security would comport with congressional intent, and stated that the acts “create for participants in note transactions a broad but nevertheless not boundless federal forum for vindicating their grievances. We doubt that Congress intended by these Acts to render federal judges the guardians of all beguiled markers or payees.” 495 F.2d at 1114.
Bank\textsuperscript{79} presented another securities acts suit by a note maker alleging that fraud was involved in the grant of a bank loan. The principal difference from the earlier cases was that the note involved in \textit{McClure} had a maturity period beyond nine months. Under previous decisions, this transaction should have been covered by the Exchange Act \textit{regardless} of its commercial or investment nature.\textsuperscript{80} The \textit{McClure} court reasoned, however, that the commercial/investment analysis evolved in \textit{John Nuveen, Lino and Bellah} was not limited in its effect to the Exchange Act’s exclusion clause and the Securities Act’s registration exemption, but went directly to the determination of what was or was not a security. The court concluded that its “investment” nature is the central feature of a security; therefore, a note which is part of a commercial transaction is not a security and is not subject to the Exchange Act despite its maturity period.\textsuperscript{81} In the view of the court in \textit{McClure}, the commercial or investment features, not the Exchange Act exclusion, are determinative of whether or not “any note” is a security.\textsuperscript{82}

The investment/commercial approach for distinguishing notes which are securities from those which are not appears to be reasonable in theory. Yet while the courts have professed to know them when they see them, they have not been particularly adept at expressing standards or criteria for determining whether a note is a

\textsuperscript{79} 497 F.2d 490 (5th Cir. 1974), \textit{cert. denied}, 420 U.S. 930 (1975).

\textsuperscript{80} The exclusion of § 3(a)(10) of the Exchange Act, 15 U.S.C. § 78c(a)(10) (1970), is available only to notes with a maturity not exceeding nine months. Previous cases had only dealt with notes with maturity under nine months. \textit{See}, \textit{e.g.}, \textit{Bellah v. First Nat’l Bank}, 495 F.2d 1109 (5th Cir. 1974).

\textsuperscript{81} 497 F.2d at 493-95. The court frankly admitted:

\begin{quote}
We realize that our holding today that the Act does not apply to commercial notes of a longer duration than nine months, taken with the decisions voiding the short-term exemption as to investment paper, virtually writes that exemption out of the law. . . .

Thus, the investment or commercial nature of a note entirely controls the applicability of the Act, depriving of all utility the exemption based on maturity length.
\end{quote}

\textit{Id.} at 494-95. The court recognized that its holding could not be squared with the express language of § 3(a)(10) of the Exchange Act:

\begin{quote}
The original scrivener of the definitional section may well wonder what happened to his carefully drawn exemption on the way to the courthouse, but if the judicial decisions do not properly reflect the intent of Congress as to the coverage of the Act, only that body can properly rectify the situation at this point, if stare decisis is to apply and the Supreme Court does not make some definitive decision contrary to the presently decided cases.
\end{quote}

\textit{Id.} at 495.

\textsuperscript{82} \textit{Id.} at 494-95.
security under the investment/commercial analysis.\textsuperscript{83} A review of the cases does suggest some factors bearing on whether the note is a security under the commercial/investment dichotomy. Under the guidance of \textit{Lino} and \textit{McClure}, a court may inquire whether there was any public offering, or whether the notes were acquired for speculation or investment.\textsuperscript{84} \textit{Bellah} perhaps would suggest only a different phrasing of the latter question: did the lender intend to profit from the successful operation of the borrower's business?\textsuperscript{85} In all, the criteria proposed in these and other cases have focused on the borrower's use of the proceeds to determine the nature of the lender's interest. Are they used to promote a new corporation or bail out a foundering one (that is, do they involve risk or venture capital)\textsuperscript{86} Are the proceeds used to finance ongoing operations, or are they used to acquire capital assets?\textsuperscript{87} If used for capital assets, does the lender take a purchase money security interest in the specific asset, or an interest in all the borrower's assets, or is the loan unsecured?\textsuperscript{88}

The essence of investing is the expectation by the investor that he will realize some return from the investee's employment of his contribution. Recognizing this basic requirement, there has been unanimous assent that a note issued in connection with a sale of consumer goods or services is not a security.\textsuperscript{89} The lender who ac-

\begin{footnotes}
\footnote{83. For example, in \textit{McClure}, after concluding that the investment nature of the transaction determined whether a note was a security, the court noted that an investment transaction would generally be indicated if the notes were offered to a class of investors, or acquired by the payees for speculation or investment, or if the payees acquired investment assets. 497 F.2d at 493, 494.}
\footnote{84. See notes 67-74 & 79-82 and accompanying text \textit{supra}.}
\footnote{85. See 495 F.2d at 1113.}
\footnote{86. See \textit{Zabriskie} v. \textit{Lewis}, 507 F.2d 546, 551-52 (10th Cir. 1974); \textit{SEC} v. \textit{Continental Commodities Corp.}, 497 F.2d 516, 523-27 (5th Cir. 1974); \textit{Lino} v. \textit{City Investing Co.}, 487 F.2d 689, 694-95 (3d Cir. 1973). See generally \textit{Economic Reality}, \textit{supra} note 38.}
\footnote{88. See generally \textit{Great W. Bank \& Trust} v. \textit{Kotz}, 532 F.2d 1252 (9th Cir. 1976); \textit{Lipton \& Katz}, \textit{supra} note 75, at 776-70; \textit{A Note Is, supra} note 36, at 510-12.}
\footnote{89. \textit{United Housing Foundation, Inc.} v. \textit{Forman}, 421 U.S. 837 (1975) (purchasers of stock in a housing cooperative motivated by desire to obtain place to live, not profit); \textit{Zabriskie} v. \textit{Lewis}, 507 F.2d 546 (10th Cir. 1974) (if a note is given in a consumer purchase it is not a security; if given in a business transaction, a commercial/investment analysis must be applied).}
\end{footnotes}
cepts a note in return for financing a new television set expects to be repaid with interest, but does not expect the borrower to earn the interest through his use of the loan proceeds; thus, financing of a consumer transaction reasonably does not involve the sale of a security.

