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# Originating Lender Bank Liability to Participants in the B-Tranche of a Leveraged Loan: Mending the Gap between Federal Banking and Federal Securities Regulation

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# **Originating Lender Bank Liability to Participants in the B-Tranche of a Leveraged Loan: Mending the Gap Between Federal Banking and Federal Securities Regulation**

## I. INTRODUCTION

Traditionally, banks loaned money to borrowers with whom they had a direct relationship. This direct relationship gave banks direct access to the borrower, its collateral, and its current financial information. Thus, when these borrowers defaulted on a loan, the lending banks could seek recourse against the borrower to recover their losses. In recent years, however, banks have explored non-traditional methods of lending. One example of such non-traditional lending is loan participation. In a loan participation program, the originating bank lends money to a borrower, but then sells interests in the underlying loan to third party participants. Loan participation programs can be simple or complex. The originating lender may sell participations in a single-tiered loan, or it may divide a large loan facility into an A-tranche<sup>1</sup> and a longer B-tranche, and sell participations with differing maturities in the two tranches.

Unlike the relationship between the bank and borrower in a traditional loan, a third-party participant in a loan participation does not have a direct relationship with the borrower and cannot take recourse against the borrower to recover its losses should the borrower default. Thus, in an effort to minimize their losses, some participants have sought to recoup their losses from the originating bank. Such participants try to prove (1) that they purchased a “security” rather than a “traditional loan participation” from the originating lender bank, and (2) that the originating bank made materially false or misleading statements about the borrower’s credit condition. The participant’s motive is to solicit the protections of the federal securities laws. Under the securities laws, if the participant proves that the loan participation is a security, and that the originating bank made false or misleading statements, then the participant may rescind the participation agreement under Section 12(2) of the Securities Act of 1933<sup>2</sup> or receive damages from the originating bank under Section

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1. “Tranches” are portions of a loan.

2. Securities Act of 1933, ch. 38, title I, § 1, 15 U.S.C. §§ 77a-77aa (1994) [hereinafter 1933 Act].

10b(5) of the Securities Exchange Act of 1934.<sup>3</sup> In the recent decision of *Banco Espanol de Credito v. Security Pacific National Bank*, the United States Court of Appeals for the Second Circuit rejected the assertion that a loan participation note is a security.<sup>4</sup>

This Comment will discuss the sale of participations in the B-tranche of a leveraged loan to institutional investors. Leveraged lending is the practice of providing credit to a firm with a low credit rating and a high debt-to-equity ratio.<sup>5</sup> In order to minimize its exposure to these risky borrowers, a bank will underwrite a leveraged loan and then divide the loan into “tranches”—portions with differing maturity dates.<sup>6</sup> The tranches are given letter designations based on increasing maturities.<sup>7</sup> Principal payments are made on the tranche with the shortest maturity (the A-tranche) first.<sup>8</sup> Once that tranche is paid off, principal payments on the tranche with the next shortest maturity begin. Thus, the longer tranches do not receive principal payments until the shorter maturities are paid in full or retired. Most commonly, a leveraged loan will be divided into an A-tranche loan and a B-tranche loan.<sup>9</sup> The A-tranche has a relatively short maturity

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3. Securities Exchange Act of 1934, ch. 404, title I, 15 U.S.C. §§ 78a-78I-1 (1994) [hereinafter 1934 Act].

4. 973 F.2d 51 (2d Cir. 1992). In *Reves v. Ernst & Young*, 494 U.S. 56 (1990), the Supreme Court resolved circuit conflict over which test should be applied to determine if a note is a security by adopting the family resemblance test. *Banco Espanol* is the first post-*Reves* decision to address whether a loan participation is a security under the family resemblance test. See e.g., Richard Roberts & Randall W. Quinn, *Financial Services Regulation; A Mid Decade Review: Essay: Leveling the Playing Field: The Need For Investor Protection for Bank Sales of Loan Participations*, 63 FORDHAM L. REV. 2115, 2127 (1995) (noting that *Banco Espanol* is the only court of appeals decision addressing loan notes as securities).

5. See *Leveraged Loans Jump*, INVESTOR'S BUS. DAILY, Nov. 7, 1996, at B1 (describing leveraged lending as “bank lending to lower-rated companies”).

6. See Lyn Perlmut, *Option B for Highly Leveraged Borrowers*, 27 INSTITUTIONAL INVESTOR 229 (1993) (discussing how originating banks minimize their exposure to risky corporations by arranging B-tranche loans that can be sold to prime rate funds, insurance companies, and other banks). Although commercial banks purchase B-Tranche participations, they typically do so through their trading and investment departments. See *Banco Espanol*, 973 F.2d at 57 (Oakes, C.J. dissenting) (noting that although commercial banks were involved in the loan participation program, most of the commercial banks purchased participations through their investment and trading departments).

7. See Daniel Dunaief, *Finding Profit in the Longer-Term Parts of Loans*, AM. BANKER, Dec. 20, 1994, at 24 [hereinafter Dunaief, *Finding Profit*].

8. See Joseph V. Rizzi, *Comment: Leveraged Lending Should Remain Strong, But Watch Out for Slipping Credit Quality*, AM. BANKER, June 9, 1995, at 22 (noting that the lower tranches of a multi-tranche loan typically begin amortizing after the bank-held loans retire).

9. See *LPC-Siligan Corp B Term Loan To Grow by \$125 Mln*, REUTERS FIN. SERV., June 10, 1996 [hereinafter *LPC-Siligan Corp*] (describing use of a B-tranche in a \$675 million credit backing of Siligan Corp in order to take advantage of liquidity in the secon-

(commonly, five years), and like a traditional bank loan, typically requires repayment of a substantial amount of principal prior to maturity.<sup>10</sup> The B-tranche has a longer maturity than its A-tranche counterpart, and the borrower is permitted to repay all of the principal at maturity (bullet amortization), or beginning in the last two years of maturity (back-ended amortization).<sup>11</sup> Thus, the lender may not receive payments on the B-tranche for an extended period of time. In order to avoid lengthy exposure to default and interest rate risks, the originating bank sells participations in the B-tranche to nonbank institutions, mutual funds, prime rate mutual funds,<sup>12</sup> and pension funds.<sup>13</sup>

This Comment will consider the likelihood that loan notes evidencing participation interests in the B-tranche of a leveraged loan participation would be deemed securities subject to the federal securities laws' investor protections against nondisclosure, misrepresentation, and fraud.<sup>14</sup> Part II describes the decline of traditional banking activities during the 1980s, and examines the development of variations on the traditional bank loan participation scheme as designed by commercial banks to respond to increasing competition in the financial markets.<sup>15</sup> Part III discusses commercial banks' increasing involvement in leveraged lending, and describes

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dary lending market). Bankers have also begun to offer "C" and "D" tranches with even longer maturities and richer pricing than B-tranche loans. See *LPC-High-Yield "B" Loans Soar As Pricing Falls*, REUTERS FIN. SERV., June 4, 1996 [hereinafter *LPC-High-Yield*].

10. See James S. Altschul, *Junk Bonds With Ballast*, CFO: THE MAGAZINE FOR SENIOR FINANCIAL EXECUTIVES, Nov. 1993, at 61, 62 (noting that a traditional seven year bank facility might require repayment of a minimum of 3/4 of principal prior to maturity).

11. See generally *LPC-High-Yield*, *supra* note 9 (describing the lengthier maturities, richer pricing and back-ended amortization of Tranche-B loans). Amortizing assets repay principal gradually, thereby reducing the lender's exposure to the borrower over time. In contrast, nonamortizing assets pay the principal amount of the loan in full on the date of maturity. Back-ended amortizing assets begin repaying principal in periodic payments beginning in the later years of maturity. See *id.*

12. See Ben Edwards, *Let's Shuttle Those Loans*, EUROMONEY No. 316, at 22, 23 (1995) (defining prime rate funds as closed-end mutual funds that specialize in loan investing).

13. See *LPC-High Yield*, *supra* note 9 (noting that B-tranche loans are "marketed almost always exclusively to prime rate funds and other non-bank institutions interested in higher-yielding, floating-rate term debt"); *LPC-Siligan*, *supra* note 9 (noting that a Loan Pricing Corp. survey of prime rate funds showed that there was \$25 to \$30 billion available from prime rate funds, insurance companies, and other institutional investors to fund B-tranche loans).

14. For a brief discussion of remedies available under the federal securities laws, see *infra* note 129 and note 221.

15. See *infra* notes 21-81 and accompanying text.

how commercial banks use B-tranche loan participation programs to minimize their exposure to highly leveraged borrowers.<sup>16</sup> Part IV discusses the adoption of the “family resemblance test” as the appropriate analytical framework for analyzing whether certain loan participations are securities within the meaning of the securities laws.<sup>17</sup> Part IV also examines the Second Circuit’s application of the “family resemblance test” to participations in debt instruments in *Banco Espanol de Credito v. Security Pacific National Bank*<sup>18</sup> and *Pollack v. Laidlaw Holdings*.<sup>19</sup> Finally, Part V examines participations in the B-tranches of leveraged loans under the “family resemblance test,” and concludes that Congress should amend the statutory definition of “security” to include certain loan participations.<sup>20</sup>

## II. THE DECLINE IN THE PROFITABILITY OF TRADITIONAL BANKING AND THE EVOLUTION OF LOAN PARTICIPATIONS

### A. *What Is a Loan Participation?*

A loan participation is a “contract which sells the cash stream from an underlying bank loan to a third party.”<sup>21</sup> This contract is typically in the form of a loan participation agreement between the originating bank and one or more third-party participants.<sup>22</sup> The loan participation agreement does not give rise to a debtor-creditor relationship between the participants and the borrower; only the originating bank holds a formal contract with the borrower.<sup>23</sup> The originating bank makes a loan to a customer, but then funds the loan

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16. See *infra* notes 82-103 and accompanying text.

17. See *infra* notes 104-62 and accompanying text.

18. *Banco Espanol de Credito v. Security Pac. Nat'l Bank*, 973 F.2d 51 (2d Cir. 1992).

19. *Pollack v. Laidlaw Holdings, Inc.*, 27 F.3d 808 (2d Cir.); see *infra* notes 124-67 and accompanying text.

