Reinsurance Pools and the Federal Securities Laws

Michael L. Weissman

Partner, Aaron, Aaron, Schimberg & Hess, Chicago, IL

Follow this and additional works at: http://lawecommons.luc.edu/luclj
Part of the Securities Law Commons

Recommended Citation

Available at: http://lawecommons.luc.edu/luclj/vol9/iss2/2
Reinsurance Pools and the Federal Securities Laws

MICHAEL L. WEISSMAN*

INTRODUCTION

Reinsurance involves the transfer of a risk by agreement from one company, the "reassured," to another, the "reinsured." Although the reinsurance agreement may be structured in a number of different ways, the motive underlying the execution of the agreement is always the same. The original insurer, the so-called direct-writing company, finds itself with more liability to policyholders than it wishes to carry. It may seek to lessen its liability by persuading some other company to assume part of the burden in the event of a loss. The business relationship is a reinsurance agreement.2

Reinsurance operations are not limited to this kind of transaction—they can be far more intricate. A reinsurer, like a direct-writing company, may want to expand the volume of its business, but fears it will be over-exposed if it does. Consequently, one of the things it may do is reinsure some of the reinsurance it has written. One of the vehicles used to effectuate this reinsurance is a reinsurance pool.

Reinsurance pools generally consist of groups of companies solicited by a professional reinsurance company to participate in the "book of reinsurance" which the reinsurer assembles and manages. The professional reinsurer, which acts as manager of the pool, obtains contractual commitments of indemnification from the pool participants; these commitments are needed to support the reinsurance it has assumed. In return, the pool manager grants each participant a proportional interest in the profits of the pool. The profits are measured by the excess, if any, of premiums received over loss settlements, less the pool manager's fee.

Until recently, little consideration was given to the question


2. The domestic property and casualty reinsurance industry is large and growing rapidly. In 1958 total net reinsurance premium volume was estimated to be $977,000,000. By 1963 it had grown to $1,377,000,000 and in 1968 the volume was estimated to be $1,794,000,000. Estimated premium volume has grown from $3,332,000,000 in 1973 to $4,644,000,000 in 1975. Between 1960 and 1975, premium volume increased by 334%. See J. Zech, Annual Analysis of the United States Reinsurance Market, THE NATIONAL UNDERWRITER (December 10, 1976).
whether the participatory interests in these reinsurance pools are more than "just insurance" and possibly identifiable as securities under the federal securities laws. This article will examine the scope of the McCarran-Ferguson Act and its relationship to reinsurance pools. It will also consider whether participatory interests in the pools are securities under the Securities Act of 1933 and the Securities and Exchange Act of 1934. Special attention will be given to the Illinois Appellate Court's decision in American Mutual Reinsurance Co. v. Calvert Fire Insurance Co., the first judicial consideration of these matters.

The American Mutual Case

The plaintiff in American Mutual, American Mutual Reinsurance Company (Amreco), managed a reinsurance pool of one hundred insurance companies. Calvert executed an agreement to participate in the pool. Under the contract, Calvert's participation commenced on January 1, 1974, and could be terminated by either party on December 31st by one party giving the other six months prior written notice.

On April 22, 1974, Calvert requested retroactive termination, which Amreco refused. Amreco brought suit to compel Calvert to share the losses and premiums attributable to that period. Calvert counterclaimed, alleging that Amreco's offer and sale of the participatory interest constituted a security; it alleged that Amreco did not comply with the registration requirements of the Securities Act of 1933, and that Amreco violated rule 10b-5 of the Securities and Exchange Act of 1934 by making omissions and misrepresentations of material facts. Amreco argued that its contract with Calvert did not constitute a security, and that the McCarran-Ferguson Act precluded application of federal securities law to the reinsurance contract.

The trial court found that the agreement did not constitute a security and struck those portions of Calvert's answer and counterclaim containing those allegations. Following an interlocutory ap-

4. Id. §§ 77b et seq.
5. Id. §§ 77c et seq.
7. Quite apart from whether the Illinois Appellate Court reached the proper result is the question of whether the decision was rendered in the proper forum. See Calvert Fire Ins. Co. v. Will, 560 F.2d 792 (7th Cir. 1977).
8. 52 Ill. App. 3d at 923, 367 N.E.2d at 106.
9. Id. at 924, 367 N.E.2d at 106-07.
10. Id. at 923, 367 N.E.2d at 106.
The court first determined that the reinsurance pool constituted the “business of insurance” under the McCarran-Ferguson Act and thus was exempt from federal securities laws. Moreover, it said that the Illinois Insurance Code provided a scheme of state regulation of insurance which rendered the federal securities laws unnecessary. Finally, the court held that even without the McCarran-Ferguson Act, the federal securities acts of 1933 and 1934 are nonetheless inapplicable because insurance contracts are not “securities” within the meaning of those acts.

To fully understand the implications of these holdings, it is necessary to consider the relevant federal laws and their judicial interpretation.

The McCarran-Ferguson Act

Through 1944, insurance was not considered to be commerce and, therefore, not subject to the regulatory power of the federal government, even when conducted on an interstate basis. Until that time state regulation of insurance was exclusive. The United States Supreme Court’s opinion in United States v. South-Eastern Underwriters Association radically changed this situation.