In other contexts, a predictable and satisfactory method of applying the commercial/investment analysis to determine the security status of notes has not been developed. Two cases recently reported acknowledged this problem and suggested different solutions. In *Great Western Bank & Trust v. Kotz*, the Ninth Circuit, in a per curiam opinion holding that the note at issue was not a security, rejected the complaint as "another attempt to convert Section 10(b) of the Securities Exchange Act into a source of general federal jurisdiction." The test for a security (or for an "investment") developed by the Ninth Circuit is whether the lender has contributed "risk capital" subject to the "entrepreneurial or managerial efforts" of the borrower. Because the loan agreement in *Great Western* was carefully tailored to the bank's requirements, placing extensive restrictions on the borrower's use of the loan proceeds and the conduct of its financial operations, the loan was not regarded as risk capital subject to the borrower's "essential managerial efforts," but was simply a commercial loan subject to the risks normally attendant on such loans. The court concluded that a note given to a bank is generally not a security. A concurring opinion in *Great Western*
written by Judge Wright went further. The judge noted that there is no indication in the securities acts that Congress intended to include commercial financing within their protection; as the McClure court had concluded, the reality of commercial bank lending is totally unrelated to the abuses involved in trading for speculation or investment that Congress sought to eliminate through the Exchange Act. Moreover, Judge Wright also argued that banks, unlike investors covered under the acts, have the ability to gather information about borrowers and protect themselves from fraud.

The majority and concurring opinions in Great Western, when read together, seem to imply that a bank loan is presumptively not an investment, and hence not a security. That was the inference drawn from the decision by the Second Circuit in Exchange National Bank v. Touche Ross & Co. The court did conclude that notes given the Exchange National Bank were securities under the commercial/investment test, but principally devoted its opinion to criticizing that test and the view expressed in Great Western. The Exchange National Bank court surmised that it was Judge Wright’s position that the federal securities acts should not apply to notes received by a bank in what purports to be an exercise of its lending function, a view the Second Circuit found appealing because it was dissatisfied with previous efforts to provide meaningful criteria for a case by case determination utilizing the commercial/investment analysis. Judge Wright’s reasoning offered at least a modicum of certainty to those grappling with the problem of determining a security vel non. Nevertheless, largely because it felt his view mis-

95. Id. at 1260-62 (Wright, J., concurring).
97. 544 F.2d 1126 (2d Cir. 1976). The borrower was a brokerage firm and member of the New York Stock Exchange. There were strict limitations on the collectibility of the subordinated, unsecured notes, based on the Exchange’s capitalization requirements for member firms. The loan was not an isolated transaction, but was part of a large-scale financing operation involving 19 lenders.
98. Id. at 1138-39.
99. See text accompanying notes 85 & 96 supra.
100. 544 F.2d at 1136-37. The court observed: Directing courts to “weigh” a number of such dubious factors, without any instructions as to relative weights . . . is scarcely helpful to hard-pressed district judges or to counsel. Adoption of Judge Wright’s view thus would afford the hope of bringing a modicum of certainty into one large section of a field in bad need of it.

Id. at 1137.
construed the protection offered by the acts, the court did not adopt Judge Wright's position.\textsuperscript{101} It concluded that the best alternative was to follow more closely the language of the acts, which include as a security every note with a maturity over nine months, unless the party asserting there is no security proves that the context requires otherwise.\textsuperscript{102} Whereas \textit{Great Western} suggested that a bank loan presumptively did not involve a security, \textit{Exchange National Bank} proposed the converse, a presumption that a note involved in a bank loan is a security.\textsuperscript{103}

Although a majority of the decisions since \textit{Lehigh Valley} have held notes at issue to be securities,\textsuperscript{104} \textit{Lehigh Valley}'s literal approach to interpreting "any note" has been replaced by analysis under the commercial/investment dichotomy. Applying this approach, in virtually every determination of the status of a note issued in a bank loan transaction, the courts have concluded that the note was not a security.\textsuperscript{105} Unless there is intervention by Congress or the Supreme Court to clarify the status of banking transactions under the securities acts, or unless the Second Circuit's new literal-

\begin{footnotesize}
101. In the court's view, Judge Wright's position was largely based on the perceived ability of banks to gather information and to protect themselves from fraud, and the conclusion that they were not in need of the protection of the securities acts. It noted, however, that the Exchange Act reaches fraud in the "purchase or sale" of securities, not just in their sale; many of the recent cases involved claims of fraud by the makers of notes "purchased" by banks. The Second Circuit argued that even if it were banks claiming fraud, the statutes' antifraud provisions should apply where a bank or group of banks loaned millions of dollars to a borrower for a term of years. The court reasoned that a bank's ability to obtain disclosure cannot always prevent fraud. \textit{Id.} at 1137. See notes 156-63 and accompanying text infra.