20. See *infra* notes 163-231 and accompanying text.

21. Gary B. Gorton & Joseph G. Haubrich, *The Loan Sales Market*, in 2 RESEARCH IN FINANCIAL SERVICES 85, 85 (George Kaufman ed., 1990).

22. See Bradley Anderson, *Loan Participations and The Borrower's Bankruptcy*, 64 AM. BANKR. L.J. 39, 40 (1990).

23. See Robert O. Weinke, *Loan Syndications and Participations: Trends and Tactics*, COMMERCIAL LENDING REVIEW, Spring 1994, available in LEXIS, Banking Library, BIS File [hereinafter Weinke, *Loan Syndications*]. Syndicated lending can either take the form of direct lending with assignments, or indirect lending with participations. For purposes of this Comment, “participation” shall refer to the sale of an *indirect* interest in the loan by the originating bank to the participant. This should be distinguished from a direct form of syndication where the originating bank “sells off *and assigns* a pro rata interest in the loan to another lender that *directly* enters into a lending arrangement with the borrower.” *Id.* (emphasis added).

by selling participations in the borrower's principal and interest payments to third parties.<sup>24</sup> The originating bank continues to manage the loan and serves as a conduit for payments between the borrower and the participants.<sup>25</sup> The participant is not involved in the "underwriting or negotiation of the loan, is not named in the loan documents as a lender, has no direct recourse against the borrower, and does not have a security interest in the collateral pledged by the borrower to secure the loan."<sup>26</sup> Moreover, the loan participation agreement does not guarantee the value of the loan and explicitly deprives the participant of any recourse against the originating bank.<sup>27</sup> Thus, by selling participations to fund all or a portion of a loan, the originating bank can profit from loan origination fees and some of the interest on the loan, even though it has shifted most or all of the default and interest rate risks to participants.<sup>28</sup>

### *B. Traditional Loan Participation Schemes Versus Nontraditional Loan Participation Schemes*

The sale of loan participation interests is not a novel idea; banks have been selling participations in their loans to other banks for decades.<sup>29</sup> However, contemporary, nontraditional loan participation programs differ greatly from traditional loan participation programs.<sup>30</sup> Traditionally, banks sold participations to enhance their

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24. See *id.*

25. See Robert R. Kornegay, Jr., Comment, Bank Loans as Securities: A Legal and Financial Economic Analysis of the Treatment of Marketable Bank Assets Under the Securities Acts, 40 UCLA L. REV. 799, 820 (1993) (noting that the originating bank is responsible for collecting payments from the borrower and forwarding them to participants).

26. Weinke, *Loan Syndications*, *supra* note 23.

27. See generally David L. Eaton, *Trouble with the Syndicate: Avoiding Disputes Over Syndicated Loan Documents and Participation Agreements in Insolvency*, LENDER LIABILITY NEWS, Nov. 3, 1995 (noting that participation agreements normally state that "a) there is no agency relationship between the lead and the participant; b) amounts received from the borrower are not held in trust for the participant's benefit; c) the lead bank has no fiduciary responsibilities to the participant; and d) the participant has no ownership interest in the borrower's loan itself, or in any collateral therefor"). The provisions of the participation agreement protect the bank against claims of negligence or breach of fiduciary duty for withholding information regarding the borrower's financial situation.

28. See Kornegay, *supra* note 25, at 803 n.13 (noting that loan participation agreements allow banks to spread the credit risk of a loan while still profiting from origination and servicing fees).

29. See John V. Murray & Anthony F. Vittone, *The Banking and Securities Businesses and the Recondite Line Between Them*, 110 BANKING L.J. 388, 409 (1993).

30. See Kornegay, *supra* note 25, at 826 (noting that changing financial markets in the 1980s "altered banks' motivation to sell loans, the characteristics of the loans being sold,

commercial lending activities.<sup>31</sup> When a corporate borrower demanded more money than the bank could provide under its regulatory lending limits, the bank would sell participations to other banks to fund the excess amount.<sup>32</sup> Although these participations did not give rise to a direct relationship between the participating banks and the borrower, the originating bank typically granted participating banks the opportunity to conduct independent credit evaluation and due diligence on the borrower.<sup>33</sup> Since the participants were other banks that were experienced in lending and credit evaluation, they were able to effectively assess the risks involved in a particular loan participation.<sup>34</sup> In contrast to the predominately bank-held participations of early loan participation programs, loan participations are now mass marketed outside of the banking community to nonbank institutions and funds.<sup>35</sup> The participation agreements in these non-traditional loan participation programs no longer afford participants with direct access to the borrower or the originating bank's records on the loan to facilitate an independent credit evaluation of the borrower's financial situation.<sup>36</sup> Moreover, many of these institutional investors are not in the lending business and they lack the expertise to effectively evaluate the creditworthiness of the borrower and the risk involved in the loan.<sup>37</sup> Thus, they are forced to rely on public documents regarding the borrower, or any information provided by the originating bank in order to assess the risk involved in a certain loan participation.<sup>38</sup> In addition, to buy a participation, purchasers are required to sign a participation agreement which states that the

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and the make-up of loan purchasers").

31. *See id.* (stating that banks used participations to solve overline loan problems).

32. *See id.* at 826 n.80. The National Bank Act limits the amount a national bank may lend to a single borrower to a percentage of the bank's capital and surplus. *See* 12 U.S.C. § 84 (1994). However, the Office of the Comptroller of the Currency ruled that portions of loans funded by participations are not counted in the selling bank's lending limits. *See* 12 C.F.R. § 32.107.

33. *See* Roberts & Quinn, *supra* note 4, at 2117-18 (noting that early loan participation programs only involved a "handful of participants" who were given access to the company's collateral and finance records and had the right and the expertise to conduct their own inspections on the borrower).

34. *See id.*

35. *See* LPC-High-Yield, *supra* note 9 (noting that B-tranche loans are marketed "almost exclusively to prime rate funds and other non-bank institutions interested in higher-yielding, floating-rate term debt").

36. *See* Martin G. Byrne, *Loan Participation Interests as Securities*, REV. OF BANKING AND FIN. SERV., Sept. 14, 1994, available in LEXIS, Banking Library, RBFS File.

37. *See id.*

38. *See id.*

purchaser "warrants that its purchase was made solely upon its own independent evaluation of creditworthiness and the seller states that it makes no representation or warranty as to collectibility or other matters relating to the loan or its security."<sup>39</sup> Thus, not only are purchasers denied access to the borrower's private financial records, they also disclaim any reliance on the bank to disclose information on the borrower's financial situation.<sup>40</sup> This arrangement allows banks to restrict the amount of information they pass on to participants, thereby allowing them to sell low quality loans to inadequately informed purchasers, with no liability for nondisclosure.<sup>41</sup>

C. *Forces Behind the Growth of Nontraditional Loan Participations: The Commercial Paper Market and Conservative Lending Practices of the 1990s*

The sale of loan participations exploded in the 1980s and, despite a slight decline, has remained substantial in the 1990s.<sup>42</sup> Among others, two significant forces in the financial markets have helped bolster the continued growth of loan participation sales since the early 1980s. First, a decline in the profitability of traditional banking has forced banks to diversify their activities in order to satisfy earnings and growth expectations.<sup>43</sup> Selling loan participations allows banks to "earn fee income while avoiding (1) the capital requirements of placing a loan on the balance sheet and (2) the reserve requirements of taking on a liability to fund the loan."<sup>44</sup> In addition, loan participations served as a "competitive response" by commercial banks to "investment banks' ability to underwrite lower-risk commercial paper."<sup>45</sup> Second, after the failure of many banks in the late 1980s,

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39. Edward P. Mannino, *New Developments in Lender Liability Litigation*, LENDER LIABILITY NEWS, July 22, 1996, available in LEXIS, Banking Library, LRP File.

40. For a list of provisions that originating banks include in participation agreements to eschew any fiduciary relationship between the originating bank and the borrower, see *supra* note 27.

41. See generally Gorton & Haubrich, *supra* note 21, at 87 (noting that banks are increasingly selling participations to a wider audience).

42. See generally Weinke, *Loan Syndications*, *supra* note 23 (noting the continued growth of loan syndications and participations evidenced by a 66% increase from \$234 billion in 1983, to \$389 billion in 1993).

43. See generally Franklin R. Edwards & Frederic S. Mishkin, *The Decline of Traditional Banking: Implications for Financial Stability and Regulatory Policy*, 1 ECON. POL'Y REV. 27 (July 1995) (explaining the economic forces that have undercut the profitability of traditional commercial lending activities).

44. Kornegay, *supra* note 25, at 841.

45. *Id.*; see also Edwards & Mishkin *supra* note 43, at 31.



banks began to adopt a more conservative approach to lending.<sup>46</sup> Instead of holding a few large loans on their balance sheet, loan participations allow banks to actively manage and diversify their loan portfolios by keeping small portions of various loans on their balance sheet.<sup>47</sup>

### 1. Decline in the Profitability of Traditional Banking

Changes in the financial services industry in the late 1970s and 1980s forced banks to change their traditional operations.<sup>48</sup> Prior to the 1980s, commercial banks held a competitive lending advantage over other lending institutions due to their ability to provide low cost credit to borrowers.<sup>49</sup> Commercial banks gathered customer deposits, and used them to provide bank credit for commercial and consumer customers.<sup>50</sup> Due to low regulatory ceilings on the amount of interest banks were allowed to pay customers on their deposits, these customer deposits provided banks with a low cost source of funds that they could use to issue commercial and consumer loans.<sup>51</sup> However, with a rise in inflation in the 1970s and early 1980s, depositors became increasingly dissatisfied with the low amount of interest their money was earning in bank deposits.<sup>52</sup> These depositors (particularly corporations) began looking for ways to earn higher interest on their

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46. See Weinke, *Loan Syndications*, *supra* note 23 (stating that the growth of loan participations "is attributable to the more conservative lending practices of the 1990s").

47. See Randall Devere, *Besieged*, INVESTMENT DEALER'S DIG., Sept. 2, 1996, at 12 (noting that commercial banks aim to diversify their risks by actively managing their loan portfolios in order to achieve "light exposure to a greater variety of companies, sectors, and industries").