The South-Eastern Underwriters case arose from an indictment charging 128 corporations and twenty-seven individuals with a conspiracy to fix and maintain arbitrary and non-competitive rates on fire insurance which they sold in violation of the Sherman Act. The defendants challenged the sufficiency of the indictment, alleging the federal district court lacked jurisdiction because fire insurance was not commerce. The district court dismissed the indictment. However, the Supreme Court held that interstate insurance transactions did constitute commerce, and, thus, were subject to regulation by Congress. Congress responded to this decision by passing the McCarran-Ferguson Act in 1945 (McCarran Act or Act). The Act was intended to give support to state systems which regulated and taxed “the business of insurance.”

11. Id. at 929, 367 N.E.2d at 111.
12. Id. at 927, 367 N.E.2d at 109.
13. Id.
17. Id. at 551-53.
The McCarran Act places the business of insurance beyond the purview of federal securities laws. In order for the Act to bestow such immunity, however, the business in question must be: (1) the "business of insurance" within the meaning of the Act; (2) subject to state regulation; and (3) it must be demonstrated that application of the federal securities laws would invalidate, impair, or supersede the state system of regulation.

**Legislative History**

Two important observations about the McCarran Act are pertinent. First, the stimulus for its enactment was the imminent probability that federal antitrust laws would be applied to an industry in which prices are usually established through rating bureaus sanctioned under state law. Industry members actively participated in these rating bureaus. Obviously, this could have produced an anomalous result i.e., a company engaged in conduct expressly permitted under state law thereby might have subjected itself to prosecution under federal law. Second, when advised that it had the power to regulate interstate insurance transactions, Congress made it clear that in passing the McCarran Act, it did not intend to cede to the states any greater power to regulate or tax the business of insurance than they had possessed prior to the *South-Eastern Underwriters* decision.

In its Committee Report accompanying the McCarran Act, the Report of the Committee on the Judiciary stated:

> It is not the intention of Congress in the enactment of this legislation to clothe the States with any power to regulate or tax the business of insurance beyond that which they had been held to possess prior to the decision of the Supreme Court in the *Southeastern Underwriters Association* case. Briefly, your committee is of the opinion that we should provide for the continued regulation and taxation of insurance by the States, subject always, however, to the limitations set out in the controlling decisions of the United States Supreme Court, as for instance, in *Allgeyer v. Louisiana*, . . . *St. Louis Cotton Compress Co. v. Arkansas*, . . . and *Connecticut General Insurance Co. v. Johnson*, . . . which hold, inter alia, that a State does not have the power to tax contracts of insurance or reinsurance entered into outside its jurisdiction by individuals or corporations resident or domiciled therein covering risks within the State or to regulate such transactions in any way.19

In view of the foregoing admonition, the decisions mentioned in the Committee's Report illustrate the extent to which federal regulation of the insurance business was to continue irrespective of the passage of the McCarran Act. In *Allgeyer v. Louisiana* and *St. Louis Cotton Compress Co. v. Arkansas*, state statutes purporting to regulate or tax interstate insurance transactions were held unconstitutional. More significantly, in *Connecticut General Life Insurance Co. v. Johnson*, the Supreme Court held that California could not constitutionally tax reinsurance premiums received outside California even though the reinsured risks had originally been insured in California by companies authorized to do business in that state. *Connecticut General* demonstrates that there are significant limitations upon the power of any state to regulate interstate insurance transactions. A state's attempt to regulate interstate reinsurance transactions would run afoul of *Connecticut General*. Thus, it is quite evident Congress did not intend by the McCarran Act to completely withdraw from regulation of the insurance industry. Whatever the states could not constitutionally tax or regulate remained subject to federal control.

**The Scope of the Act**

Although the McCarran Act enumerates federal statutes which may be applied to the insurance industry, it does not necessarily follow that all others are excluded. There are numerous instances where federal laws were held applicable to the activities of insurance companies despite the McCarran Act. For example, in *Zachman v. Erwin*, the Securities Act of 1933 was applied to an allegedly fraudulent sale of securities by an insurance company, notwithstanding the McCarran Act. Even in state court proceedings, the Act is not recognized as an absolute bar to the application of federal law to insurance companies. And the exemption from the federal

---

20. 165 U.S. 578 (1897).
22. 303 U.S. 77 (1938).
26. In *Langdeau v. United States*, 363 S.W.2d 327 (Tex. Civ. App. 1962), it was held that
antitrust laws under the McCarran Act is not absolute.\textsuperscript{27}

Moreover, all aspects of the business of an insurance company are not perforce "the business of insurance." A federal district court rejected this argument in American Family Life Assurance Co. v. Planned Marketing Associates.\textsuperscript{28} The American Family court perceived 1969 as the turning point in McCarran Act interpretation because in that year the Supreme Court held in SEC v. National Securities, Inc.\textsuperscript{29} that the "business of insurance" pertained only to those activities peculiar to the insurance industry.\textsuperscript{30} The American Family court noted that such acts include "the relationship between the insurer and the insured, the language and content of the insurance policy, [and] the financial reliability of an insurance company . . . ."\textsuperscript{31} According to National Securities, business activities of insurance companies which are not peculiar to the insurance industry remain subject to federal regulatory controls.\textsuperscript{32} The district court again referred to National Securities to delineate the scope of the term "the business of insurance":

The Supreme Court in National Securities suggested a number of activities in which State regulation would be paramount. These include the fixing of rates, the selling and advertising of policies, the licensing of companies and their agents, the contract of insurance, itself, the type of policy which could be issued, the policy's reliability, interpretation and enforcement, and "other activities of insurance companies relate[d] so closely to their status as reliable insurers."\textsuperscript{33}

The American Family court declined to characterize a raid by one insurance company upon the business and agents of another as the "business of insurance" under the National Securities standards. The court stated that the "activities complained of by plaintiff pertain to none of the [abovementioned] categories nor to any other category of activity that bears on the relationship between the insurance company and the policyholder."\textsuperscript{34} The activities com-


\textsuperscript{28} 389 F. Supp. 1141, 1144 (E.D. Va. 1974).

