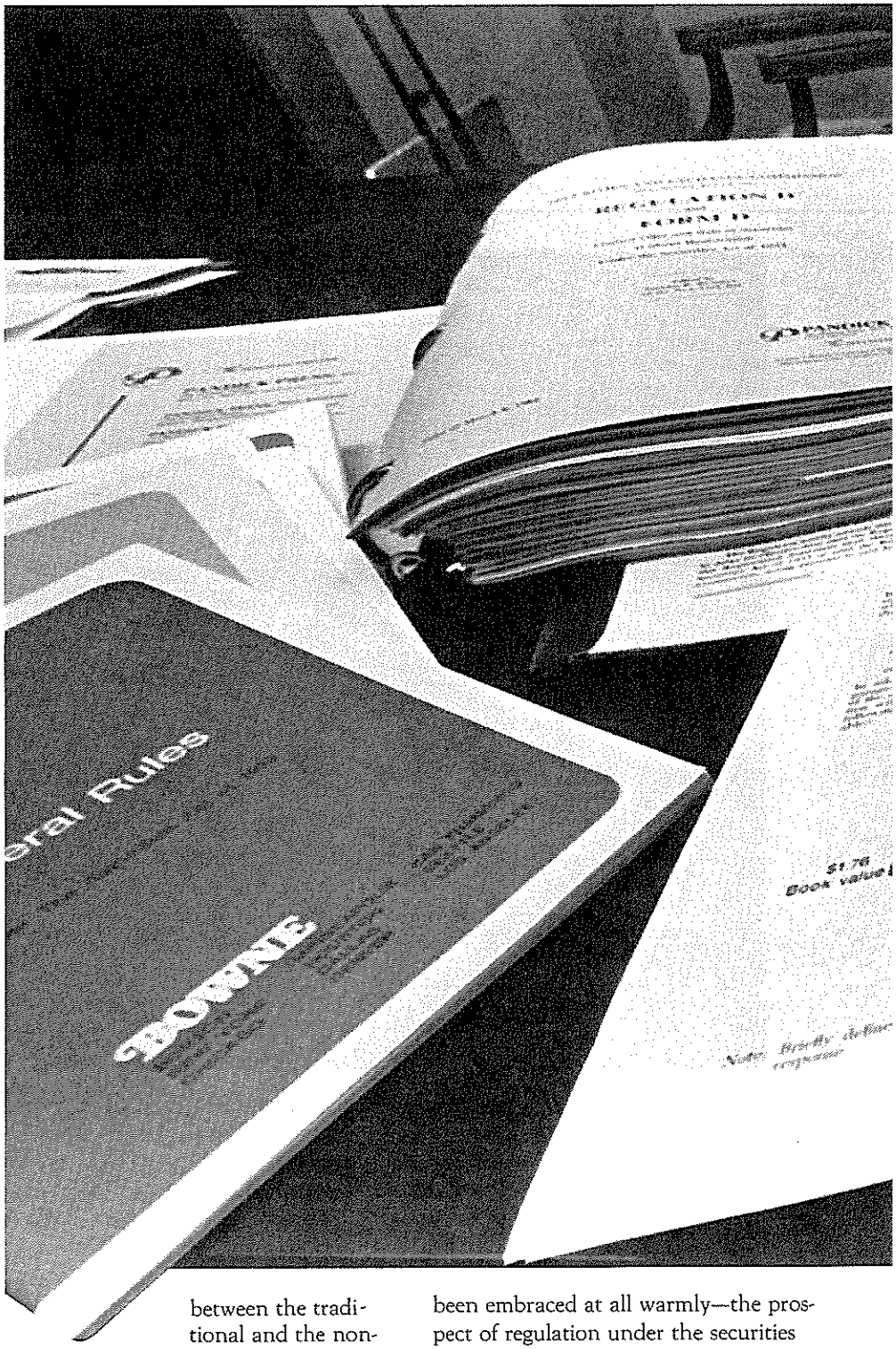
Leasing Brokers & the Securities Laws



by Michael Downey Rice, Esq.