48. See generally Edwards & Mishkin, *supra* note 43, at 31 (discussing the way in which increased competition for depositors' funds and growth of finance companies as competitive lenders has diminished commercial banks' traditional cost advantage in lending and thereby undercut their profitability).

49. See *id.* at 4 (noting that the zero interest cost on checkable deposits, which were a major source of bank funds, resulted in a low average cost of funds for commercial banks).

50. See *id.* at 27 (discussing the traditional banking activity of "borrowing short and lending long").

51. A lot of post-depression legislation focused on maintaining the soundness and security of the banking system and protecting bank depositors. Federal banking regulations prevented banks from paying interest on checkable deposits and placed caps on the amount of interest that could be paid on savings and other time deposits. Federal Reserve Board Reg. G, 12 C.F.R. § 217. Many of these caps were eliminated or relaxed over a six-year period following Congress' adoption the Depository Institutions Deregulation and Monetary Control Act of 1980. See Murray & Vittone, *supra* note 29, at 405 n.96.

52. See Edwards & Mishkin, *supra* note 43, at 31 (asserting that increased inflation made depositors more sensitive to yield differentials on different assets).

balances in order to keep pace with inflation.<sup>53</sup> In addition to the interest rate ceilings on depository funds, the Banking Act of 1933 (commonly known as Glass-Steagall)<sup>54</sup> further precluded the ability of commercial banks to respond to their depositors demands for higher yields. Glass-Steagall was passed after the depression to protect the security of the banking system by prohibiting banks from underwriting or marketing securities.<sup>55</sup> Congress determined that allowing commercial banks to invest in risky securities would be incompatible with protecting depositors' funds.<sup>56</sup> In addition, Congress sought to avoid the conflicts of interest that might arise when a commercial bank "goes beyond the business of acting as a fiduciary or managing agent and develops a pecuniary interest in marketing securities."<sup>57</sup> Due to commercial banks' inability to provide customers with market rate returns, depositors began to pull their money out of commercial bank deposits and invest it in the commercial paper market or money market mutual funds.<sup>58</sup>

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53. *See id.*

54. *See* Banking Act of 1933, Ch. 89, 48 Stat. 162 (codified in scattered sections of 12 U.S.C.).

55. *See id.* Glass-Steagall was passed by Congress in order to separate commercial bank activities from investment bank activities "as completely as possible." Board of Governors v. Investment Co. Inst., 450 U.S. 46, 70 (1981). Section 16 of the Banking Act of 1933 prohibits commercial banks from underwriting "securities or stock." Section 21 prohibits commercial banks from marketing "stocks, bonds, debentures, notes, or other securities."

56. *See* Securities Industry Association v. Board of Governors of the Federal Reserve System No. 82-1766 (1984).

57. *Id.*

58. *See* Murray & Vittone, *supra* note 29, at 403-08 (describing the development of money market funds and the commercial paper market and the outflow of cash from commercial banks). During the 1980s banks were increasingly losing their depositors to the commercial paper market and money market mutual funds. Providing low cost credit was no longer an easy task for commercial banks. Deposits were down and commercial banks were forced to look elsewhere to find sources to fund their traditional lending activities. Traditionally banks profited from the interest rate differential between the low interest rate they paid depositors, and the higher interest rate charged on loans (minus the cost of FDIC insurance on the loan). However, without sufficient depository funds as a source of credit, banks were forced to go out and borrow at market rates to raise funds. Many banks suffered losses from a failure to match maturities on the funds they lent and the funds they borrowed. For example, a bank would offer certificates of deposit (CD) with a two year maturity, paying 7% interest, in order to fund a loan with a seven year maturity at 10% interest. The bank assumed it would gain a profit from the interest rate differential. However, the CDs would mature after 2 years, and the bank would have to borrow again to fund the remainder of the loan. If interest rates had risen to over 11%, then the bank would have been forced to borrow at 11% to lend money out at 10%. Failure to match maturities in this manner led to huge losses for many commercial banks. *See generally* Edwards & Mishkin, *supra* note 43 (discussing the decline in the profitability of commercial banking).

Unconstrained by the banking regulations, investment banks responded to the bank depositors' demands for higher returns by sponsoring innovatively designed money market mutual funds.<sup>59</sup> In a money market mutual fund, customers invest their money in a fund which invests in money market instruments.<sup>60</sup> These funds offer customers market rate returns, but also allow them to write checks against their investment. The investment company further protects customers' ability to access their deposits by standing ready to buy back customers' shares at their current net asset value.<sup>61</sup>

Commercial bank credit also faced competition from the emerging commercial paper market.<sup>62</sup> In the 1980s, businesses seeking financing began to borrow directly from the public by issuing short-term unsecured promissory notes (commercial paper), which offered investors a higher rate of return than bank deposits.<sup>63</sup> Purchasers of commercial paper have historically included banks, business corporations, insurance companies, government entities, and pension funds.<sup>64</sup> The growth of money market mutual funds<sup>65</sup> also created a "ready market" for commercial paper, since money market mutual funds are required to hold "liquid, high-quality, short-term assets."<sup>66</sup>

In sum, in order to reach former profit levels, commercial banks were forced to "minimize their traditional business of gathering deposits and transforming them into bank credit for commercial and consumer customers, and increase their role as the distributor of financial and investment products."<sup>67</sup> Thus, banks began to use loan participations to compete with investment bankers who could underwrite commercial paper for corporations at a lower cost than

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59. See Murray & Vittone, *supra* note 29, at 405-06.

60. Money market instruments are short-term credit instruments including U.S. Treasury bills, bankers' acceptances, commercial paper, finance paper, short-term tax exempts, jumbo market interest rate bank certificates of deposits, U.S. government and agency repurchase agreements or commercial paper, and other private or government obligations with a maturity of less than one year.

61. See Murray & Vittone, *supra* note 29, at 405 (noting that money market funds offer customers prompt access to their funds).

62. See *id.* at 403-04.

63. Commercial paper is an unsecured obligation. Repayment is dependent on the issuer's ability to repay the debt from general revenues.

64. See Murray & Vittone, *supra* note 29, at 404.

65. Growth of assets in money market mutual funds reached more than \$500 billion by 1995. See Edwards & Mishkin, *supra* note 43, at 31.

66. See *id.* at 31 (noting that by creating a "ready market" for commercial paper, money market funds further undercut the profitability of commercial banks).

67. Murray & Vittone, *supra* note 29, at 406.

traditional commercial bank loans.<sup>68</sup>

## 2. Conservative Lending of the 1990s Calls for Loan Participations

In the early 1980s, banks were eager to take part in leveraged buy-outs and real estate development loans. To fund these large loan facilities, banking attorneys "tested the bounds of regulatory limits."<sup>69</sup> Only when a bank reached its own lending limits would it resort to loan participations to fund the excess amount of credit needed.<sup>70</sup> Consequently, when these loans failed, the losses for many banks were devastating.<sup>71</sup> As a result of the harsh lessons of the 1980s, banks now use loan participations to avoid large exposure to risky loans.<sup>72</sup> Banks underwrite the loan and then target a sell-down of their exposure to well below their maximum credit limits.<sup>73</sup> In a leveraged loan, the originating bank breaks the loan down into tranches and aggressively markets participations in the lower tranches to institutional investors, including insurance companies, mutual funds, and pension funds.<sup>74</sup> Using participations to fund the loan removes the bulk of the loan from the originating bank's balance sheet.<sup>75</sup> Senior lending officers favor this approach to leveraged loans because it allows them to earn high fees, while freeing up capital and avoiding absorption of all of the risks inherent in a loan onto their own books.<sup>76</sup> Unfortunately, this can have an adverse affect on investors. In a loan participation scheme, the originating bank "remains closest to the borrower and is the most cost efficient gatherer of information."<sup>77</sup> Consequently, if a bank knows that it has superior knowledge of the borrower's credit condition and that the participants are not likely to otherwise obtain this information, the bank may have an incentive to withhold negative credit information and sell low quality loans to third party participants.<sup>78</sup> Thus, as a bank moves loans off its

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68. See Kornegay, *supra* note 25, at 841.

69. Weinke, *Loan Syndications*, *supra* note 23.

70. *See id.*

71. *See id.*; *see also* Edwards & Mishkin, *supra* note 43, at 32 (noting that bank failures from 1960 to 1980 averaged less than ten per year, but during the 1980s averaged more than 200 a year).

72. *See* Weinke, *Loan Syndications*, *supra* note 23.

73. *See id.*

74. *See* Roberts & Quinn, *supra* note 4, at 2119; *see also, e.g.*, Perlmuth, *supra* note 6, at 229 (discussing sales to institutional investors and prime rate, pension, or mutual funds).

75. *See* Gorton & Haubrich, *supra* note 21, at 120-123.

76. *See* Weinke, *Loan Syndications*, *supra* note 23.

77. Kornegay, *supra* note 25, at 821.

78. *See id.* at 817-24 (asserting that there are two ways in which "economic dishonesty

balance sheet, borrower credit standards and evaluation may decline.<sup>79</sup> This can result in the sale of participations in low quality loans to nonbank institutional investors.<sup>80</sup> Losses by participants to troubled loans have led to litigation which has brought to the forefront the question of whether certain nontraditional loan participations are "notes" that are "securities."<sup>81</sup>

### III. LEVERAGED LENDING IN THE 1990S

#### A. Growth in Leveraged Lending

Leveraged lending soared to a record volume of \$104.2 billion in the first nine months of 1996.<sup>82</sup> Due to an overall decline in pricing in the loan market in recent years,<sup>83</sup> commercial banks (and investment banks) are eager to provide leveraged loans to non-investment grade firms.<sup>84</sup> These loans have traditionally offered rich pricing relative to

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leading to asymmetric information" threatens the loan sales market). The first reason that economic dishonesty leads to asymmetric information is because the bank, as originator, "can best assess the quality of loans being sold and has incentives to market low-quality assets (the adverse selection problem)." *Id.* The second reason that economic dishonesty leads to asymmetric information is because the bank, as servicer, "is instrumental in determining the actual yield that a buyer realizes on the assets and has an incentive to shirk its responsibilities in monitoring the loan (the moral hazard problem)." *Id.*

79. See Gorton & Haubrich, *supra* note 21, at 85-86 (describing the paradoxical relationship that arises when the participant relies on the bank to reveal credit risks and enforce loan covenants against the borrower even though the sale of the loan removes the bank's incentive to perform on the original contract).