\textsuperscript{29} 393 U.S. 453 (1969).


\textsuperscript{31} Id.

\textsuperscript{32} 393 U.S. 453 (1969).

\textsuperscript{33} 389 F. Supp. at 1145.

\textsuperscript{34} Id. at 1147.
Reinsurance Pools

plained of could be employed as easily by one stock brokerage firm against another. The court concluded: "[T]he activities complained of are not part of the business of insurance. They are merely a part of business."

In American Mutual, the Illinois Appellate Court held the McCarran Act barred the application of the federal securities laws to the reinsurance pool because it constituted the "business of insurance" within the meaning of the Act. The American Mutual court failed to perceive that the activities involved, i.e., the procurement of contractual commitments of indemnification, was not peculiar to the insurance industry. Rather, it was a program of capital procurement and capital procurement is something common to all businesses, not just insurance companies.

THE FEDERAL SECURITIES LAWS

In SEC v. Howey Co., the Supreme Court established a definition of a security which encompasses items that at first glance appear to be excluded. The Supreme Court has also explicitly recognized that a contractual relationship originating in the insurance industry may have both an insurance and non-insurance component, with the latter classified as a security. Justice Brennan, concurring in SEC v. Variable Annuity Life Insurance Co., stated:

"Much bewilderment could be engendered by this case if the issue were whether the contracts in question were "really" insurance or "really" securities—one or the other. It is rather meaningless to view the problem as one of pigeonholing these contracts in one category or the other."

Moreover, it often has been stated that all elements of a transaction do not have to be "securities" in order for the entire transaction to so qualify and be subject to the federal securities laws.

35. Id.
37. 328 U.S. 293 (1946).
40. Id. at 80. In the United Benefit case, a unanimous Court affirmed Justice Brennan's approach which included the observation that "[f]irst, we do not agree with the Court of Appeals that the 'Fexible Fund' must be characterized in its entirety. Two entirely distinct promises are included in the contract . . . ." 387 U.S. at 207 (emphasis added).
41. In Jones v. Internat'l Inventors, Inc. East, 429 F. Supp. 119 (N.D. Ga. 1976), this aspect of Howey was specifically noted: Interestingly, in Howey, the touchstone of the "investment contract" therein was the existence of an optional management agreement, in the sense that the court found that the feasibility and success of the enterprise, in attracting individuals to
Section 2(1) of the Securities Act of 1933\(^\text{42}\) and section 3(a)(10) of the Securities and Exchange Act of 1934\(^\text{43}\) include an "investment contract" in the definition of a security. An investment contract, in turn, was defined by the Supreme Court in \textit{Howey} as 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 . . . ."\(^\text{44}\)

Courts are mindful of the remedial nature of federal securities laws when applying this definition to particular contracts, transactions, or schemes to determine whether or not they constitute securities. Accordingly, they adopt "the familiar canon of statutory construction that remedial legislation should be broadly construed to effectuate its purpose."\(^\text{45}\) In a search for the meaning and scope of the term "security," substance is considered rather than form, and the emphasis is on economic reality. In \textit{SEC v. C.M. Joiner Leasing Corp.},\(^\text{46}\) the Supreme Court stated:

\[\text{[T]he reach of the Act does not stop with the obvious and commonplace. Novel, uncommon, or irregular devices, whatever they appear to be, are also reached if it be proved as a matter of fact that they were widely offered or dealt in under terms or courses of dealing which established their character in commerce as}\]

\[\text{invest, and in cultivating, harvesting, and marketing the citrus product, rested upon the availability of the Howey Company's management. Thus, the fact that what the investors had purchased was nominally an interest in real estate did not preclude the court from finding that the investors had purchased a "security".} \]

\[\text{In a similar vein, the investment of money herein in consideration for a so-called "service contract" does not ipso facto preclude the applicability of the federal securities laws.} \]

\[^{42}\text{15 U.S.C. \S\S 77a et. seq. (1970).}\]
\[^{43}\text{Id. \S\S 77b et seq.}\]
\[^{44}\text{Tcherepnin v. Knight, 389 U.S. 332, 336 (1967).}\]
\[^{45}\text{320 U.S. 344 (1943).}\]
"investment contracts," or as "any interest or instrument commonly known as a security."47

Courts have thus found a myriad of diverse financial schemes to constitute securities despite the fact that, on first examination, they do not resemble the common and traditional forms of securities. Examples include promotional memberships in a yet-to-be developed country club,48 assignments of oil and gas leases with test drilling,49 live silver foxes with maintenance agreements,50 whiskey warehouse receipts,51 sale of land with a contract to develop citrus groves,52 investments in trust deeds,53 and contracts for delivery of oil by a purchaser of oil royalties.54 The Supreme Court has itself led the way in expanding the concept of a security by reversing restrictive lower court decisions five of the six times it has considered the question.55 In the only case in which the Court declined to find that securities were involved, the holding was premised on the fact that shares of stock in a state-subsidized and supervised non-

---

47. Id. at 351.
49. Buie v. United States, 420 F.2d 1207 (5th Cir. 1969); Atherton v. United States, 128 F.2d 463 (9th Cir. 1942).
53. Los Angeles Trust Deed & Mortgage Exchange v. SEC, 285 F.2d 162 (9th Cir. 1960).
profit housing cooperative had been purchased “solely to acquire subsidized low-cost living space; . . . not to invest for profit.”