While the courts have made no determinations in this area, certain interests in equipment lease transactions may be construed as securities under federal securities laws, thereby subjecting these interests and the lease brokers who handle them to federal regulations. This article reviews the determining factors inherent in classifying a lease as a security offering, and concludes that registration of lease brokers as broker/dealers under the Securities Exchange Act of 1934 is preferable to possible exposure to noncompliance.

For many years, equipment lessors and leasing brokers have positioned themselves as an alternative to traditional financing and investment sources. Leasing offers to users of capital a low-cost financing medium in certain circumstances, supplementing the usual sources of debt and equity capital. For investors, leasing provides yields not otherwise available in the investment marketplace.

Although the financial services offered by the leasing industry are different from those offered by traditional financial institutions, they do the same type of job, and they do it for many of the same customers. The similarities between the traditional and the non-traditional financial service houses are more important than the differences. Many leasing brokers and equipment lessors now characterize themselves as financial service companies in their corporate name and in their business approach. For leasing is not an end in itself, only a means to achieve financial goals.

While leasing brokers see themselves as having much in common with traditional financial institutions, one aspect of the financial services business has not been embraced at all warmly—the prospect of regulation under the securities laws. Leasing brokers have steadfastly denied that their activities should be regulated by this complex scheme of federal and state regulation, arguing that interests in lease transactions are not "securities." Otherwise, leasing brokers would be dealing in securities and would be required to register under section 15 of the Securities Exchange Act of 1934, submitting to SEC jurisdiction and baring their corporate soul in public filings.