80. See generally Kornegay, *supra* note 25 (noting that an originating bank, which holds private information about the borrower, may be tempted to sell bad loans).

81. See generally Weinke, *Loan Syndications*, *supra* note 23 (noting that a recurring problem for originating banks is loan participants claiming they purchased a security instead of a loan participation).

82. See Daniel Dunaief, *Leveraged Lending Soared 51% During 2d Quarter, To Record \$37.2 Billion*, AM. BANKER, July 31, 1996, available in LEXIS, Banking Library, AMBANK File [hereinafter Dunaief, *Leveraged Lending Soared*]. This represented a 51% increase over the first quarter and was attributed to both refinancings and leveraged buyouts. See *id.* Leveraged loan volume has increased significantly in recent years, growing from approximately \$28 billion in 1993, to over \$81 billion in 1994, to \$101.3 billion in 1995, to \$104.2 billion in the first nine months of 1996. See *id.*; see also Joseph Rizzi, *Capitalize On Shifting Market Opportunities: Lending Frenzy Rewards Borrowers* 16 CORP. CASHFLOW 30, 30 (1995). Investment banks are moving into leveraged lending. See *Business Lines Converging At Banks*, BANK LOAN REP., Sept. 30, 1996, available in LEXIS, Busfin Library, IDD File (noting the movement of investment banks into "the commercial banks sweetspot: leveraged lending") [hereinafter *Business Lines Converging*].

83. See, e.g., *LPC-High Yield*, *supra* note 9 (noting that overall loan pricing hit benchmark lows in 1996).

84. See *id.*

investment grade loans.<sup>85</sup> The attractive pricing of leveraged loans to non-investment grade borrowers reflects the default risks involved in lending to a firm with a low credit rating and high debt-to-equity (leverage) ratio. Due to the high leverage ratio of the borrowing firm, repayment of the loan is a direct function of the borrower's ability to generate future cash flow.<sup>86</sup> In order to minimize their exposure to the borrower's credit condition for the maturity of the loan, (and to compete for non-investment grade borrowers by offering them longer maturities and less demanding amortization schedules), banks have begun to innovatively structure loans.<sup>87</sup>

### B. Structuring the Loan to Account for Inherent Risks

Analysis of a borrower's overall leverage is used to determine the structure of the loan.<sup>88</sup> The key leverage measurement a lender looks at is debt to free operating cash flow (FOCF),<sup>89</sup> defined as earnings before interest, depreciation, amortization, and taxes (EBIDAT) minus capital expenditures.<sup>90</sup> Based on the borrower's leverage, the lender can determine the maximum supportable level of principal and interest obligations that can be ascertained given the character and level of the company's cash flow stream.<sup>91</sup> Based on this debt capacity determination, the lender structures the loan.<sup>92</sup>

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85. See Rizzi, *Slipping Credit*, *supra* note 8, at 22 (recognizing leveraged lending as a "profit engine" for banks compared to the unattractive pricing of investment grade loans). Leveraged loans are loans priced at 150 basis points or more over Libor. See *Business Lines Converging*, *supra* note 82.

86. See, e.g., James V. Lentino & Joseph V. Rizzi, *Credit Analysis for the Highly Leveraged Credits: Deja Vu All Over Again*, 11 COM. LENDING REV. 21, 21 (1996) [hereinafter Lentino & Rizzi, *Deja Vu*] (noting that "a leveraged capital structure increases the fixed contractual financial obligations over a firm's cash flow stream").

87. See *NationsBank Sees the Present as the Glory Days in Syndication Market*, Bank Loan Report, Sept. 30, 1996, available in LEXIS, Busfin Library, IDD File (noting that having created the pricing grid concept for loans and also having introduced loans as marketable assets into the institutional market, the leveraged lending market is "the most innovative market there is").

88. See generally Lentino & Rizzi, *Deja Vu*, *supra* note 86, at 21 (noting that "the analysis of structure begins with the overall leverage of the company").

89. Free operating cash flow refers to cash flow available for debt service once a borrowing firm meets the cash flow demands necessary to operate its basic business. See *id.* at 21.

90. See *id.*; see also Joseph V. Rizzi, *Determining Debt Capacity*, 9 COM. LENDING REV. 25, 25 (1994).

91. See Lentino & Rizzi, *Deja Vu*, *supra* note 86, at 21.

92. See *id.*; see also Kenneth C. White, *LBO Financing, Trends, and Concerns*, 343 PLI REA 499, 580 (noting that credit analysis in a leveraged loan transaction looks at cash flow, not traditional factors like profitability and balance sheet strength).

Increased competition in the leveraged loan market has led to innovative and aggressively structured loan transactions.<sup>93</sup> Many borrowers need financing but cannot afford to have all their debt mature at one time.<sup>94</sup> To address these borrowers' needs, as well as to protect themselves from the credit risks of a leveraged loan, lenders now structure loans in different tranches, offering longer maturities and back-ended amortization<sup>95</sup> in the lower tranches. Each tranche is assigned a different rating ranging from AAA down into unrated territory. Banks keep portions of the less risky A-tranches (due to a shorter maturity and more demanding amortization schedule) for themselves, and aggressively market B-tranches to nonbank institutional investors. The riskier B-tranche loans begin amortizing after retirement of the bank-held Tranche-A loans.<sup>96</sup>

The lengthier maturities and back-ended amortization of B-tranche loans make their default risks high.<sup>97</sup> This is because in a leveraged loan, the borrower's ability to repay its debt is based on cash flow coverage ratios and B-tranche investors are exposed to the borrower and cash flow risks for a longer period of time.<sup>98</sup> However, the riskiness of the loan transaction provides high-yields for B-tranche investors.<sup>99</sup> Luckily, an "improving economy" in the 1990s has restored investor confidence just as low interest rates have forced them "to seek higher returns to maintain portfolio yields as higher-yielding assets mature."<sup>100</sup> To reach these higher yields, investors have become more willing to assume the higher levels of risk inherent in leveraged debt transactions.<sup>101</sup> In response, commercial banks have begun to act like brokers, transforming B-tranche leveraged loans into marketable instruments and selling them to investors with an appetite for high-yield investments.<sup>102</sup> Many of these institutions, after experiencing losses from investments in loan participations, claim

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93. See generally Lentino & Rizzi, *Deja Vu*, *supra* note 85 (noting that banks are increasingly offering multi-tiered loans with longer maturities to appeal to companies who need financing but need to moderate their fixed-charge burdens).

94. See Dunaief, *Finding Profit*, *supra* note 7, at 24.

95. Amortization refers to the retirement of debt over a period of time.

96. See Dunaief, *Finding Profit*, *supra* note 7, at 24.

97. See *id.*

98. See *id.*

99. See, e.g., *B of A Running Pacificare Acquisition Deal*, 11 BANK LOAN REP. 10, 10 (1996) (referring to institutions lining up to purchase participations in the acquisition deal's B-tranche).

100. Joe Rizzi, *Leveraged Financings: Cold Ashes Yield New Flames*, 14 CORP. CASHFLOW 30, 32 (1993).

101. See *id.*

102. See *id.*

that they were unable to assess the risk of loan participation; therefore, the originating bank that sold them the instrument without disclosing its risks should be liable for their losses. These institutions are essentially arguing that although they are a sophisticated entity, "that institutional sophistication is limited in scope and that they are no more sophisticated than a widow or an orphan in the area of complex financial instruments."<sup>103</sup> Thus, in the context of loan participation, those institutional investors, which are not in the business of lending or credit evaluation, are in need of the investor protections provided by the securities laws.

#### IV. THE REVES "FAMILY RESEMBLANCE TEST" FOR SECURITIES

##### A. *The Statutory Construct: Definition of "Security" Under the Securities Act of 1933 and Security Exchange Act of 1934*

The securities laws were enacted by Congress "to regulate *investments*, in whatever form they are made and by whatever name they are called."<sup>104</sup> Thus, in Section 2(1) of the 1933 Act<sup>105</sup> and Section 3(a)(10) of the 1934 Act,<sup>106</sup> Congress broadly defined 'security'<sup>107</sup> to include "... any note . . . evidence of indebtedness, . . . investment contract, . . . or any certificate of interest or participation in . . . any of the foregoing."<sup>108</sup> Congress hoped this broad definition would promote "full and fair disclosure relative to the issuance of the many types of instruments that in our commercial world fall within the ordinary concept of security."<sup>109</sup> However, many of these instruments, like notes, are also often used in settings that do not involve invest-

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103. Jerry W. Markham, *Protecting the Institutional Investor—Jungle Predator or Shorn Lamb?*, 12 YALE J. ON REG. 345, 368 (1995). However, Professor Markham argues that these institutions should not, on the one hand, take advantage of deregulation based on their apparent sophistication and then, on the other hand, take action against their securities broker claiming that they were unsophisticated and unable to assess the risks of a complex financial instrument. *See id.*

104. *Reves v. Ernst & Young*, 494 U.S. 56, 56 (1990); *see also* Dennis S. Corgill, *Securities As Investments At Risk*, 67 TUL. L. REV. 861, 864 (1993) (noting that the 1933 Act and the 1934 Act were passed to eliminate fraud in a largely unregulated securities market).

105. Securities Act of 1933 § 2(1).

106. Securities Act of 1934 § 3(a)(10).

107. The definition of "security" varies slightly in the 1933 Act and the 1934 Act; however, "the coverage of the two acts may be considered the same." *Reves*, 494 U.S. at 65 n.1; *see also* Byrne, *supra* note 36.

108. *Banco Espanol de Credito v. Security Pac. Nat'l Bank*, 973 F.2d 51, 54 (2d Cir. 1992) (quoting Securities Act of 1933, § 2(1)).