Guided by the Supreme Court, lower courts have not hesitated to cut across other non-securities fields to give full content to what the Court in Tcherepnin v. Knight called the “expansive concept of security.” Under the Howey test, four elements must be present to establish an investment contract; there must be (1) an investment of money, (2) in a common enterprise, (3) with the expectation of profits, (4) solely from the efforts of others. The last two criteria clearly apply to reinsurance pools, but the first two require elaboration.

**Investment of Money**

Commentators have agreed that the Howey requirement of an investment of money does not mandate a cash contribution. Even though the Howey Court spoke in terms of money, there is no justification for excluding contributions of services or other property. Although the investor’s commitment in a securities transaction is often expressed in terms of money, actual payment of money is not required: “There must be money’s worth invested, but the consideration does not have to take the form of cash received.”

Thus the first Howey element can be satisfied by any legally suffi-

---

57. 389 U.S. 332, 338 (1967). In Tcherepnin, the savings and loan industry was under consideration. In National Ass’n of Securities Dealers, Inc. v. SEC, 420 F.2d 83 (D.C. Cir. 1969), vacated on other grounds sub nom. Investment Co. Institute v. Camp, 401 U.S. 617 (1971), it was the commercial Bank industry, over whose “commingled managing agency accounts” the SEC had taken jurisdiction. In SEC v. First American Bank & Trust Co., 481 F.2d 673 (8th Cir. 1973), the court considered it “clear” that the bank’s capital notes, certificates of investment, and passbook savings accounts were “securities.” Even the traditional test for an investment contract articulated in Howey has been relaxed in recent cases by de-emphasizing the “solely” in Howey’s reference to the investor’s expectation of profits “solely from the efforts of a promoter or a third party.” See SEC v. Koscot Interplanetary, Inc., 497 F.2d 473 (5th Cir. 1974); Miller v. Central Chinchilla Group, Inc., 494 F.2d 414 (8th Cir. 1974); SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476 (9th Cir. 1973); Mitzner v. Cardet Internat’l, Inc., 358 F. Supp. 1262 (N.D. Ill. 1973). See also SEC Sec. Act Rel. No. 5211, [1971] Fed. Sec. L. Rep. (CCH) ¶78,446.
59. See, e.g., Hannan & Thomas, The Importance of Economic Reality and Risk in Defining Federal Securities, 25 Hastings L. Rev. 219, 236 (1974), where the authors comment: The investor must supply some consideration; Howey spoke of money, presumably cash. There seems to be no analytic reason, however, to suggest that Justice Murphy purposely excluded the investor who furnishes property or services. Any distinction based upon conditions which may accompany the property or services goes to the nature of the expectation of return, or to the control exercised, not to the furnishing of valuable consideration.
sufficient consideration, as long as it is a source of capital for the venture. Several cases illustrate this point.

In *El Khadem v. Equity Securities Corp.*, the plaintiff borrowed $40,000 from Nationwide Investment Corporation, and used the proceeds of the loan to purchase mutual funds which were then pledged as collateral for the loan. The plaintiff received certain tax benefits and investment leverage from the transaction. Nationwide had the power to rehypothecate her collateral up to the amount of her indebtedness, and pledged it to secure Nationwide's own business borrowings. The Ninth Circuit confronted the question whether the “economic realities” of the plan rather than its formal structure were such that it was an “investment contract” and, therefore, a security as defined in the 1933 and 1934 Acts.

Nationwide argued that the transaction did not meet the first *Howey* test because the plaintiff had not provided Nationwide with capital. It contended that the plaintiff instead received investment capital in the form of a loan. The court flatly rejected this argument, declaring that even though the plaintiff received a loan for investment purposes, she in turn provided Nationwide with capital for its business operations. After discussing the other elements of *Howey*, the Ninth Circuit summarized its holdings and rationale as follows:

In conclusion, the Nationwide plan was an investment of risk capital. Ms. El Khadem risked financial loss in order to gain certain financial advantages. Nationwide sought the use of Ms. El Khadem's capital, in the form of credit and collateral, for its own business purposes. Ms. El Khadem's risk depended on the skill with which Nationwide conducted its business ventures and managed her collateral and promissory note. It is precisely this type of risk venture that the Securities Act of 1933 and the Securities Exchange Act of 1934 were designed to control. Therefore, we hold that the Nationwide plan was a security as defined by the Acts.

In *Hector v. Wiens*, the Ninth Circuit confirmed the *El Khadem* rationale and again held that an immediate cash investment was not necessary for a contractual arrangement to involve an investment contract. *Hector* dealt with an arrangement wherein a grain farmer executed promissory notes in order to carry out a business transaction in which a feedlot was to buy, feed and sell livestock for the farmer's account. The promissory notes were to be repaid out

---

61. 494 F.2d 1224 (9th Cir.), cert. denied, 419 U.S. 900 (1974).
62. Id. at 1228.
63. Id. at 1229-30.
64. 533 F.2d 429 (9th Cir. 1976).
of the proceeds from the sale of the livestock. The farmer contended that the arrangement involved the sale of an investment contract. The Ninth Circuit agreed, holding that "an 'investment of money' means only that the investor must commit his assets to the enterprise in such a manner as to subject himself to financial loss."565