102. \textit{Id.} at 1137-38. The court was able to suggest several cases where the context of the transaction would require the note to be outside the acts' protection—consumer financing, home mortgages, a short-term note secured by a lien on the assets of a small business, accounts receivable financing, or a note evidencing open-account debt in the ordinary course of business.

103. \textit{Id.} at 1138. Once again it was emphasized that there was a need for congressional explanation of the meaning of "note" in the acts' definitions.

104. See, e.g., \textit{Exchange Nat'l Bank} v. Touche Ross & Co., 544 F.2d 1126 (2d Cir. 1976); Zabriskie v. Lewis, 507 F.2d 546 (10th Cir. 1974); SEC v. Continental Commodities Corp., 497 F.2d 516 (5th Cir. 1974); Sanders v. John Nuveen & Co., 463 F.2d 1075 (7th Cir. 1972); Movielab, Inc. v. Berkley Photo, Inc., 452 F.2d 662 (2d Cir. 1971).

105. See \textit{Great W. Bank} v. Kotz, 532 F.2d 1252, 1260 (9th Cir. 1976) (Wright, J., concurring) and cases cited therein.

ism gains judicial acceptance,\textsuperscript{107} it is probable that notes issued for future bank loans will not be regarded as securities in the absence of specific, particular circumstances.\textsuperscript{108}

B. The Investment Contract

As the Lehigh Valley court observed, the lead bank-defendant therein was not charged with fraud in the sale of a note, but in the sale of a participation in the note.\textsuperscript{109} After enumerating the specific instruments which constitute securities, the securities acts provide that any "certificate of interest or participation in" any of the named instruments is also a security; in other words, a participation in a security is a security. If the borrower's note given to a lead bank is a security, as at least some are, then a participation in it should clearly be a security.

If held to be an "investment contract,"\textsuperscript{110} a loan participation would be a security regardless of the status of the underlying note. The federal securities acts utilize the term "investment contract" as a catchall; after listing specific, commonly understood instruments such as stocks, bonds, and notes, the acts include in their definitions of a security the term "investment contract," apparently, to protect investors from imaginative schemes which have the characteristics of securities but differ from the instruments specified.\textsuperscript{111} The term "investment contract" is undefined in the acts themselves or in their legislative histories,\textsuperscript{112} leaving the task of its

\begin{itemize}
  \item \textsuperscript{107} Since the Third, Fifth, Seventh, Ninth, and Tenth Circuits have already recognized and applied the commercial/investment analysis, it is unlikely that the Second Circuit's literal approach to the securities acts will be adopted. See cases cited at note 50 supra. In addition, the First Circuit seems to have accepted the commercial/investment dichotomy for analyzing security-like transactions. See Spencer Cos. v. Armonk Indus., Inc., 489 F.2d 704 (1st Cir. 1973). District courts in the Eighth Circuit have also utilized the approach. See, e.g., Joseph v. Norman's Health Club, Inc., 336 F. Supp. 307, 313 (E.D. Mo. 1971).
  \item \textsuperscript{108} See, e.g., Exchange Nat'l Bank v. Touche Ross & Co., 544 F.2d 1126 (2d Cir. 1976) (loan proceeds used to satisfy capital requirements). See also notes 99-106 and accompanying text supra.
  \item \textsuperscript{109} 409 F.2d at 992.
  \item \textsuperscript{110} Both securities acts include "investment contract" in their lists of instruments which are considered to be securities for the purposes of the acts. See note 38 supra for the pertinent statutory language.
  \item \textsuperscript{111} See, e.g., Long, An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation, 24 OKLA. L. REV. 135, 138 (1971) [hereinafter cited as Investment Contracts]. The federal securities acts adopted the same definitional strategy as state blue sky laws, naming specific instruments and including nonspecific descriptive terms such as "profit-sharing agreement" and "investment contract" in their explication of a security. See SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 351 (1943).
  \item \textsuperscript{112} SEC v. W.J. Howey Co., 328 U.S. 293, 298 (1946).
\end{itemize}
construction to the courts. In deciding whether challenged interests fall within the term, the court's inquiry must go beyond the transaction's form to its substance; it is in determining whether the substance of a transaction constitutes an investment contract that courts often pronounce their views on the attributes of a security.\textsuperscript{113}