109. *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 687 (1985) (quoting *SEC v. W.J. Howey Co.*, 328 U.S. 293, 299 (1946) (quoting H.R. REP. NO. 73-85, (1933))).



ments.<sup>110</sup> In order to avoid regulating these instruments when they are being used in a non-security setting, the Supreme Court adopted the “family resemblance test” in *Reves v. Ernst & Young*.<sup>111</sup>

Under the “family resemblance test” (the *Reves* test), all instruments included in the definition of a “security” under the securities laws are presumed to be securities, “unless the context otherwise requires.”<sup>112</sup> Courts have interpreted this statutory phrase as reserving to them the authority to “disregard the literal language of the statute and analyze the economic realities of the transaction.”<sup>113</sup> The burden is on the issuer of the financial instrument to draw out the economic realities of the transaction and demonstrate to the court that the instrument is in fact being used in a non-security setting.<sup>114</sup> To do so successfully, the issuer must show that the instrument in question “‘bear[s] a strong family resemblance’ to an item on a judicially crafted list of non-securities, or convinces the court to add a new instrument to the list of non-securities.”<sup>115</sup> If the issuer successfully demonstrates that the instrument in question does not fall within the statutory definition of a security, a cause of action under the federal securities laws will not be available to the plaintiff.<sup>116</sup>

In determining whether the instrument in question closely resembles one of the non-security instruments on the judicially-enumerated list, the court considers four factors (the *Reves* factors).

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110. See Murray & Vittono, *supra* note 29, at 390 n.11 (noting that “the context or transaction may determine the nature of a note as an investment vehicle” since a note may be issued in a consumer context, a commercial context, or an investment context).

111. See *Reves*, 494 U.S. at 75 (Stevens, J., concurring) (noting that definitions in the Acts may not apply if “the context otherwise” requires).

112. *Marine Bank v. Weaver*, 455 U.S. 551, 556 (1982). Courts have relied on this statutory language which states that the definitions in the Securities Acts apply “unless the context otherwise requires” to exclude certain transactions. See *id.* (noting that the broad statutory definition of security is “preceded by the statement that the terms mentioned are not to be considered securities if ‘the context otherwise requires’”).

113. *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967) (noting that “form should be disregarded for substance and emphasis should be on economic reality” in the determination of what instruments constitute securities).

114. See Corgill, *supra* note 104, at 896 (noting that in determining if an instrument is an investment instrument, courts “should not follow the label on the investment instrument,” but instead, should “take account of the economics of the transaction under investigation”).

115. *Reves*, 494 U.S. at 66 (quoting *Exchange Nat’l Bank of Chicago v. Touche Ross & Co.*, 544 F.2d 1126, 1137 (1976)).

116. It is important to note that Congress only intended to regulate fraud within the securities markets, it did not intend to create a “general federal cause of action for fraud.” *United Hous. Found., Inc., v. Forman*, 421 U.S. 837, 847-848; see also Corgill, *supra* note 104, at 865 (noting that Congress did not intend to supplant common law fraud in markets other than the securities market).

The *Reves* factors are:

(1) the motivations that would prompt a reasonable buyer and seller to enter into the transaction; (2) the plan of distribution of the instrument; (3) the reasonable expectations of the investing public; and (4) whether some factor, such as the existence of another regulatory scheme, significantly reduces the risk of the instrument, thereby rendering application of the securities laws unnecessary.<sup>117</sup>

In *Banco Espanol de Credito v. Security Pacific National Bank*,<sup>118</sup> the Second Circuit firmed up the *Reves* test as the appropriate analytical framework for determining if "loan participations could be considered notes which are also securities."<sup>119</sup> However, the "multi-spectrum" *Reves* test has been criticized for being "completely opened."<sup>120</sup> When the Supreme Court adopted the *Reves* test, it provided no guidance regarding the weight that should be given to each factor.<sup>121</sup> Therefore, as the financial markets rapidly produce new and innovative financial instruments, the *Reves* test provides issuers of and investors with little predictability as to which instruments will be considered securities.<sup>122</sup>

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117. *Banco Espanol de Credito v. Security Pacific National Bank*, 973 F.2d 51, 55 (2d Cir. 1992).

118. *Id.*

119. *Banco Espanol*, 973 F.2d at 55. The "family resemblance test" was adopted by the Supreme Court in *Reves*. See *Reves*, 494 U.S. at 63-67. However, until the Second Circuit revisited the family resemblance test in *Banco*, there was some confusion over whether the *Howey* test, which had been used prior to *Reves* to determine if instruments were securities would still be used. The *Howey* test, first articulated by the court in *SEC v. W.J. Howey Co. I*, focused on whether the participation interests at issue were "investment contracts." However, the Second Circuit's use of the family resemblance test reiterates that it is the new analytical framework for the determining if instruments are securities within the scope of the securities laws.

120. Park McGinty, *What is a Security?* 1993 WIS. L. REV. 1033, 1076 (1993).

121. The Supreme Court adopted the *Reves* test despite a warning by the Second Circuit that "directing district courts to 'weigh' a number of . . . factors, without any instructions as to relative weights . . . is scarcely helpful to hard-pressed district judges or to counsel." *Id.* at 1077 n.198 (quoting *Exchange Nat'l Bank v. Touche Ross & Co.*, 544 F.2d 1126, 1137 (2d Cir. 1976)).

122. See *id.* at 1077 (noting that, by requiring courts to examine several factors, "*Reves* left each court on its own to assign whatever meaning or relative weights to the different spectra that the court desired"). The Supreme Court acknowledged this lack of predictability, by noting that "an approach founded on economic reality rather than a set of per se rules is subject to criticism that whether a particular note is a 'security' may not be entirely clear at the time it is issued." *Reves*, 494 U.S. at 63 n.2.

B. *The Banco Espanol Litigation: The Second Circuit's Rejection of "Loan Participation Notes" as "Securities" Under the 1933 and 1934 Acts*

The Second Circuit was unwilling to classify loan participation notes as securities in *Banco Espanol*.<sup>123</sup> However, the Second Circuit limited the scope of its opinion to the particular notes in question, and thereby "left open the possibility that other participation schemes may be found to be securities."<sup>124</sup>

In *Banco Espanol*, Security Pacific Merchant Bank (Security Pacific) sold participations in loan notes owed to them by a corporate borrower on a commercial loan.<sup>125</sup> Security Pacific sold these participations to other banks, and to nonfinancial institutions and funds.<sup>126</sup> After the borrower defaulted on over seventy-five million dollars of loan notes, eleven of the participants brought suit seeking to rescind their participation agreements.<sup>127</sup> These participants claimed that Security Pacific withheld information regarding the borrower's financial condition, and thereby violated Section 12(2) of the Securities Act.<sup>128</sup> After applying the *Reves* test, the district court concluded that the participations were not 'securities' under the 1933 Act, and therefore, the plaintiffs were not entitled to a cause of action under Section 12(2) of the Act.<sup>129</sup> Although the district court noted that a participa-

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123. 973 F.2d 51 (2nd Cir. 1992)

124. *Banco Espanol*, 973 F.2d at 56 (noting that the *Banco* court ruling only applied to the certain participations in question).

125. *See id.* at 53.

126. *See Banco Espanol*, 973 F.2d 51, 56 (Oakes, C.J., dissenting). Although the participants included foreign and national banks, 53% of the participants were non-bank investors: 23% were corporations; 18% institutional investors; 4% insurance companies; 2% mutual funds; 2% trust departments; and 4% money managers. *See id.* at 57.

127. Although a majority of the participants in *Banco* were nonbank investors, eight of the eleven plaintiffs in the case were banks. Some suggest that this made *Banco* "a poor test case, from an investor protection perspective, for deciding whether loan notes are securities." Roberts & Quinn, *supra* note 4, at 2120. This is because the more banks are involved, the more the participation program looked like a traditional use of loan participation, where banks purchased and sold participations among themselves as part of the banking business.

128. *See Banco Espanol*, 973 F.2d at 53. Section 12(2) of the 1933 Act provides for liability for fraud or misrepresentation in the interstate sale of securities, regardless of whether or not the registration with the SEC was involved. Thus, transactions exempt from registration with the SEC under Sections 3(a)(3) through 3(a)(8) do not escape civil liability under Section 12(2). If fraud or misrepresentation is found, then Section 12(2) allows the purchaser to rescind the purchase agreement. Upon tendering the security, the purchaser can recover consideration paid for the security with interest, less the amount of any income received from holding the instrument. *See* Herbert S. Wadner, et. al, *Civil Liabilities Under the Federal Securities Laws*, C635 A.L.I.-A.B.A. 83, 84 (1991).

129. *See Banco Espanol*, 973 F.2d at 55-56.

tion in an instrument may be a security even when the underlying instrument is not, the court found that these participations were analogous to notes evidencing loans issued by banks for commercial purposes.<sup>130</sup> On appeal, a divided panel of the Second Circuit upheld the district court decision, stating that the district court was correct in finding that the participation interests in question were not securities within the meaning of the federal securities laws.

1. Application of the *Reves* Family Resemblance Test to *Banco Espanol*

The first *Reves* factor requires an examination of the transaction in order to “assess the motivations that would prompt a reasonable seller and buyer to enter into it.”<sup>131</sup> The court then characterizes the parties’ motivations as either commercial or investment.<sup>132</sup> In *Banco Espanol*, the district court concluded that the originating bank was motivated by a desire to correct the issuer’s cash flow problems and to diversify its own risks, while the participants were motivated by a desire for short term returns on excess cash.<sup>133</sup> The district court characterized these motivations as commercial and held that the “overall motivation of the parties was the promotion of commercial purposes and not investments in a business enterprise.”<sup>134</sup>

The second *Reves* factor requires a court to examine the plan of distribution to determine if the note is an instrument in which there is “common trading for speculation of investment.”<sup>135</sup> A note need not be traded on an exchange to fulfill this requirement.<sup>136</sup> The court will find that there is ‘common trading’ if the notes are either traded on

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130. The list of notes the Court has deemed not to be securities include:

(1) the note delivered in consumer financing; (2) the notes secured by a mortgage on a home; the short-term note secured by a lien on a small business or some of its assets; (4) the note evidencing a character loan to a bank customer; (5) short-term notes secured by an assignment of accounts receivable; (6) a note that simply formalizes an open account debt incurred in the ordinary course of operations; and (7) notes evidencing loans by commercial banks for current operations.