It is commonly accepted, therefore, that an immediate cash outlay is not necessary to find that a contractual arrangement involves an "investment contract." Howey's first prerequisite requires "[a]n investment of money, or tender of initial value."566 In the reinsurance situation, each pool participant "invests" with the pool manager in that the members supply the pool with investment capital in the form of contractual commitments to indemnify the manager. These commitments enable the pool manager to enter into the various contracts which are expected to produce a profit for the pool. Moreover, the indemnity agreements subject the assets of the pool participants to the risk of financial loss. Thus, the first Howey requirement for an investment contract is satisfied.67

65. Id. at 432.
66. In re Bestline Products Securities, 412 F. Supp. 732, 738 (S.D. Fla. 1976)(emphasis added). Decisions reaching the same conclusion include: SEC v. Continental Commodities Corp., 497 F.2d 516 (5th Cir. 1974)(forebearance from bringing legal action given in exchange for a note constituted the purchase and sale of a security); United States v. Riedel, 126 F.2d 81 (7th Cir. 1942)(trust certificate issued in consideration of the surrender of stock certificates was a security)("In other words, one may sell a security and be paid therefor in cash, or in another security, or in any other object of value such as a house, horse, etc." Id. at 83); SEC v. Addison, 194 F. Supp. 709 (N.D. Tex. 1961)(oral agreements between the defendants and various persons to the effect that the persons were employed on a non-salary basis in exchange for participation in the company's profits were investment contracts and the performance of the services constituted the giving of "value"); SEC v. Bourbon Sales Corp., 47 F. Supp. 70 (W.D. Ky. 1942) (sales of whiskey warehouse receipts are securities). Moreover, it has been repeatedly held that soliciting the consents of security holders to substantial alterations in the terms of their securities constitutes an "offer" and "sale" of a security. See 1 Loss, SECURITIES REGULATION 513-14 (2d ed. 1961) and cases cited therein. See also Ingenito v. Bermec Corp., 376 F. Supp. 1154 (S.D.N.Y. 1974)(substitution of cattle maintenance contracts with reduced monthly charges was sale of a security).

67. There is abundant authority warning against too narrow a reading of the Howey standards. In SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 480 (5th Cir. 1974), the Fifth Circuit reasoned that

a literal application of the Howey test would frustrate the remedial purposes of the Act . . . The Supreme Court admonished against such a rigid and quixotic application, noting . . . that in searching for the meaning and scope of the word security, form should be disregarded for substance, and proclaiming . . . that "[t]he statutory policy of affording broad protection to investors is not to be thwarted by unrealistic and irrelevant formulae." It would be anomalous to maintain that the Court in Howey intended to formulate the type of intractable rule which it had decried. The admitted salutary purpose of the Acts can only be safeguarded by a functional approach to the Howey test.

In Dasho v. Susquehanna Corp., 380 F.2d 262, 266-67 (7th Cir.), cert. denied, 389 U. S. 977 (1967), the Seventh Circuit said that the broad definition of the terms "purchase" and "sale"
A Common Enterprise

The second Howey requirement is investment in a "common enterprise," which is satisfied by the reinsurance pool. The pools consist of several insurance companies, each entitled to receive an agreed percentage of profits or to suffer the same percentage of the losses. Thus, all participants earn profits or suffer losses from a common revenue pool. The pool exhibits the kind of commonality that is essential to a finding that the particular instrument issued to a group of investors is a security.

This point can best be illustrated by comparing the Seventh Circuit's decision in Milnarik v. M-S Commodities Inc.68 with the Supreme Court's holdings in Tcherepnin v. Knight69 and Investment Company Institute v. Camp.70 In Milnarik, the plaintiffs sought to rescind their individual discretionary commodity trading accounts with their broker. Although it was clear that plaintiffs had invested their funds with the broker expecting that profits would be earned solely as a result of his efforts, the court concluded that no security was involved. The Seventh Circuit held that there was no common enterprise since the success or failure of any one of the individual trading accounts would have no impact on the success or failure of any other trading account.

In Tcherepnin, however, the Supreme Court found that a common enterprise was involved. The Tcherepnin investors could expect a return on their investment only if the lending institution showed a profit. The amount of dividends any investor could receive was tied directly to the amount of profits the institution made from year to year. Therefore, the crucial distinction from Milnarik is that in Tcherepnin the investment decisions of the managers affected each participant.

In Investment Company Institute v. Camp,71 the Court considered a plan under which certain customers of a bank were offered a collective investment service. Under the plan, the bank's customer tendered not less than $10,000 nor more than $500,000 and executed an authorization making the bank the customer's managing agent. Each customer's investment was added to a common trust fund. A

---

68. 457 F.2d 274 (7th Cir. 1972).
70. 401 U.S. 617 (1971).
71. Id.
written acknowledgement of participation was issued which expressed in “units of participation” the customer’s proportionate interest in the assets of the common trust fund. The Supreme Court held that the bank was involved in issuing and selling securities in violation of the Glass-Steagall Banking Act of 1933.\(^2\) Obviously, the pooling of the participants’ capital gave the investment fund the commonality requisite to a finding that securities had been offered and sold.

Reinsurance pools square with the *Tcherepnin* and *Investment Company Institute* decisions because each participant in the pool earns profits or suffers losses in common with other participants. As in *Tcherepnin*, the investment decisions of the pool manager affect every pool member. The commonality test of *Howey* is met.