Although interests alleged to constitute investment contracts have been considered by the Supreme Court a number of times,\textsuperscript{114} the relevant law has undergone little change since two Supreme Court decisions in the mid-forties. In \textit{SEC v. C.M. Joiner Leasing Corp.},\textsuperscript{115} the Securities Exchange Commission (SEC) sought to restrain the company from continuing to violate the Securities Act by selling unregistered investment contracts. Joiner assigned small leases in a large potential oil territory leased by the company. The land was worthless without the successful completion of a test well. The offer of the leases to potential assignees was promoted through reference to the test well to be drilled by the company, but the assignees were not informed that the test well was in fact being financed by the sale of the assignments. The court of appeals regarded the assignments as interests in real property and therefore not securities.\textsuperscript{116} The Supreme Court, however, found the assignments to be interests in the oil exploration enterprise since the well-drilling undertaking gave the instruments their only value and appeal. The Court reasoned that the trading "had all the evils inherent in the securities transactions which it was the aim of the Securities Act to end."\textsuperscript{117} According to the Court, securities under the Act encompass documents "in which there is common trading for specu-

\textsuperscript{113} \textit{See}, e.g., \textit{United Housing Foundation, Inc. v. Forman}, 421 U.S. 837, 851-52 (1975) (footnotes omitted):

\[\text{[W]}\text{e again must examine the substance—the economic realities of the transaction—rather than the names that may have been employed by the parties. . . . [T]he basic test for distinguishing the transaction from other commercial dealings is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others.} . . .\]

This test, in shorthand form, embodies the essential attributes that run through all of the Court's decisions defining a security.


\textsuperscript{115} \textit{320 U.S. 344 (1943)}.

\textsuperscript{116} \textit{SEC v. C.M. Joiner Leasing Corp.}, 133 F.2d 241 (5th Cir.), \textit{rev'd}, 320 U.S. 344 (1943).

\textsuperscript{117} \textit{320 U.S. at 349}.
lation or investment.”118 The general term “investment contract” was determined by the Court to reach devices, whatever their appearance, which could be proven to have been “widely offered or dealt in under terms or courses of dealing which established their character in commerce as ‘investment contracts,’ or as ‘any interest or instrument commonly known as a “security” ’.”119 In the Court’s view, the applicable test was “what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect.”120 It held that the assignments constituted securities on the basis of the actual interests involved, as well as on the basis of the promoter’s representations of the nature of the transaction.121

The Supreme Court’s discussion of “investment contract” and the test it applied in Joiner were expressed in extremely general terms. Three years later, in SEC v. W.J. Howey Co.,122 the Court’s definition of an investment contract was more specific. Another target of SEC injunctive action, Howey owned citrus groves in Florida; the company offered and sold small interests in this property, generally tied to long-term service contracts under which Howey operated the property exclusively and the property owner shared pro rata in Howey’s annual profits.123 In effect, Howey raised operating capital by “selling” portions of its holdings, and the “buyer” acquired a share in Howey’s total operation. The Court held that together the sale and offer of service contract constituted an investment contract. It acknowledged that in state courts “investment contract” had come to mean “a contract or scheme for ‘the placing of capital or laying out of money in a way intended to secure income or profit from its employment.’”124 The Supreme Court defined an “investment contract” under the Securities Act as: (1) the invest-

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118. Id. at 351.
119. Id.
120. Id. at 352-53.
121. Id. at 353.
122. 328 U.S. 293 (1946).
123. The operation was in fact highly profitable. Id. at 296. To the Court that was immaterial; where a scheme involves an investment of money in a common enterprise with profits coming solely from the efforts of others, “it is immaterial whether the enterprise is speculative or non-speculative or whether there is a sale of property with or without intrinsic value.” Id. at 301.
124. Id. at 298, quoting State v. Gopher Tire & Rubber Co., 146 Minn. 52, 56, 177 N.W. 937, 938 (1920).
ment of money, (2) in a common enterprise, (3) expecting to earn profit, (4) solely from the efforts of another employing, in part, the investment.\textsuperscript{125}

This definition has, with some modifications, remained vital.\textsuperscript{126} Under the Supreme Court's test, an investment may apparently be of something other than money; for example, it may involve the contribution of labor.\textsuperscript{127} "Profit" earned may be income, as well as capital appreciation.\textsuperscript{128} The only significant modification of the \textit{Howey} definition has been in regard to the language "solely from the efforts of others." In the last decade there has been a proliferation of franchise and pyramid investment schemes which require at least token involvement by the participant in the scheme.\textsuperscript{129} Recognizing that promoters could elude the reach of the securities acts by involving their prospective investors in an insignificant way, without permitting the investor to have any real managerial role in the