*Reves*, 494 U.S. at 65.

131. *See id.* at 66.

132. *See id.* at 56 (noting that a commercial purpose raises the likelihood that the instrument is a non-security while an investment purpose points to a security).

133. *See Banco Espanol*, 973 F.2d at 55.

134. *Banco Espanol de Credito*, 763 F. Supp. at 42-43; *but see infra* notes 183-85 and accompanying text, for a discussion of the SEC’s argument that the parties had investment purposes for entering into the transaction.

135. *Id.* at 59 (quoting *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 351 (1943)).

136. *See Byrne, supra* note 36.

an exchange, or offered and sold to a broad segment of the public.<sup>137</sup> In *Banco Espanol*, the district court concluded that the plan of distribution was “a limited solicitation to sophisticated financial or commercial institutions and not to the general public.”<sup>138</sup>

The third *Reves* factor asks a court to consider public perception of an instrument in order to determine if an instrument should be deemed a ‘security’ based on the public’s reasonable expectations.<sup>139</sup> The district court believed that by requiring participants to sign a Master Participation Agreement (MPA), the originating bank had given participants “ample notice” that they were purchasing participations in loans, not investments in a business enterprise.<sup>140</sup>

The fourth *Reves* factor requires an examination of regulatory schemes to see if they provide purchasers with investor protections similar to those provided by the federal securities laws.<sup>141</sup> In *Banco Espanol*, the district court rendered application of the federal securities laws unnecessary since certain guidelines issued by the Office of the Comptroller of the Currency address the sale of loan participations.<sup>142</sup>

### C. *Pollack: Expansion of “Securities” in the Context of Debt Instruments: A Step in the Right Direction?*

In 1994, a year after *Banco Espanol*, the Second Circuit again applied the *Reves* test in *Pollack v. Laidlaw Holding, Inc.*,<sup>143</sup> to determine whether certain participation interests in debt instruments were securities. However, this time, the Second Circuit concluded

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137. *See id.*

138. *Banco Espanol de Credito*, 763 F. Supp. at 42-43. The district court emphasized that Security Pacific also limited resales of the participations without the express written participation of the originating bank and thereby protected against sales to the general public. *But see infra* notes 184-94, for a discussion of the SEC’s argument that sale of participations to institutions and funds outside of the banking world qualifies as sale to the general public.

139. *See Banco Espanol*, 973 F.2d at 55.

140. *But see infra* notes 184-86 and accompanying text, for a discussion of the SEC’s argument that Security Pacific’s promotional material could have led the purchasers to perceive the participations to be securities.

141. *See Banco Espanol*, 973 F.2d at 55.

142. *See id.* *But see infra* notes 209-21 and accompanying text, for a discussion of the inadequacy of these guidelines to provide purchasers with protections against fraud and nondisclosure by the originating bank. Specifically, the guidelines (1) do not provide purchasers with an express or implied remedy against an originating bank; (2) do not address sale of participations to participants other than national banks; and (3) focus primarily on the activities of purchasers of participations, thereby placing little focus on the activities of the originating bank in a participation program.

143. *Pollack v. Laidlaw Holdings, Inc.*, 27 F.3d 808, 815 (1994).

that the participations in mortgages were “notes” that were “securities” within the meaning of the federal securities laws.<sup>144</sup>

The *Pollack* Court concluded that unlike the loan participations issued in *Banco Espanol*, the mortgage participations sold in *Pollack* were sold to the general investing public.<sup>145</sup> The court stated that in contrast to the marketing scheme in *Banco Espanol*, which was “more analogous to a group of highly sophisticated commercial entities engaging in short-term commercial financing arrangements than to the securities markets,”<sup>146</sup> the marketing scheme in *Pollack* was not restricted to sophisticated investors with the “capacity to acquire information about the debtor.”<sup>147</sup>

*Pollack* was an important victory for the SEC and investors in participations in debt instruments since “the applicability of the definition of security to debt instruments would have been severely and unduly restricted” had the Second Circuit held that the mortgage participations were not securities.<sup>148</sup>

### 1. Great Strides of *Pollack*

Two of the Second Circuit’s conclusions in *Pollack* modify the *Reves* test in a manner that will be favorable to participants in debt instruments seeking relief under the federal securities laws. The *Pollack* Court concluded that (1) priority should be given to the motives of the purchaser, not the seller, of a debt instrument, and (2) “mere existence of other regulation is not enough to displace the federal securities laws”<sup>149</sup> if they do not provide risk reducing protections for purchasers.<sup>150</sup>

Remembering that securities laws are designed to protect investors, the main objectives when applying the *Reves* test should be to determine if the purchasers have an investment purpose, and if so, if another regulatory scheme provides them with investor protections. Consistent with these objectives, the *Pollack* Court restricted its consideration of the parties’ motives to the purchasers’ motivations.<sup>151</sup> The Court rendered examination of the seller’s motives unnecessary and declared that if a “purchaser clearly has an investment motive, it

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144. *See id.* at 809.

145. *See id.* at 813-14.

146. *Id.* at 813.

147. *Id.* at 813-14.

148. Roberts & Quinn, *supra* note 4, at 2127.

149. *Id.* at 2126.

150. *See id.*

151. *See id.*

does not matter if the seller does not.”<sup>152</sup> This is critical since loan participations are sold by banks and other entities in the lending business. Since these entities are in the business of making commercial loans, their motivations could almost always be deemed commercial rather than investment.<sup>153</sup> Thus, “unless the purchasers’ motives are given priority, participations would never be securities under *Reves*.”<sup>154</sup>

Second, the Court stated that “mere existence of other regulation is not enough to displace the federal securities laws.”<sup>155</sup> This is significant since the banking circular relied on as an alternative regulatory scheme in *Banco Espanol* does not provide purchasers of loan participations with a private right of action.<sup>156</sup> Although these modifications to the *Reves* test appear to narrow *Banco Espanol*’s holding, *Banco Espanol* has not been overruled. Thus, the law in the Second Circuit, “the most important court of appeals on financial matters,” is that loan participation interests are only subject to regulation under the federal banking laws, not the federal securities laws.<sup>157</sup>

If courts adhere to the majority’s reasoning in *Banco Espanol*, the inadequate investor protections provided to loan participants by the banking laws will continue to shield seller banks from liability to loan participants.<sup>158</sup> This is because under the banking laws, the seller bank is not liable to the purchasers for failure to disclose negative credit information.<sup>159</sup> However, the amended opinion in *Banco Espanol*, leaves the door open for a future holding that certain non-traditional loan participation notes are securities.<sup>160</sup> Participations in B-tranche leveraged loans function like investments, and therefore provide the ideal framework for such a holding. However, in order

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152. *Id.* at 2126.

153. *See id.* at 2127.

154. *Id.*

155. *Id.* at 2126.

156. *See id.* (citing authorities asserting that the banking regulations do not create a private right of action and considering that the *Reves* court did not explain the “exact scope” of factor four, but that it did make reference to two cases in which strong, comprehensive alternative protections were available to purchasers (i.e. federal deposit insurance)).

157. *Id.* at 2128.

158. *See id.* at 2128-30.

159. For a discussion of the lack of a private action for purchasers under the banking laws, *see infra* note 211 and accompanying text.

160. *See Banco Espanol de Credito v. Security Pac. Nat’l Bank*, 973 F.2d 51, 56 (Oakes, C.J., dissenting) (noting that the court was ruling only “with respect to the loan participations as marketed in this case”).

to reach such a conclusion, courts must look beyond a loan note program's "superficial resemblance to traditional loan participations"<sup>161</sup> and note the differences that were present in *Banco Espanol* and are common to many contemporary loan note programs.

In his dissent, Judge Oakes noted that the *Banco Espanol* loan note program was different from a traditional loan note program in "several important respects, including (1) who the participants are; (2) what the purposes of the purchasers or participants are; and (3) what the promotional basis used in marketing the loan notes is."<sup>162</sup> Focusing on these three aspects of a loan note program when applying the *Reves* test reveals the significant differences between traditional loan participation programs and many modern loan participation programs. When this more exacting analysis is applied to B-tranche participations it becomes obvious that despite their label as loan participation notes, these participation interests are investment instruments that should be regulated as securities.

## V. PREDICTING THE FATE OF PARTICIPATIONS IN THE B-TRANCHE OF A LEVERAGED LOAN: "SECURITIES" IN DISGUISE?

### A. *Application of Reves Factors to Participations in the B-tranche of a Leveraged Loan*

#### 1. First *Reves* Factor—Motivation of the Parties

In *Reves*, the Supreme Court declared that a note purchaser "interested primarily in the profit the note is expected to generate" has an investment motive.<sup>163</sup> Moreover, in a footnote the Supreme Court wrote: "[w]e emphasize that by 'profit' in the context of notes, we mean 'a valuable return on an investment,' which undoubtedly includes interest."<sup>164</sup> Since "one of the primary inducements" offered to the purchasers of the promissory notes in *Reves* was "an interest rate constantly revised to keep it slightly above the rate paid by local banks and savings and loans,"<sup>165</sup> the Supreme Court concluded that purchasers bought the notes in order to earn a profit and therefore had an investment motive.<sup>166</sup> Despite the Supreme Court's clear indi-

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161. *Id.*

162. *Id.*

163. *Reves v. Ernst & Young*, 494 U.S. 56, 66 (1990).

164. *Id.* at 68 n.4.

165. *Id.* at 68. The promissory notes issued in *Reves* were issued by a farmers cooperative. *See id.*

166. *See id.* at 67-68.



cation that a primary interest in profit suffices to show an investment motive, the Second Circuit refused to restrict its interpretation of an investment motive to the Supreme Court's definition.