Is this position correct? Suppose it is not? Many leasing companies have con-

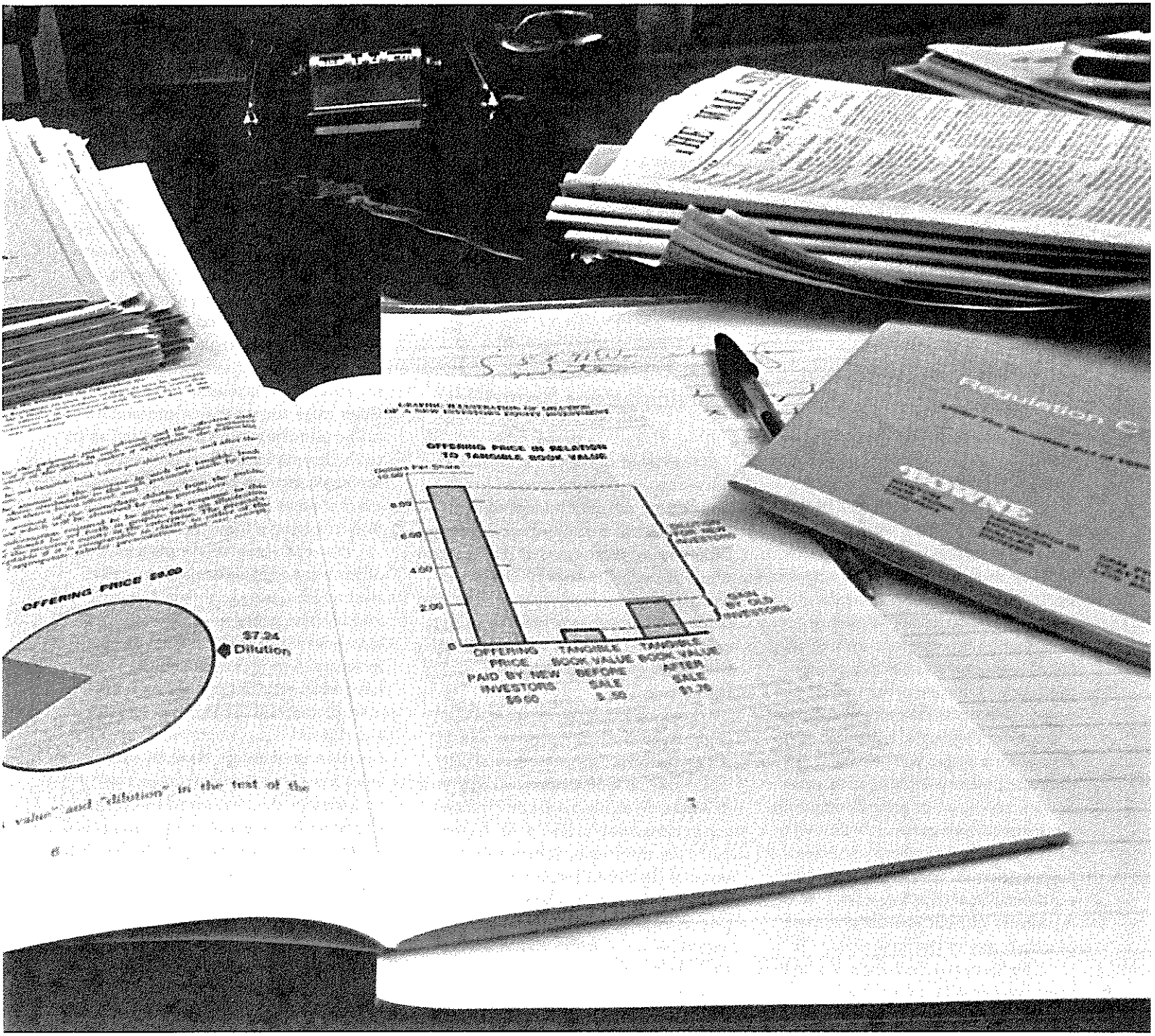


photo by Art Stein

cluded that there is enough merit in the proposition that interests in lease transactions are securities that the prudent course of action is registration under the broker-dealer registration provisions of the Securities Exchange Act of 1934, with concurrent compliance with state laws regarding dealers in securities.

What is there in a lease transaction that could be regarded as a security? Reviewing the structure of these transactions, we have a lessee who uses the equipment and undertakes to pay regular rents. The owner or owning group purchases the equipment as an investment and receives the rents as a return on the investment. The lessee is responsible for maintenance, taxes, and insurance, so the rent stream is "net" to the owners. Often the owner or owning group leverages the investment by borrowing a portion of the purchase price of the equipment and issuing notes or other obligations to a financial institution or institutions. The interests that may be regarded as securities are (a) the investment by the owner or owning group in the equipment and the interest in the lease rentals, and (b) the loan by the lender or lending group. The owner-

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ship interest is usually evidenced, not by a single instrument, but by a sheaf of papers including the lease instrument and ownership documents for the equipment, although in transactions involving a number of owners certificates evidencing the investment may be issued. The debt investment, the loan, is almost always evidenced by a note or notes.

What Is a Security?

The issue of applicability of the securities laws to these interests turns on the definition of "security." The primary definition is found in section 2 of the Securities Act of 1933: "unless the context otherwise requires—(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."[1]

The Securities Exchange Act of 1934 uses a similar definition,[2] which is usually regarded as essentially the same as the '33 Act definition.[3]

It appears from the definition that the draftsmen of the '33 Act could not distill enough of the essence of the term "security" to develop an analytic definition,[4] but nevertheless wished to include within the scope of the term everything conceivable. Undue breadth was not regarded as creating a problem of regulation of activities that did not need regulation, because specific transactions and types of securities were exempted from the registration provisions of the '33 Act in subsequent sections (sections 3 and 4).

Turning to the applicability of this definition to lease transactions, it would be difficult to conclude that debt participations, evidenced by notes, are not securities.[5] Faced with this conclusion, leasing brokers often turn to investment banking houses to place the debt in leveraged lease transactions, and some have formed subsidiaries, registered under the '34 Act, to conduct this function.

Are Equity Participations Securities?

And what of the equity participations, the ownership interests? Lease transactions are the children of the investment tax credit and accelerated depreciation, creatures that did not exist when the men of the New Deal were writing securities laws. Nevertheless, the definition of security is broadly written, and there are plenty of words in that law that could be applied to lease transactions.