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\item\textsuperscript{125} 328 U.S. at 299.
\item\textsuperscript{126} The Supreme Court applied the \textit{Howey} test in \textit{Tcherepnin v. Knight}, 389 U.S. 332 (1967). The test was reaffirmed in \textit{United Housing Foundation, Inc. v. Forman}, 421 U.S. 837 (1975).
\item\textsuperscript{127} \textit{E.g.}, \textit{SEC v. Addison}, 194 F. Supp. 709, 722 (N.D. Tex. 1961) (oral agreement that unpaid laborers would share in profits of mining operation is a security). \textit{See also Investment Contracts, supra} note 111, at 161-62.
\item\textsuperscript{128} \textit{United Housing Foundation, Inc. v. Forman}, 421 U.S. 837, 855 (1975). Profit may be any benefit other than wages. \textit{Silver Hills Country Club v. Sobieski}, 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961). \textit{See also Investment Contracts, supra} note 111, at 164-67. For example, participation in a union pension plan has been held to constitute an investment contract in \textit{Daniel v. Teamsters Union}, 410 F. Supp. 541 (N.D.III. 1976), \textit{noted in 15 DuQ. L. Rev. 359 (1977)}. Some courts have reasoned that the criterion should not be the expectation of profit, but rather the "risk" involved—whether the investor's contribution is in substantial jeopardy, as in the promotion of a new enterprise, or the continuation of a financially insecure one. This factor has been termed variously "risk," "risk capital," and "venture capital." \textit{See, e.g.}, \textit{El Khadem v. Equity Sec. Corp.}, 494 F.2d 1224 (9th Cir.), cert. denied, 419 U.S. 900 (1974); \textit{Silver Hills Country Club v. Sobieski}, 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961); \textit{State v. Hawaii Mkt. Center, Inc.}, 52 Hawaii 642, 485 P.2d 105 (1971). \textit{See also Economic Reality, supra} note 38; \textit{Investment Contracts, supra} note 111, at 167-70.
\item\textsuperscript{129} In 1973 alone, the ubiquitous Glenn W. Turner Enterprises, Inc. and its subsidiaries, Dare to be Great, Inc. and Koscot Interplanetary, Inc., were the subject of 17 actions in ten federal districts. \textit{In re Glenn W. Turner Enterprises Litigation}, 355 F. Supp. 1402, 1403 (Jud. Pan. Multidist. Litigation 1973). The common threshold question in these actions was whether the various pyramidal promotion and sales schemes constituted investment contracts under the securities acts, since each scheme to some extent involved the "investors" in its operation. \textit{See, e.g.}, \textit{SEC v. Koscot Interplanetary, Inc.}, 497 F.2d 473 (5th Cir. 1974); \textit{SEC v. Glenn W. Turner Enterprises, Inc.}, 474 F.2d 476 (9th Cir.), cert. denied, 414 U.S. 821 (1973).
\end{enumerate}
\end{footnotesize}
venture, various courts have deemphasized the word "solely,"\textsuperscript{130} until the Supreme Court itself apparently modified its \textit{Howey} stand in \textit{United Housing Foundation, Inc. v. Forman}.\textsuperscript{131} In a footnote to its opinion the Court stated that it expressed no view on the Ninth Circuit's conclusion that a court need not construe "solely" literally.\textsuperscript{132} In the text of its opinion, however, the Court characterized the test for an investment contract as involving "profits to be derived from the entrepreneurial or managerial efforts of others,"\textsuperscript{133} suggesting, perhaps, that the efforts need not be solely those of the promoter or third persons.

The \textit{Howey} test for an investment contract was recently applied in the only case since \textit{Lehigh Valley} to consider the question of whether bank loan participations are securities, \textit{NBI Mortgage Investment Corp. v. Chemical Bank}.\textsuperscript{134} The defendant bank had moved for a partial summary judgment on the ground that the loan participation sued on was not a security. While the plaintiff relied on \textit{Lehigh Valley}, the defendant relied on the later \textit{McClure} case, arguing that there was no distinction between the initial issuance of a commercial loan by a bank supported by a note, and the later sale of a participation in the loan. The court responded that the defendant had ignored the difference between self-effort and the efforts of others.\textsuperscript{135} Since the record disclosed that the plaintiff participant had no managerial responsibility for the loan which was handled by the lead, had purchased the participation in the expectation of profits,\textsuperscript{136} and had apparently relied on the lead's managerial efforts, the court could not conclude that this loan participation was not a security.\textsuperscript{137}

\textsuperscript{130} See, e.g., SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476, 481-83 (9th Cir.), \textit{cert. denied}, 414 U.S. 821 (1973). The Ninth Circuit held that in light of the remedial nature of the legislation and Supreme Court "admonitions that the definition of securities should be a flexible one, the word 'solely' should not be read as a strict or literal limitation on the definition of an investment contract." \textit{Id.} at 482. The court observed that adherence to a strict interpretation could result in a mechanical, unduly restrictive view of what is and what is not an investment contract," which would be easy to evade and would not serve the purposes of the legislation. \textit{Id.}

\textsuperscript{131} 421 U.S. 837 (1975).

\textsuperscript{132} \textit{Id.} at 852 n.16.

\textsuperscript{133} \textit{Id.} at 852.

\textsuperscript{134} [Current Binder] \textit{CCH Fed. Sec. L. Rep.} \textsection 95, 632 (S.D.N.Y. June 25, 1976).

\textsuperscript{135} \textit{Id.} at 90,147.

\textsuperscript{136} \textit{Id.} \textit{See} note 128 and accompanying text \textit{supra}.

\textsuperscript{137} [Current Binder] \textit{CCH Fed. Sec. L. Rep.} at 90,147-48.
In view of the decision in *NBI Mortgage*, it is quite likely that a loan participation may be held to be a security by virtue of its investment nature. The participant (1) purchases its interest—its investment, (2) in an existing or contemplated loan—a common enterprise between the lead and the participant, (3) expecting profit—the return of its principal plus interest, (4) from the entrepreneurial or managerial efforts of another—the lead acquires the customer, negotiates and monitors the loan, and manages its repayment or remedies on default. Clearly, the elements of the *Howey* test are present in such a transaction. Of course, the precatory language of both the securities acts, “unless the context otherwise requires,” applies to investment contracts, and those courts which have adopted the commercial/investment dichotomy for determining the securities status of notes may extend that analysis to participations in notes. Since those courts tend to view bank loans as “commercial,” rather than “investment,” transactions *because* it is a bank’s money which is involved, it is likely that such courts would view a loan participation purchased by a bank as a commercial transaction and not a security. On the other hand, although a lending bank deals directly with the borrower, a participating bank is a step removed from the borrower, is relying on the judgment and managerial efforts of another, and consequently is in greater need of the acts’ protection.