In *Banco Espanol*, the district court concluded that the participants were "motivated by the desire to obtain short-term returns on excess cash."<sup>167</sup> However, despite the presence of a profit motive, the district court held that the "overall motivation of the parties was the promotion of commercial purposes."<sup>168</sup> The *Banco Espanol* majority upheld the district court's finding of a commercial motive despite arguments by the SEC that the loan notes "were purchased by participants for investment purposes—for the high rate of return they offered compared to other financial instruments—and not as part of a commercial lending business or to facilitate an independent business relationship with the borrower."<sup>169</sup> The SEC supported their argument by noting that a majority of the participants were non-financial entities that "clearly were not acting as commercial lenders;"<sup>170</sup> (2) that the promotional literature used by the seller bank in *Banco Espanol* focused on the prospect of a higher return offered by loan participations compared to commercial paper;<sup>171</sup> and, (3) that "even the banks that purchased generally did so not through their lending departments but through their investing and trading departments."<sup>172</sup>

Similar to the scenario in *Banco Espanol*, there are multiple nonbank institutional investors among the purchasers of participations in the B-tranche of a leveraged loan. Banks market these B-tranche participations "almost exclusively to prime rate funds and other non-bank institutions interested in higher-yielding, floating rate-term debt."<sup>173</sup> Floating interest rates are attractive to participants because they "throw off a higher yield in direct correlation to interest rate rises."<sup>174</sup> However, B-tranche participants' loans have lengthy exposure to a highly leveraged borrower with a low credit rating. Furthermore, the participants do not have access to any un-

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167. *Banco Espanol*, 973 F.2d at 55.

168. *Id.*

169. Roberts & Quinn, *supra* note 4, at 2122.

170. *Id.*

171. Indeed, the promotional materials advertised the loans as yielding "15 to 50 basis points more than their commercial paper equivalents." See *Banco Espanol*, 973 F.2d at 56 (Oakes, C.J., dissenting).

172. Roberts & Quinn, *supra*, note 4, at 2121-22 (quoting the Brief of the SEC, Amicus Curiae, at 14-43, *Banco Espanol de Credito v. Security Pac. Nat'l Bank*, 973 F.2d 51 (2d Cir. 1992)).

173. See *LPC-Siligan Corp*, *supra* note 9 (noting the addition of a B-tranche loan due to the liquidity in the B-term loan market note market).

174. Dunaief, *Finding Profit*, *supra* note 7, at 24.

derlying collateral on the loan.<sup>175</sup> Consequently, they are unsecured creditors, dependent on the extended cash flow of a borrowing firm on which they have had virtually no opportunity to conduct credit analysis.<sup>176</sup> Clearly, these nonbank participants are not exposing themselves to the risk inherent in these lengthy loans in order to promote commercial lending. These investors are motivated by the competitive returns available on investments in B-tranche leveraged loans.

Drawing out the parallels between junk bonds and B-tranche leveraged loan participations further demonstrates that purchasers of B-tranche participation interests have an investment motive. In the 1980s, high yield securities became very popular and were dubbed "junk bonds." Junk bonds are less than investment grade bonds that offer high interest rates to reflect their default risk. Similarly, B-tranche leveraged loans (often referred to as "junk loans")<sup>177</sup> are less than investment grade loans that offer high interest rates to reflect their default risk.<sup>178</sup> Therefore, one of the "primary inducements"<sup>179</sup> offered to the purchasers of both instruments is the high rate of return compared to other instruments. As interpreted by the Supreme Court in *Reves*, purchasing a note primarily to earn profit through interest constitutes an investment purpose.<sup>180</sup> Following this rationale, a participant whose primary interest in purchasing a loan participation is to profit from high interest rates has an investment motive.

## 2. Second *Reves* Factor—Plan of Distribution

Under the second *Reves* factor the Court must "examine the plan of distribution of the note to determine whether the instrument is commonly traded for speculation or investment."<sup>181</sup> Ironically, notes do not need to be traded to fulfill this prong of the *Reves* test; a

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175. See *supra* notes 21-28 and accompanying text.

176. See *supra* notes 36-41 and accompanying text.

177. See Stephen Barr, *All's Fair in Love and Loans*, 10 CFO: THE MAGAZINE FOR SENIOR FINANCIAL EXECUTIVES 83, 83 (1994).

178. See Gorton & Haubrich, *supra* note 21, at 87 (noting the similarity of the loan sales market to the junk bond market). As the loan sales market has matured, originating banks increasingly sell participations in loans to firms that are not publicly traded for lengthy maturities. In addition, "[b]ecause most of the loans sold are to firms without access to the commercial paper market, the loan sales market is not simply a substitute for commercial paper. It, perhaps, most closely resembles the junk bond market." See *id.* (statement of Gary B. Gorton).

179. See *Reves v. Ernst & Young*, 494 U.S. 56, 68 (1990).

180. *Id.* at 67-68.

181. *Id.* at 66.

note need only be "offered and sold to a broad segment of the public."<sup>182</sup> The courts have not clearly defined what constitutes a broad segment of the public.<sup>183</sup>

Despite the presence of many nonbank financial institutional investors in the *Banco Espanol* participation scheme, the *Banco Espanol* majority held that the loan notes had not been sold to a broad segment of the public since Security Pacific only offered the loan notes to "sophisticated financial and commercial institutions," and resale of the notes was explicitly prohibited without its permission, thereby preventing resale to unsophisticated individuals.<sup>184</sup> In contrast, the SEC argued that Security Pacific's sale of loan notes to institutions and funds outside of the traditional banking system represented sale to the general investment public.<sup>185</sup> Disregarding the SEC's argument, the *Banco Espanol* majority did not distinguish between banks and other types of institutional purchasers and did not focus on these institutions' ability to obtain full credit information on the borrower as the defining element of the general public standard.<sup>186</sup>

A year later in *Pollack*, the Second Circuit held that certain mortgage participation interests were sold to the general public since they were offered and sold to "nonsophisticated investors"<sup>187</sup> lacking the "capacity to acquire information about the debtor."<sup>188</sup> Members of the SEC were pleased with this outcome and the emphasis the Second Circuit placed on the purchasers' access to full credit information.<sup>189</sup> However, the question remains whether the Second Circuit will continue to presume that large institutions (whether they are financial or nonfinancial) have access to full credit information;

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182. *Id.* at 68.

183. See Kornegay, *supra* note 25, at 838-39 (explaining the debate over what constitutes selling to the general public). There are two distinct arguments in the debate over selling to the general public:

On the one hand, an issuer could argue that loan participations are not sold broadly to the public but rather to large institutions. But as Gorton points out, loan sales are increasingly sold outside the banking system to parties whose business and expertise many not be in credit evaluation.

*Id.* at 838-39.

184. *Banco Espanol de Credito v. Security Pac. Nat'l Bank*, 973 F.2d 51, 55 (2d Cir. 1992).

185. See Byrne, *supra* note 36.

186. See *id.*; see also Roberts & Quinn, *supra* note 4, at 2123.

187. The purchasers in *Pollack* included two doctors, one of the doctors' sons, the doctors' retirement plan, and a family trust. See *Pollack v. Laidlaw Holdings, Inc.*, 27 F. 3d 808, 809 (2d Cir. 1994).

188. *Id.* at 814.

189. See Roberts & Quinn, *supra* note 4, at 2126.

or whether they will recognize that many nonfinancial institutions, like unsophisticated individuals, "have virtually no opportunity to conduct any due diligence regarding the borrower except by reviewing public documents provided by the lead lender."<sup>190</sup> A court that does distinguish between banks and other institutional purchasers (and recognizes that many of the latter are not making purchase decisions based on full credit information), will realize that nonfinancial institutions can be defrauded or misled by the originating bank as easily as an unsophisticated individual. Realizing this, a court should agree with the SEC and conclude that sale of participations to nonfinancial institutions and funds outside of the banking world should be construed as sales to the general investment public.<sup>191</sup> Defining the general public standard in this manner would benefit B-tranche purchasers which are primarily nonbank institutional investors or funds.<sup>192</sup> The growing presence of these nonbank investors in the secondary loan market should force courts to consider the interests of (1) nonfinancial institutional investors, and (2) "unsophisticated investors"<sup>193</sup> with "financial stakes"<sup>194</sup> in mutual and pension funds, both of whom are injured by an originating bank's failure to reveal the risks involved in the underlying loan.

### 3. Third *Reves* Factor—Public's Reasonable Expectations

Under the third *Reves* factor, "[i]nstruments can be deemed securities on the basis of the reasonable perceptions of the public, even when an economic analysis of the transaction suggests otherwise."<sup>195</sup> The *Reves* Court recognized that the "fundamental essence" of a "security" is its character as an "investment."<sup>196</sup> Thus, if the court determines that the "reasonable perception of the instrument by the investing public," is that of an "investment", the court may consider the note to be a security.<sup>197</sup> In *Reves*, the promotional literature referred to the notes at issue as "investments."<sup>198</sup> The court focused its

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190. See Byrne, *supra* note 36.

191. See *id.*

192. See Dunaief, *Finding Profit*, *supra* note 7, at 24 (noting that Bank of Boston is "one of few banks to join the prime rate funds and institutional investors who traditionally sit on the other side of the loan syndication table").

193. Roberts & Quinn, *supra* note 4, at 2130.

194. *Id.*

195. Kornegay, *supra* note 25, at 839.

196. *Reves v. Ernst & Young*, 494 U.S. 56, 68-69 (1990).

197. *Banco Espanol de Credito v. Security Pac. Nat'l Bank*, 973 F.2d 51, 55 (2d Cir. 1992).

198. *Reves*, 494 U.S. at 69.

attention on these advertisements and noted that since (i) they characterized the notes as securities and (ii) "there were no countervailing factors that would have led a reasonable person to question this characterization,"<sup>199</sup> the public could have perceived the instruments to be investment instruments.