*Expectation of Profits and Efforts of Others*

The final two *Howey* elements are clearly present in reinsurance pools. First, the investor must expect profits from the common enterprise. With reinsurance pools, the participants naturally anticipate that the pool manager’s skill and expertise will make the pool a profitable investment. Second, *Howey* requires that the anticipated profits be generated solely from the efforts of persons other than the investor. Although the recent trend is to modify this rule to allow some effort by the investor,\(^3\) reinsurance pools satisfy the stricter requirement. Participation is solicited on the basis that members can rely on the expertise of the pool manager.

Thus, a participation in a reinsurance pool is a security under the *Howey* test, and is therefore subject to federal securities laws. Whatever rationale exists against inclusion of these participations in the federal definition must rest on peripheral grounds. Some of these will be considered below.

**JUDGING A REINSURANCE POOL**

In *SEC v. C.M. Joiner Leasing Corp.*,\(^7\) the Supreme Court, in construing the Securities Act of 1933, stated that, “In the enforcement of an Act such as this it is not inappropriate that promoters’ offerings be judged as being what they were represented to be.”\(^5\) This approach to the identification of a security is suggested by the

---

74. 320 U.S. 344 (1943).
75. Id. at 353 (emphasis added).
statute itself. Section 2(1) of the Securities Act of 1933 refers to "any interest or instrument commonly known as a 'security.'"76 Thus the characterization of an interest as a security possibly could be avoided, depending on its representation by promoters. However, this test cuts both ways.

Thus, Mitzner v. Cardet International Inc.77 held that a franchise agreement was a security under both the Securities Act of 193378 and the Illinois Securities Act of 1953.79 The court was influenced by the offeror's characterization of the offered instrument as an investment, noting the repeated use of the word in the advertising brochure.

Reinsurance agreements are not inapposite. In American Mutual, for example, the pool manager and sponsor repeatedly and consistently characterized a participation in the pool as an investment which would prove sound, profitable, and very rewarding. It did not represent the transaction as merely a reinsurance contract. Nevertheless, the American Mutual court gave no weight to Amreco's characterization of the participations.80 Under the Joiner rationale, the court's consideration of Amreco's label for the instrumentalities would have been an appropriate factor in deciding whether an investment contract had been issued to the defendant.

THE "SOPHISTICATED INVESTOR" RATIONALE

An argument can be made that pool participants are "sophisticated investors" and should be capable of looking out for themselves. Thus, they would not require the protection of federal securities laws. But this "sophisticated investor" rationale is without a sound basis in law.

In Hill York Corp. v. American International Franchises, Inc.,81 the Fifth Circuit, after recognizing that the Securities Act of 1933 is remedial legislation entitled to a broad construction with the result that exemptions must be viewed narrowly, dismissed the "sophisticated investor" defense as follows:

The defendants rely most strongly on the fact that the offering was made only to sophisticated businessmen and lawyers and not the average man in the street. Although this evidence is certainly favorable to the defendants, the level of sophistication will not carry

79. ILL. REV. STAT. ch. 121 1/2, § 137.1 et seq. (1970).
80. 52 Ill. App. 3d 922, 930, 367 N.E.2d 104, 111.
81. 448 F.2d 680 (5th Cir. 1971).
the point. In this context, the relationship between the promoters and the purchasers and the "access to the kind of information which registration would disclose" become highly relevant factors. Obviously if the plaintiffs did not possess the information requisite for a registration statement, they could not bring their sophisticated knowledge of business affairs to bear in deciding whether or not to invest in this franchise sales center.82

Hence, even if pool participants are "sophisticated," this would not eliminate the sponsor's duty to comply with the Securities Act of 1933 by furnishing participants with information sufficient to make a fully informed investment decision. The arguments apply with equal force to the Securities and Exchange Act of 1934.83

PRESENT INDUSTRY PRACTICE

Currently, managers of reinsurance pools do not comply with the federal securities laws. Pool managers, however, cannot take refuge behind the fact that compliance is not customary in the reinsurance industry. In Chasins v. Smith, Barney & Co.,84 the defendant claimed that it did not violate the federal securities laws because it had simply adhered to the customary practice of the industry. The court rejected this argument. It held that "even where a defendant is successful in showing that it has followed a customary course in the industry, the first litigation of such a practice is a proper occasion for its outlawry if it is in fact in violation."85 Thus, the reinsurance industry cannot evade securities regulation merely by arguing that it is not the practice in the industry to comply.

OTHER DISTINCTIONS

There are other distinctions capable of placing reinsurance participations outside the scope of Howey, but most fall on close analysis. It could be argued, for example, that unlike the Tcherepnin invest-

82. Id. at 690. See also Haber v. Bordas [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶95,330 (S.D.N.Y. 1975) ("Sophistication of the offerees involved is not a substitute for 'access to the kind of information which a registration statement would disclose'."). In Andrews v. Blue, 489 F.2d 367 (10th Cir. 1973), the court commented: "The statute is intended to promote full disclosure to every investor regardless of his particular business background . . . . [SEC v.] Ralston Purina [346 U.S. 119 (1953)] rejects the idea that an exemption exists based only on the individual sophistication of the offeree and without regard to his actual knowledge concerning the issuer." Id. at 373-74.

83. See SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969), where the Second Circuit held that, in reference to the 1934 Act, even "speculators and chartists . . . are . . . 'reasonable' investors entitled to the same legal protection afforded conservative traders."

84. 438 F.2d 1167 (2d Cir. 1970).