III. ANALYSIS

A. The Commercial/Investment Dichotomy—The Rationale

Most bank loans and bank loan participations are securities within the literal wording of the securities acts, but the judicially created commercial/investment dichotomy which has evolved over the last five years frequently excludes bank loan transactions from the coverage of the securities acts; this doctrine could also be applied as a basis for a determination that a loan participation is not an investment contract. Yet the evolution and application of

138. See notes 96 & 96 and accompanying text *supra*.
139. The element of reliance on another party’s managerial efforts has been called the most important element in the *Howey* formula, and hence of primary significance in determining a “security.” *Investment Contracts, supra* note 111, at 170-74. For a court that is convinced that the commercial/investment analysis should apply to banking transactions, the element of reliance may not be as relevant. See notes 90-102 and accompanying text *supra*.
140. See notes 50-108 and accompanying text *supra*.
the dichotomy doctrine do not seem to reflect persuasive judicial reasoning. The doctrine's origin in Sanders v. John Nuveen & Co. was based on a minor inconsistency between the Securities and the Exchange Acts, whereby an instrument immune from the antifraud provisions of the latter was subject to those of the former. Nothing in the acts or their legislative histories supports the inferences subsequently drawn by the courts from that inconsistency. If Congress had actually intended to distinguish between "investment" and "commercial" notes, it could be expected to have clearly stated that intention, rather than purposefully creating a small inconsistency between two statutes, enacted a year apart, to imply such a distinction. What Congress did say clearly in each Act was that a security is "any note"; it is hardly to be supposed that Congress could not foresee and therefore did not intend the very obvious and significant impact of that wording on the many transactions involving notes.

If, as it has been frequently said, the securities acts are for the protection of investors, the courts have erred in their application of their commercial/investment analysis by too narrowly interpreting the term "investment," and concluding that bank loans are "commercial" transactions. An investment is the contribution of one's money to another in the expectation that the latter will make the money grow through his employment of it. Generally, that is precisely what occurs when a bank makes a loan to or for a business. The courts, however, have held that bank loans constitute

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142. 463 F.2d 1075 (7th Cir.), cert. denied, 409 U.S. 1009 (1972).
143. See notes 58-66 and accompanying text supra.
144. See notes 58-96 and accompanying text supra. Indeed, the court in McClure v. First Nat'l Bank, 497 F.2d 490 (5th Cir. 1974), cert. denied, 420 U.S. 930 (1975), recognized that its decision did not comport with the literal meaning of the statutes. See note 81 supra.
145. In contrast with this argument, the Third Circuit stated in Lino v. City Investing Co., 487 F.2d 689 (3d Cir. 1973), that if Congress had intended the Exchange Act to reach the note before the court it "most certainly would have given a real indication of such an intent." Id. at 695. Consistent with Lino, Professor Loss, has commented that because all definitions apply unless the context otherwise requires, "[i]t might be argued that Congress would have been more explicit if it had intended to provide a federal civil remedy in the context of the ordinary promissory note." 1 L. Loss, SECURITIES REGULATION 546 (2d ed. 1961).
146. See note 73 supra.

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
no investment unless the bank becomes an actual shareholder in the borrower,\textsuperscript{149} or the loan proceeds are used for capital expenditures.\textsuperscript{150} The former requirement fails to recognize that equity and debt may both be securities;\textsuperscript{151} the latter one ignores the fact that repayment of the loan with interest is dependent on the success of the business regardless of the use made of the loan.

The Supreme Court has noted in \textit{Forman} that the focus of the securities acts is on the capital market of the enterprise system—the procurement of capital for profit-making purposes.\textsuperscript{152} Bank loans for beginning, operating, and expanding enterprises are part of that capital market, and in extending loans, banks “invest” in the borrowers’ businesses within the common meaning of that term and as it has been employed by the Supreme Court in \textit{Howey} and \textit{Forman}. Calling such loans “commercial,” without persuasively drawing the distinction between the terms “commercial” and “investment,” does not alter their investment character. Applying the Supreme Court’s \textit{Forman} standard to bank loan participations, the solicitation of purchasers to take an overline or liquidity participation is, in substance, the solicitation of capital. The lead bank, undercapitalized or overextended, needs capital to carry on its business of lending money, and the business borrower is indirectly procuring capital from the participant.\textsuperscript{153} When a bank with surplus funds seeks to purchase participations, it is carrying on its business of placing capital for profit. When capital is placed with a business, an investment—the hallmark of a security—occurs.