Looking through the examples of securities in the definition, we come across the term "investment contract." The Supreme Court explained that term in a case involving a scheme for investing in citrus groves, *SEC v. W.J. Howey, Inc.*[6] "An investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by a nominal interest in the physical assets employed by the enterprise."[7] The Court went on to suggest that a "flexible rather than a static principle" be used, and distilled the principle somewhat: "The test is whether the scheme involves an investment of money in a common enterprise with the profits to come solely from the efforts of others."[8]

The definition in the *Howey* case has received some judicial gloss in other decisions over the years. Often these cases involved some kind of swindle, and the aggrieved parties sought to use the securities laws to obtain the relief of rescission of the transaction, or damages for fraud; more often than not, courts accepted this approach. Parsing the *Howey* definition of an investment contract, courts have held that the requirement of profits "solely from the efforts of others" was not a limitation on the term;[9] although the term "common enterprise" suggests a collaboration of a group of investors at the same level,[10] the necessary commonality could also be derived from the simple relationship of the investor with the enterprise in which the investment is made.[11] The high-water mark for expansive interpretations of the term "investment contract," as far as the leasing business is concerned, was the application of the term to the interest of a single lessor in a lease transaction involving a franchise restaurant.[12]

However, courts have stopped short of permitting the securities laws to be used as a broad federal remedy for all fraud.[13] The remedies of the securities laws have been withheld from plaintiffs in several recent cases where the courts have felt that other remedies were available, or that the draftsmen of the Securities Act did not contemplate the situation in question. Some of these cases have held that instruments or transactions that seemed to be on the statutory list were not, in fact, securities of the type contemplated by the '33 Act.

Courts have used two excuses for taking a narrow view of the definition. The "context" theory is based on the introductory phase for all of the '33 Act definitions: "unless the context otherwise requires . . . ,"[14] and holds that the definition of "security" depends on the nature of the transaction in which the interest is transferred.[15] The "commercial/investment" test concludes from the legislative history of the securities laws that the primary aim of these laws is the protection of investors, and that transactions that are primarily of a commercial rather than investment nature were not intended to be covered.[16]

Using these tests and other rationale, courts have excluded from the coverage of the term "securities" various instruments seeming to be covered by the language of the definition in the '33 Act: notes and term loans in commercial transactions,[17] shares of stock in closely-

held corporations,[18] and certificates of deposit.[19] With less analytic difficulty, the Supreme Court has withheld the remedies of the securities laws from application to shares in a cooperative apartment project[20] and interests in a pension plan.[21] Very recently, the Supreme Court has confirmed that the scope of the term has practical limits, and should not be applied to certain unique transactions negotiated "one-on-one" by the parties.[22]

Although the case law on this definition is extensive, and the literature on the point exhaustive, we cannot reach a firm conclusion as to whether an equity interest in a lease transaction is a "security" for the purpose of the securities laws, or what is more important, whether a court is likely to regard it so—for what the courts will do in the quest for justice does not always comport with the results of analytical investigation by scholars.[23] We can draw some conclusions about the outer boundaries of the question, however. If a broker brings a lessee together with a financial institution of some sophistication, and the parties work out, face-to-face and "one-on-one," a complex, specialized commercial transaction, we can be reasonably sure that the transaction is not a "security" for the purpose of the federal securities laws, and that the parties to this transaction will not allege that it is. This conclusion can be reached in the case of the equity interest in a lease, or the debt interest in a loan.

At the other extreme is an interest in a lease transaction, documented and packaged by a broker, and sold to a number of parties who take the deal as a passive investment. The promotional aspects[24] and the passive nature of the investment[25] suggest that this is the type of transaction that the securities laws were intended to reach, and reach it they will.

In between, we cannot be sure. While many transactions should not be construed as securities, we must consider carefully the effect on the business of a leasing broker if other transactions are, for some certainly have enough of the indicia of "investment contracts" to suggest that an affirmative conclusion on the point is a strong possibility.

What if Interests in Lease Transactions Are Securities?