85. Id. at 1171.
tors, a pool participant has no right to receive dividends contingent upon an apportionment of profits. In addition, the participatory interest is neither negotiable nor subject to hypothecation.

The first distinction is one of nomenclature rather than substance. As to the second, there is authority that non-negotiability does not preclude a finding that the securities acts are inapplicable. The Ninth Circuit in *El Khadem* considered a non-negotiable promissory note to be an investment contract. Furthermore, the promissory note in *El Khadem* was not subject to pledge or hypothecation, since it had already been hypothecated by the issuer of the security. Nevertheless, the court held the federal security laws were applicable.

Another distinction between generally recognized securities and pool participations is that pool participations carry no voting rights. Yet in both *Howey* and *Joiner* the Supreme Court considered instruments to be securities despite the absence of voting privileges.

Another possible difference is that the contract at issue in the reinsurance case does not appreciate in value. But many non-convertible debt instruments, sold to investors primarily for income, have little likelihood of capital appreciation. Nonetheless, they are considered to be securities.

**Analogy to Bank Loan Participations**

The legal structure of bank loan participations bears striking resemblance to that of reinsurance participations. Therefore, this line of authority is pertinent to an understanding of whether the federal securities law should apply in the reinsurance pool situation.

In *American Mutual*, it was established that the pool manager organized the pool each year with participants from the United States and Canada. Contractual commitments were collected from the various participants and a participation agreement was signed by each of them. The special expertise of the pool manager was used to assemble and manage a book of reinsurance for the common account of all members of the pool. The managing company retained 4 1/2% of the premiums collected for its managerial services. The pool participants relied upon the managing company's widely promoted skill and expertise in the selection and management of the book of reinsurance to make the pool successful and their investments profitable.

---

Bank loan participations have many similar characteristics. They have been described as follows:

In a loan participation . . . the lead bank is not a conduit, but is the promoter of the entire lending scheme. It attracts the capital needed to support the actual loan, and superintends the lending arrangement with the borrower. Practical exigencies dictate that the participants rely heavily on the lead bank's judgment, collateral information, and procedures necessary to protect the credit involved in the participated loan. The lead is the focal point in the entire lending structure; consequently, the participants invest in the judgment and skill of the lead bank in making the enterprise a success.88

Thus, in a bank loan participation, only the lead bank is named as the secured party in the loan agreement and as the payee in the notes evidencing the borrower's obligation.89 In the reinsurance pool arrangement, only the pool manager is a party to the various reinsurance agreements made with the companies whose policies are reinsured by the pool. The rights of a bank participating in a loan are formalized in a document called a participation certificate.90 In the reinsurance pool, the pool participant's rights are evidenced by a document called a participating agreement. A bank acquiring an interest in a participation loan receives an undivided share of the loan as well as an undivided share in the collateral securing the loan.91 In similar fashion, the insurer acquiring an interest in the reinsurance pool generally obtains an undivided share of the entire book of reinsurance which the pool manager has procured for the benefit of the members of the pool.

Given these meaningful similarities, the resolution of whether a bank loan participation is a security under federal securities laws has a direct bearing on reinsurance pools. In Lehigh Valley Trust Co. v. Central National Bank of Jacksonville,92 the plaintiff bank bought a participating interest in a loan originated by the defendant bank. When the loan became uncollectable, the plaintiff sued for damages on the grounds that the defendant, in selling the loan participation, had issued a security and failed to make a full disclosure of all material facts, thereby violating rule 10b-5 under the Securities and Exchange Act of 1934. On appeal, the defendant

89. Id. at 808.
90. Id.
91. Id. at 807-08.
92. 409 F. 2d 989 (5th Cir. 1969).
argued that no security was involved. The Fifth Circuit prefaced its
discussion by distinguishing between the loan participation and the
underlying note evidencing the loan. The court found that the loan
participation was “clearly within the statutory definition of a secu-

3 rity . . . . ” In reaching this conclusion the court relied on the
Supreme Court’s policy of giving a broad construction to the definition of a security and its generally “expansive construction” of the
anti-fraud provisions of federal securities laws.

The holding in Lehigh Valley is now well accepted in the Ameri-
can banking industry. It is only a matter of time before the same
principles will probably be applied to reinsurance pools.

CONCURRENT REGULATION

Perhaps the most glaring misconception in the American Mutual
opinion was the court’s finding that participations in reinsurance
pools, like insurance policies, need not be subjected to the federal
and state securities laws because other agencies regulate some as-
pects of the pool manager’s business. A recent decision by the
Fourth Circuit illustrates the fallacies in this holding.

In Burrus, Cootes & Burrus v. MacKethan, the court found that
investment certificates issued by an industrial loan corporation
were not securities within the meaning of the Securities and Ex-
change Act of 1934. One of the principal reasons which the court
advanced for its holding was the possibility of an overlap in jurisdic-
tion. It noted that if certificates of deposit were treated as securities, SEC regulations would be superimposed upon an existing system of state and federal regulation of the banking industry. Finding no
indication that Congress intended this result, the court noted that
the overlap might cause inter-agency conflict. As further justifica-