\begin{itemize}
\item his money to a borrower who uses it for a price and is expected to return it one day. \textit{Id.} at 1359. Nevertheless, the court concluded that the notes at issue were not securities since the bank involved was neither an investor nor a copartner in the borrower’s business.
\item 151. \textit{See} note 128 and accompanying text \textit{supra}. \textit{See} Exchange Nat’l Bank v. Touche Ross & Co., 544 F.2d 1126, 1136 (2d Cir. 1976) (“securities laws cover debt, even supposedly gilt-edged debt, as well as equity”).
\item 152. United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 849 (1975).
\item 153. This is accurate despite the fact that the participation may well have been purchased as an accommodation to a correspondent bank. \textit{See} notes 14-19 and accompanying text \textit{supra}.
\end{itemize}
B. The Commercial/Investment Dichotomy—The Purpose

A court's purposes for applying the commercial/investment doctrine to remove some notes, particularly those involved in bank loans, from the coverage of the securities acts are as unpersuasive as the rationale of the doctrine itself. Several reasons have been expressed in support of using the analysis to remove these transactions from the acts' protection, predominantly, the floodgate philosophy. But fear of the litigious masses should not be a basis for statutory interpretation, although it may be a relevant factor to consider in a close case. Moreover, the statutes do not seem to need such narrow interpretation. A seldom articulated reason for excluding notes from the acts' coverage appears to be the courts' disbelief that Congress intended what the acts state. Yet it is hard to believe that Congress could not have intended the acts to mean what they say. In any event, the courts' "common sense" approach should not supplant a clearly stated congressional mandate; it is a familiar principle that the judiciary may not substitute its judgment for a legislative determination unless the latter has been proven to be patently arbitrary.

It has also been argued that banks do not need the protection of the securities acts, and, consequently, bank loans should not be construed as involving securities. This implies that a functional approach should be adopted by the courts, under which a security is defined as much in terms of its participants as in terms of the transaction itself. Utilizing this approach, for the securities laws to apply, a certain type of financial transaction must occur, and those particularly involved must need special protection. Attractive as

154. See notes 143-45 and accompanying text supra.
155. See Carter, Bank Loans and Bank Credit Agreements: Federal Securities Laws Status, 93 Banking L.J. 1020, 1030 (1976). The Supreme Court had held that a court must follow the letter of a statute unless it would lead to absurdity so gross as to shock the general moral or common sense. Crooks v. Harrelson, 282 U.S. 55, 59-60 (1930). The Court has since modified its standard, holding that a court may justifiably depart if the letter of the law produces a result plainly at variance with the policy of the legislation. United States v. American Trucking Ass'ns, 310 U.S. 534, 542-43 (1939). It can be argued that the proponents of the commercial/investment dichotomy have not met either test in their construction and application of the securities acts.
156. E.g., Great W. Bank & Trust v. Kotz, 532 F.2d 1252, 1261-62 (9th Cir. 1976) (Wright, J., concurring).
such an approach may be, there is no basis for it in the statutes or in the decisions rendered by the Supreme Court. On the contrary, it is the Court's pronouncement that the securities acts are aimed broadly at the capital market. The primary objective of the acts is to impose a high standard of conduct on capital seekers by requiring full and fair disclosure of all material facts involved in a sale or purchase. By requiring registration of certain securities offerings, and through the threat of private suits, the acts' objective is expected to be attained; only when these other requirements have failed are the antifraud sanctions applied. If the primary purpose of construing a business venturer's promissory note to a bank as a security is to ensure a high standard of conduct on the part of the note's maker in its search for capital, and only secondarily to protect the bank, then the securities acts should apply to bank loans regardless of the bank's need for protection. Furthermore, many cases have involved claims by the note makers against their banks; holding that the transaction does not involve a security because the bank does not need protection leaves a defrauded borrower simply unprotected. That was manifestly not the intent of Congress when it prohibited fraud in the purchase or sale of any security. Congress clearly intended to protect all parties to a transaction; determining that the note is not a security eviscerates the congressional intent. Finally, banks may also be defrauded, particularly in the broad sense of the securities acts. There is, as well, a failure by courts which adopt the premise that banks do not need the protection of the securities acts to perceive that there are widely varied levels of sophistication among different banks' managements, and that some such managements may be in great need of the protection of the acts. In any event, if banks do not need the protection of the acts, they will not avail themselves of it. The litigation floodgates will not be breached from that quarter, and Congress' protective benevo-
lence will, as to banks, be merely a solicitous but patronizing gesture.

C. The Commercial/Investment Dichotomy—"Unless the Context Otherwise Requires"

The argument that notes differ from one another is valid: in light of the Supreme Court’s view in Forman, only those notes which represent investments may be securities. This principle may be applied in specific cases through the construction of the introductory clause of the securities acts, “unless the context otherwise requires.” Placed in context, a note might not be subject to the acts where it does not represent an investment, as in the case of consumer financing. Certainly, loans to businesses are not securities per se. A valid distinction might well be drawn between a loan to a florist shop to purchase a delivery van, secured by a purchase money security interest in the van, and the financing of a fleet of trucks, similarly secured, for a hauling company. The former resembles a consumer transaction; in the latter, the bank has financed a substantial portion of the business’ capital assets.