Let us consider certain implications of the conclusion that the financial instruments in which a leasing broker deals are securities. The Securities Act of 1933 requires registration of an issue of securities, including the preparation of a prospectus, but a number of exemptions are available. Section 3 of the '33 Act exempts from registration a variety of instruments,[26] but the only exemption on this list that might be of interest to leasing brokers is that for railroad equipment obligations. The most important exemption to registration is that under section 4, covering transactions "not involving a public offering,"[27] the so-called private placement exemption. Most of the transactions in which leasing brokers participate would come under this exemption, because of the nature of the parties and the usual lack of need of the potential investors of lease transactions for the protection afforded by registration.[28] With a little care in selecting potential investors of sufficient financial strength and sophistication, a leasing broker should be able to rely on the private placement exemption, either by complying with the rules set forth for the "safe harbor" of Regulation D,[29] or by respecting the traditions of this exemption developed over the years.[30]

Utilization of the private placement exemption or another exemption from the registration provisions of the '33 Act provides relief from the need to prepare a prospectus and go through the registration process, but these exemptions do not extend to certain other provisions of the '33 Act—the section 12 rescission remedies and the section 17 prohibition against fraud; these sections cover securities whether required to be registered or not. The section 12 rescission remedies are particularly frightening to brokers—that section provides that any person offering or selling a security in violation of the registration provisions, or by means of a communication that is untrue or misleading, shall be liable for the amount paid for the security with interest thereon. The bite of these provisions can be avoided very simply, however—make no misrepresentations and commit no fraud.

Broker-Dealer Registration Requirements

Turning to the '34 Act, however, we encounter a situation that can expose a broker to liability even in the absence of fraud or misrepresentation—a technical violation of the broker-dealer registration provisions may provide remedies for an investor against the broker if a deal goes sour. If an interest in a lease transaction is construed as a "security," then the broker arranging the transaction will be regarded as a "broker" for the purposes of the '34 Act.[31] And section 15 of that act says that "it shall be unlawful for any broker . . . to make use of the mails or any means or instrumentality of interstate commerce to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security . . . unless such broker . . . is registered in accordance with subsection (b) of this section."[32]

The danger in the violation of this section is not so much that the sleuths of the SEC will seek you out and subject you to administrative sanctions,[33] but that a private litigant will allege a violation of the registration provisions and attempt to unwind a transaction and recover the investment from the broker. Section 15 does not provide for specific private remedies for failure to register as a broker, but private remedies are generally available for violation of the securities laws,[34] and section 29(b) of the '34 Act provides that "Every contract made in violation of any provision of this title . . . shall be void . . . ."[35] Courts have held that violation of the registration provisions of the securities laws by a broker can give to an investor the remedy of recovery of its investment from the broker—not just the broker's fee, but the investment.[36]

In a world where lessees are not immune to business difficulties, the prospect of recovery of a transaction investment from a broker suggests that a defensive strategy be established.

The business of some brokers may permit the good faith conclusion that transactions in "securities" are not being effected. In the limited business of bringing together parties for "one-on-one" negotiations leading to "commercial," rather than investment transactions, it may be sufficient for the broker to fasten disclaimers to its documents and correspondence, and put the parties on notice that it is not a registered broker and does not regard the transactions as coming under the purview of the securities laws. Many leasing brokers, however, have taken a more cautious (and probably more realistic) view of the business that they are in and taken the steps necessary to comply with the broker registration requirements of the '34 Act.

Registration

The conclusion of these brokers has been that the difficulty and expense of compliance is not terribly onerous, and that it is well worth the trouble to limit the exposure to private remedies for noncompliance. The principal initial steps involved are the registration application to the SEC and qualification of certain officers and employees by testing. The most expeditious way to handle the testing is membership in a self-regulatory organization, such as the National Association of Securities Dealers. Qualification under state blue-sky laws can be handled simultaneously, with little additional difficulty. The job should not be beyond the capacity of house counsel, if some extra time is available.

After the initial registration, regular compliance with SEC rules[37] requires some care, but except for the reporting requirements, little more than prudent business practice is required. The net capital rules, recently softened,[38] do not require significant capitalization when customer securities are not in the custody of the firm, and the "suitability" rule (relating to suitability of investment recommendations for a customer) and other rules for the conduct of business would cause greater headaches in a retail securities business than in a leasing brokerage.