93. Id. at 992.
94. See Isaac, Loan Participation and the Securities Laws, 58 J. of Commercial Banking
Lending 50 (1975). The author comments:
Although many people are surprised by this fact, it is pretty well established that
loan participations are securities . . . . In the only reported case directly in point,
Lehigh Valley Trust Co. v. Central National Bank of Jacksonville, . . . the 5th
Circuit Court of Appeals held that a loan participation agreement between banks
was a security within the meaning of the Federal securities laws.
Id. at 52 (citation omitted).
95. Since the McCarran Act has no bearing on state Blue Sky laws, the court should have
considered whether a security as defined under state law had been issued. However, the
American Mutual court dismissed the applicability of the Blue Sky laws by referring to
concurrent regulation by other state authorities, saying that this was also a rationale for
finding the federal securities laws to be inapplicable. 52 Ill. App. 3d 922, 927, 367 N.E.2d 104,
109 (1st Dist. 1977).
96. 537 F.2d 1262 (4th Cir. 1976).
tion, it cited the SEC's lack of expertise in the field of banking.77

The Securities and Exchange Commission obtained leave of court to file a memorandum as amicus curiae in support of a petition for rehearing. In its memorandum, the Commission noted that under sections 3(a)(2) and 3(a)(5) of the Securities Act of 1933,98 securities issued by a banking institution which were subject to state and federal regulation were exempt from the registration requirements of the federal securities laws, but not necessarily exempt from the antifraud provisions.99

Turning to the question of whether or not the possibility of an overlap of the federal securities laws with state and federal banking regulations was a proper basis for the court's ruling, the Commission said the overlap concern "cannot itself justify a restrictive and incorrect reading of the statutes . . . ."100 The SEC's principal argument was that

[w]hile the existence of state or federal bank regulations may result in an exemption for bank securities from the Securities Act's registration provisions, and may result in the administration by bank authorities of certain regulatory provisions of the Securities Exchange Act, it has no bearing on whether an instrument is a security and therefore subject to the antifraud protections, which were intended to be available to all investors, even those who invest in bank-type securities.101

Furthermore, the SEC disagreed with the Burrus court's effort to distinguish Tcherepnin v. Knight,102 a case in which the Supreme Court found that withdrawable capital shares were securities. The Burrus court found the situations distinguishable because the withdrawable shares had characteristics of equity securities while the Burrus securities were debt securities.103 The SEC argued that this distinction was irrelevant, and that the overlapping jurisdictional problem, if it existed at all, was the same in Burrus as in Tcherepnin, because the issuers in both cases were subject to state regulation.104

97. Id. at 1265.
101. Id.
The SEC's memorandum struck a responsive chord. Rehearing was granted, and subsequently the court wholly withdrew its earlier opinion and expressly declared that its earlier ruling that the certificates were not securities was moot. The foregoing discussion indicates that the possibility of overlapping jurisdiction is not of itself a sufficient reason to hold that the federal securities laws are inapplicable to reinsurance pools.

The SEC's emphasis on Tcherepnin was well founded. In Tcherepnin, the Seventh Circuit failed to consider the Howey test. The Supreme Court held this was erroneous and analyzed the withdrawable capital shares using the Howey criteria. Despite extensive regulation of the business of the savings and loan association under the Illinois Savings and Loan Act, the Tcherepnin Court held the withdrawable capital shares were securities: "While Illinois law gives legal form to the withdrawable capital shares held by the petitioners, federal law must govern whether shares having such legal form constitute securities under the Securities Exchange Act."

In SEC v. Variable Annuity Life Insurance Co., the Supreme Court considered whether the annuities issued by an insurance company were subject to the federal securities laws. Justice Douglas specifically observed that "[r]espondents are regulated under the insurance law of the District of Columbia and several other States," but nonetheless found that the federal securities laws should apply, saying:

We start with a reluctance to disturb the state regulatory schemes that are in actual effect, either by displacing them or by superimposing federal requirements on transactions that are tailored to meet state requirements. When the States speak in the field of "insurance," they speak with the authority of a long tradition. For the regulation of "insurance" though within the ambit of federal power . . . has traditionally been under the control of the States. We deal, however, with federal statutes where the words "insurance" and "annuity" are federal terms . . . . [H]ow the States may have ruled is not decisive. For, as we have said, the meaning of "insurance" and "annuity" under these Federal Acts is a federal question.

---

105. 545 F.2d 1388 (4th Cir. 1976). The Fourth Circuit affirmed the result it had reached but on grounds entirely unrelated to the securities laws.
106. 389 U.S. at 339 n.21.
108. 389 U.S. at 337-38.
110. Id. at 67.
111. Id. at 68-69 (emphasis added)(citations omitted).
Thus, regulation by another state or federal agency does not end the inquiry. Other state or federal regulation will not, per se, take any particular contract, certificate or instrumentality outside the reach of the securities laws. In both Variable Annuity and Tcherepnin the Supreme Court expressly acknowledged the existence of state regulation but, nevertheless, decided whether a particular instrumentality was a security under the Howey test.

CONCLUSION

The reinsurance industry is expanding rapidly and reinsurance pools are an important part of that industry. Whether reinsurance pool participations come within the federal and state securities laws is a question which deserves careful consideration. The Illinois Appellate Court in American Mutual Reinsurance Co. v. Calvert Fire Insurance Co. did not address this issue in a satisfactory manner. The court’s opinion is contrary to the weight of authority concerning the McCarran-Ferguson Act, and the holding cannot be reconciled with that of the Supreme Court in SEC v. National Securities. At a minimum, the court should have analyzed the reinsurance contract in light of the Howey criteria.

It is anticipated that other courts confronted with comparable cases in the future will look beyond the fact that the insurance industry is involved, and recognize these participatory interests are securities. Given the questions left unanswered by American Mutual, it seems safe to predict that more will be heard on this subject in the future.

113. See text accompanying notes 19-36 supra.