D. Loan Participation as a Security

If the lead bank’s loan and the borrower’s note to the lead are

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164. See notes 73, 89 & 146-53 and accompanying text supra.
165. The commentators and courts considering these questions have uniformly construed the statutory “context” language as referring to the facts of the particular case to which the securities acts are being applied. There is an equally plausible argument that the clause refers to the contexts of the various sections of the securities acts. In SEC v. National Sec., Inc., 393 U.S. 453, 466 (1969), the Court observed:

The meaning of particular phrases must be determined in context... Congress itself has cautioned that the same words may take on a different coloration in different sections of the securities laws; both the 1933 and the 1934 Acts preface their lists of general definitions with the phrase “unless the context otherwise requires.” The Court then examined the meaning of “purchase or sale” in the context of § 10(b) of the Exchange Act.

166. See cases cited at note 89 and accompanying text supra. The Supreme Court’s determination in Forman that shares in a cooperative housing project were not securities was based largely on its finding that the shares were purchased to acquire living quarters, not for profit, and that the term “shares” was a misnomer, since what was involved was a rental security deposit. 421 U.S. at 851. This determination was bolstered by the fact that the shares paid no dividends and could not be transferred for profit.

investment in nature, and therefore a security under the commercial/investment doctrine, then a participation sold in a loan would be a security by virtue of the language of the acts.\textsuperscript{168} Regardless of the status of the underlying loan and note, however, a participation sold in them may be an "investment contract," and in that case it would be determined to be a security. An investment contract results when one invests in a common enterprise with the expectation of profit from another's entrepreneurial or managerial efforts.\textsuperscript{169} In a participation, the lead and participant are engaged in a common enterprise—the letting of money to a particular borrower—and the participant expects to profit. There is an investment by the participant to the extent that it seeks this profit through allowing the lead the use of its money to earn money. The nature of the loan participated in should not control the question of investment, because there is no relationship between the participant and the borrower. The participant contributes to the lead's enterprise, not the enterprise of the borrower.

The controlling question should be whether the participant expects its profit to come from the entrepreneurial or managerial efforts of the lead bank. If a participation is purchased without knowledge about the loan, such as a participation purchased in a lead's loan pool, the transaction clearly constitutes an investment contract. Otherwise, a factual determination should be made in which factors of information and control of the loan proceeds would be particularly relevant. If, for example, the participant has direct access to the borrower for gathering information before and after purchasing the participation, and shares control with the lead over administration of the loan, the participant clearly is not significantly relying on the efforts of the lead bank. If the participation agreement gives the participant no share in the administration of the loan, the participant must rely on the lead's efforts, regardless of what information may be available. Conversely, a right of control is meaningless if the participant would be unable to obtain the information necessary to make management decisions.\textsuperscript{170} When the participant has both authority over the loan and access to the infor-

\textsuperscript{168} See notes 40-108 and accompanying text \textit{supra}.
\textsuperscript{169} See notes 122-33 and accompanying text \textit{supra}.
\textsuperscript{170} Commentators have recognized the importance of shared information and control. \textit{See, e.g.}, \textit{Investment Contracts, supra} note 111, at 170-74; \textit{Coffey, supra} note 157, at 396-98.
mation necessary to effectively assist the lead in administering it, the participant is not relying on the entrepreneurial and managerial efforts of the lead within the meaning of the Howey test,171 and there is no investment contract. Absent either or both of these key elements, information and control, the participant must rely on the lead; what the participant has purchased is an investment contract, bringing it within the protection of the federal securities acts.

IV. CONCLUSION

Under a literal reading of section 2(1)172 of the Securities Act, and section 3(a)(10)173 of the Exchange Act, a bank loan participation agreement is a security as was held in Lehigh Valley Trust Co. v. Central National Bank.174 Under the current course of decisions in the federal courts that apply the "commercial/investment dichotomy," it is rather unlikely that a participation agreement would be governed by the rationale of Lehigh Valley. Despite a forceful denunciation of the dichotomy concept in Exchange National Bank v. Touche Ross & Co.,175 the approach seems firmly entrenched in a majority of the federal circuits, and intervention by Congress or the Supreme Court would be necessary to displace the analysis. With the issue clearly framed by the two most recent decisions, Great Western Bank & Trust v. Kotz,176 suggesting that bank loans and their notes presumptively are not securities,177 and Exchange National Bank, holding that they presumptively are securities,178 the question of when "any note" is a security is ripe for decision by the Supreme Court.

Whether it comes from Congress or the Court, however, clarification is required, because the commercial/investment dichotomy is legally unsound in its present application by the courts, and because it does not facilitate the purpose of the securities acts as explained by the Supreme Court in United Housing Foundation, Inc. v.

171. See notes 125-39 and accompanying text supra.
174. 409 F.2d 989 (5th Cir. 1969).
175. 544 F.2d 1126 (2d Cir. 1976).
176. 532 F.2d 1252 (9th Cir. 1976).
177. See notes 90-96 and accompanying text supra.
178. See notes 97-103 and accompanying text supra.
Forman;179 moreover, the meaning of "investment" and "investors," and the status of bank financing under the acts need to be interpreted. It should be recognized that bank loan participation agreements constitute securities when the underlying loan and note are investment in nature. Furthermore, participation agreements should constitute investment contracts, and hence securities, between lead bank and participant when the participant significantly relies on the efforts of the lead bank to obtain a return on its investment.

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