Nevertheless, compliance with the requirements for brokers involves some diligence, and many firms feel that it is easier to police such compliance if the firm's activities are compartmentalized, with a subsidiary or division registering as a broker and conducting those activities that run the risk of being treated as effecting transactions in securities. It is not necessary to form a separate corporation; a "separately identifiable department or division" may register.[39]

Bank-affiliated leasing companies that choose to register as brokers may seem to be acting inconsistently with the Glass-Steagall Act. That act, which decreed the divorce of commercial banking from investment banking, prohibits parties that are "engaged in the business of issuing, underwriting, selling, or distributing, at wholesale or retail, or through syndicate participation, stocks, bonds, debentures, notes, or other securities . . ." from engaging at the same time in the business of receiving checking or passbook deposits.[40] Fortunately, the definition of securities in the Glass-Steagall Act receives a less broad construction than that under the '33 and '34 Acts, and interests in lease transactions are not likely to be regarded as securities under Glass-Steagall. Bank-affiliated leasing companies have registered as brokers under the '34 Act, without undue concern that the Comptroller of the Currency will regard this, alone, as stepping out of bounds. The risk in not registering is considered greater.

Thus the problem has a solution, even if it does not have an answer. It is not necessary to find the answer to the question of whether lease participations, in whatever circumstances, are securities. The risk to leasing brokers of an adverse answer to that question can be substantially mitigated, with only slight administrative burden, by registering as a broker under federal and state securities laws.

Footnotes

1. Pub. L. No. 22, ch. 38, 48 Stat. 74 (1933), section 2(1); 15 U.S.C. 77b(1).

2. Pub. L. No. 291, ch. 404, 48 Stat. 881 (1934), section 3(a)(10); 15 U.S.C. 78c(a)(10).

3. Marine Bank v. Weaver, __ U.S. __ n. 3 (1982), 50 U.S.L.W. 4285; United Housing Foundation, Inc., v. Forman, 421 U.S. 837, 847 n. 12 (1975).

4. The legal literature is full of efforts to develop an analytic definition, or at least an analytic method of determining what is and is not a security, but courts continue to construe the term on an ad hoc basis. *E.g.* Marine Bank v. Weaver, *supra* note 3. For a recent survey, see Dillport, Restoring Balance to the Definition of Security, 10 Sec. Reg. L.J. 99 (1982); *see* FitzGibbon, What is a Security—A Redefinition Based on Eligibility to Participate in Financial Markets, 64 Minn. L. Rev. 893 (1980); Lowenfels, Recent Supreme Court Decisions under the Federal Securities Laws: The Pendulum Swings, 65 Georgetown L.J. 891 (1977); Coffey, The Economic Realities of a "Security": Is There a More Meaningful Formula? 18 Case W. Res. L. Rev. 367 (1967).

5. But some courts have: *e.g.* Great Western Bank & Trust v. Kotz, 532 F. 2d 1252 (9th Cir. 1976). See Sonnenschein, Federal Securities Law Coverage of Note Transactions: The Antifraud Provisions, 35 Bus. Law. 1567 (1980).

6. 328 U.S. 293 (1946).

7. Id. at 298.

8. Id. at 299, 301.

9. SEC v. Glenn W. Turner Enterprises, 474 F. 2d 476 (9th Cir. 1973), *cert. denied*, 414 U.S. 821.

10. Milnarik v. M-S Commodities, Inc., 457 F. 2d 274 (7th Cir.), *cert. denied*, 409 U.S. 887 (1972).

11. SEC v. Glenn W. Turner Enterprises, *supra* note 9. *See* Savino v. E.F. Hutton & Co., 507 F. Supp. 1225 (S.D. N.Y. 1981).

12. Huberman v. Denny's Restaurants, Inc., 337 F. Supp. 1249 (N.D. Cal. 1972). *See* Note, The Expanding Definition of "Security": Sale Leasebacks and other Commercial Leasing Arrangements, 1972 Duke L. J. 1221.

13. Great Western Bank & Trust v. Kotz, *supra* note 5.

14. 15 U.S.C. 77b.

15. Lino v. City Investing Co., 487 F. 2d 689 (3d Cir. 1973).

16. *See generally* Dillport, *supra* note 4, at 109.

17. *See* Lizzul, The Evolution of Bank Term Lending and the Status of Term Notes Under the Federal Securities Laws, 31 Syracuse L. Rev. 959 (1980).

18. *See* Dillport, *supra* note 4, at 113, note 48.

19. Marine Bank v. Weaver, *supra* note 3.

20. United Housing Foundation, Inc. v. Forman, *supra* note 3.

21. International Brotherhood of Teamsters v. Daniel, 439 U.S. 551 (1979).

22. Marine Bank v. Weaver, *supra* note 3.

23. For a thorough analysis in the context of lease transactions, see Bedford, Equity Interests in Leveraged Leasing: Are They Securities under the Federal Securities Laws, paper delivered at the Law Forum of the American Association of Equipment Lessors, Itasca, Illinois, May 20, 1982.

24. *See* Rapp, The Role of Promotional Characteristics in Determining the Existence of a Security, 9 Sec. Reg. L. J. 26 (1981).

25. One analyst points out that an element of participation by the investor in management of the enterprise or transaction reduces the likelihood that a lease transaction would be regarded as a security. Manwell, Federal Securities Aspects of Leasing, in T. Ford & S. Odell, Creative Leveraged and Operating Leases 161 (1979).

26. Securities issued or guaranteed by government agencies, securities of banks, interests in common trust funds, industrial development bonds, interests in qualified pension and profit-sharing plans, notes maturing in nine months or less (the "commercial paper" exemption), securities of non-profit organizations, securities of savings and loan associations and certain farmers' cooperatives, securities or regulated motor carriers, railroad equipment obligations, certificates issued by a trustee or debtor in possession in a case under the Bankruptcy Code, insurance policies, securities issued in intra-state transactions, and such other securities as the SEC may decide to exempt (as under Regulation A). 15 U.S.C. 77c(a).

27. 15 U.S.C. 77d.

28. SEC v. Ralston Purina Co., 346 U.S. 119 (1953).

29. 17 C.F.R. 230.501—6; SEC Release No. 33-6339 (1980); SEC Release No. 33-6389 (1982).

30. *See* Kinderman, The Private Offering Exemption: An Examination of Its Availability under and outside Rule 146, 30 Bus. Law. 921 (1975).

31. "The term 'broker' means any person engaged in the business of effecting transactions in securities for the account of others, but does not include a bank." Securities Exchange Act of 1934, section 3(a)(4), 15 U.S.C. 78c(a)(4). *See* Murdock, Tax Sheltered Securities: Is there a Broker-Dealer in the Woodwork? 25 Hastings L. J. 518 (1974).

32. Securities Exchange Act of 1934, section 15(a)(1), 15 U.S.C. 78o(a)(1).

33. That is a hazard not to be taken lightly, even though Stanley Sporkin has been neutralized, because the SEC can put a broker out of business for a period of up to twelve months, or revoke the registration altogether. Securities Exchange Act of 1934, section 15(b)4, 15 U.S.C. 78o(b)4. In the case of firm that had been effecting transactions in securities without registering, and then sought registration, the SEC accepted the application, but immediately suspended the rights of the firm. Kauma Investment Corp.; Elden Roy Kauma, SEC Release No. 34-9743 (1972); *see also* Gregory &

Co., SEC Release No. 34-5680, 38 S.E.C. 304 (1958).

34. *E.g.* Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11 (1979).

35. Securities Exchange Act of 1934, section 29(b), 15 U.S.C. 78cc(b).

36. Eastside Church of Christ v. National Plan, Inc., 391 F. 2d 357 (5th Cir.), *cert. denied*, 393 U.S. 913 (1968); American General Insurance Co. v. Equitable General Corp., 493 F. Supp. 721 (E.D. Va. 1980). *See* Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1970).

37. 17 C.F.R. 240.15b.

38. SEC Release Nos. 34-18417—18420, 47 Fed. Reg. 3512 (1982); *see* Kibler & Molinari, The SEC's Recent Revisions to its Uniform Net Capital Rule and Customer Protection Rule, 10 Sec. Reg. L. J. 141 (1982).

39. Securities Exchange Act of 1934, section 15(a)(2)(B), 15 U.S.C. 78o(a)(2)(B).

40. Pub. L. No. 66, ch. 89, 48 Stat. 162 (1933); 12 U.S.C. 378.