In contrast to the Supreme Court in *Reves*, the Second Circuit majority in *Banco Espanol* did not mention the marketing methods used to promote the loan participation notes.<sup>200</sup> Instead, the court focused on the seller's requirement that each purchaser sign an MPA. The majority believed that requiring the "sophisticated purchasers" to sign participation agreements gave them "notice through the contractual provisions of the MPA that the loan notes were not investments in a business enterprise."<sup>201</sup>

On the other hand, the SEC focused on the originating bank's methods of marketing participations and argued that the purchasers would reasonably expect the loan notes to be securities since the originating bank framed its promotional literature in terms commonly used in the securities market and presented the loan notes as "equivalent" to commercial paper.<sup>202</sup> Specifically, the promotional literature for the *Banco Espanol* notes: "(1) represented the Loan Notes as competitive with commercial paper, (2) referred to Security Pacific as a 'trader' and 'distributor,' (3) referred to potential Participants as 'investors,' and (4) stressed the wide range of issuers, maturities, and amounts of the loan notes."<sup>203</sup> However, the *Banco Espanol* majority did not agree with the SEC's arguments and firmly stated that "in the case of an arm's length transactions between financial institutions, no fiduciary relationship exists unless one was created in the participation agreement."<sup>204</sup>

Lead lenders are wise to the protections of participation agreements and require purchasers of B-tranche loans to sign participation agreements containing disclaimer provisions. These provisions explicitly waive any duty on the part of the originating bank to disclose financial information on the borrower to participants. Particularly after *Banco Espanol*, the originating bank can easily manipulate this prong of the *Reves* test. To protect themselves from liability, lead

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199. *Id.*

200. *See* Byrne, *supra* note 36.

201. *See id.*

202. *See* Roberts & Quinn, *supra* note 4, at 2122.

203. Byrne, *supra* note 36.

204. *Banco Espanol de Credito v. Security Pacific National*, 763 F. Supp. 36, 45 (S.D.N.Y. 1991).

lenders should (1) require the purchaser sign a separate participation agreement for each transaction; (2) include a provision stating that the purchaser has conducted its own due diligence and credit analysis; (3) prohibit resales without the lead lender's express written permission; (4) identify notes as interests in underlying loans, not investments; and (5) avoid use of securities language in the promotional materials or participation agreement.<sup>205</sup> However, a sharper focus on marketing will reveal that many originating banks refer to loan participations as an equivalent to commercial paper.

#### 4. *Reves* Factor Four—Alternate Regulatory Scheme

Finally, under the fourth *Reves* factor, a note is not a security if "... some factor such as the existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering application of the Securities Acts unnecessary."<sup>206</sup> The *Banco Espanol* majority held that Banking Circular 181,<sup>207</sup> issued by the Office of the Comptroller of the Currency, was an adequate substitute for the federal securities laws since it contained "specific policy guidelines addressing the sale of loan participations."<sup>208</sup> However, the Court stopped short of examining OCC 181 guidelines to ensure that they would provide participants with protections against nondisclosure, fraud, or misrepresentation by the originating bank.

##### a. The Inadequacies of Circular 181

The OCC 181 guidelines do not provide adequate legal protection to purchasers of bank loan participations.<sup>209</sup> The inability of OCC 181 to protect purchasers from nondisclosure of risks, fraud or misrepresentation on the part of the originating bank stem from three main factors: (1) its guidelines are mostly geared towards the activities of the purchasers and insufficiently regulate the activities of banks selling loan participations;<sup>210</sup> (2) the Office of the Comptroller

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205. See Byrne, *supra* note 36.

206. *Reves v. Ernst & Young*, 494 U.S. 56, 67 (citing *Marine Bank v. Weaver*, 455 U.S. 551, 557-59 & n.7 (1982)).

207. See, e.g., *Loan Participations by National Banks*, Banking Circular 181, Fed. Banking L. Rep. (CCH) ¶ 60,799 (Aug. 2, 1984) [hereinafter Banking Circular 181].

208. *Banco Espanol*, 973 F.2d at 55.

209. See *Roberts & Quinn*, *supra* note 4, at 804 (noting that banking regulations protect bank depositors but, "afford no protection to purchasers of bank assets against a selling bank's fraud, misrepresentation, or nondisclosure"). Federal banking law does not provide a private right of action to participants. See *id.*

210. Cf. Byrne, *supra* note 36. Although Banking Circular 181 (OCC 181) does not provide legal protections for purchasers of participation interests, its guidelines do recommend "meaningful actions" that purchasers can take to protect themselves. In general

of the Currency's jurisdiction is limited to national banks so its guidelines do not cover the sale of participation interests to other entities; and (3) OCC 181 does not provide purchasers with any express or implied remedies against banks selling loan participations.<sup>211</sup> Consequently, without the protections of the securities laws, purchasers of loan participation interests are forced to rely on common law fraud or breach of contract claims.<sup>212</sup> Claims based on common law fraud, negligent misrepresentation, and breach of duty of good faith and fair dealing are normally rejected if the parties entered into a loan participation agreement.<sup>213</sup> Loan participations typically state that the purchaser purchased the participation based on an independent evaluation of the borrower's financial situation.<sup>214</sup> The courts rely on this language to assert that the originating bank absolved itself of any duty to provide participants with information regarding the borrower's creditworthiness, and therefore, a participant could not have reasonably relied on the originating lender in its decision to purchase a loan participation.<sup>215</sup>

In sum, many of the purchasers of loan participations in Tranche-B loans are nonbank institutions. These institutions lack expertise in credit evaluation and participation agreements deprive them of an opportunity to verify the representations given to them by the bank on the borrower's financial condition.<sup>216</sup> Furthermore, origi-

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these include: (1) maintaining written policies and procedures governing purchase of participation interests; (2) conducting an independent credit analysis of the borrower to determine if this is a credit risk the purchaser would take directly; and (3) obtaining an agreement from the seller bank that they will continually provide the purchaser with credit information which may affect quality of the purchaser's interest. *See Banking Circular 181, supra* note 207.

211. *See id.* (noting that OCC 181 appears to be the only direct attempt by the federal government to regulate the activities of banks involved in the sale and purchase of loan activities, and asserting that the guidelines: mainly relate to the activities of the purchasers, not the sellers of loan participations; do not govern entities other than national banks; and do not provide purchasers with remedies).

212. *See id.*

213. *See Mannino, supra* note 39; *see also Banco Espanol*, 973 F.2d 56 (rejecting the plaintiffs contractual and other common-law claims since the waiver provision in the MPA's signed by participants "specifically absolved Security Pacific of any responsibility to disclose information relating to Integrated's [the borrower] financial condition"). The Second Circuit also asserted that "as an arms length transaction between sophisticated financial institutions, the law imposed no independent duty on Security Pacific to disclose information that plaintiffs could have discovered through their own efforts." *Id.* In addition, the Second Circuit recently upheld a dismissal of fraud claims brought by a foreign bank participant against a U.S. bank acting as an originating lender. *See Banque Arabe et Internationale D'Investissement v. Maryland Nat'l Bank*, 57 F.3d 146 (2d Cir. 1995).

214. *Id.*

215. *Id.*

216. *See supra* notes 35-41, for a discussion of the inability of nonfinancial institutional

nating banks use contractual provisions to absolve themselves of any duty to disclose negative credit information to participants, and federal banking law does not provide participants with a private right of action for nondisclosure, fraud or misrepresentation by the originating bank.<sup>217</sup> Consequently, if these institutions want to purchase loan participations, they are forced to do so with minimal credit information about the borrowing firm. However, by refocusing the fourth *Reves* factor on risk-reduction, the *Pollack* court presented a more promising forecast for these nonbank participants. The *Pollack* Court achieved this focus by noting that the "mere existence of an alternate regulatory scheme is not enough to displace the federal securities laws."<sup>218</sup> Therefore, although a regulatory scheme may address a particular instrument, courts will no longer consider it to be a sufficient substitute for the federal securities laws unless it provides purchasers with "comprehensive and strong protections for purchasers such that investment risk is substantially eliminated."<sup>219</sup> Applying this more rigorous "risk-reducing" analysis to OCC 181 would reveal (1) that OCC 181 does not regulate the activities of banks selling loan participations; (2) that it cannot govern the activities of entities other than national banks; and (3) it does not provide purchasers with any express or implied remedies.

In contrast, under the securities laws, participants would have access to Section 12(2) of the 1933 Act which would allow a participant to rescind the participation agreement if the originating bank made materially false or misleading statements about the borrower's financial condition.<sup>220</sup> Furthermore, a defrauded purchaser of a loan participation may be able to bring a private fraud action for damages under Rule 10b-5 of the 1934 Act (unless a loan participation fell within the Act's exemptions for certain types of commercial paper).<sup>221</sup> Similar remedies against fraud and misrepresentation are completely

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investors to verify credit information on the borrower.

217. See *supra* note 211 and accompanying text, for a discussion of OCC 181's failure to provide participants with a private right of action.

218. Roberts & Quinn, *supra* note 4, at 2126 (citing *Pollack v. Laidlaw Holdings, Inc.*, 27 F.3d 808, 814-15 (2d Cir. 1994)).

219. *Id.* at 2127 (noting that the 10th Circuit statement that "the risk-reducing factor must essentially guarantee the individual's investment" (quoting *Useton v. Commercial Lovelace Motor Freight*, 940 F.2d 565, 582 (10th Cir.))).

220. § 12(2).

221. See *Corgill*, *supra* note 104, at 867 n.20 (discussing the debate over the scope of the Acts' exemptions for short-term notes); see also J. William Hicks, *Exempted Transactions Under the 1933 Act* (1990 Looseleaf) (discussing Rule 10b-5 as a remedy against "fraud" generally (i.e., devices, schemes, acts or practices) and not merely misrepresentations or omissions to state material facts" in the purchase or sale of securities).



absent from the federal banking guidelines on loan participations. Thus, the federal banking laws should not be regarded as an adequate substitute for the federal securities laws in the context of loan participations.

## VI. CONCLUSION

Federal banking law and the federal securities laws “rest on the empirically bankrupt assumption that bank assets are not marketable.”<sup>222</sup> However, sale of participations in B-tranche leveraged loans to nonbank institutions and funds is a first rate example of commercial banks’ “evolution out of old style-banking into investment banking, in an effort to compete with the borrowing of money through debt instruments, such as commercial paper, rather than through traditional bank loans.”<sup>223</sup> Commercial banks have increasingly transformed their assets into marketable financial instruments by taking assets from their own balance sheet and selling them to investors. This increased marketability of bank assets has created an overlap between banking activities and securities activities.<sup>224</sup> Unfortunately, the federal regulations have not caught up with these market developments and continue to regulate banking activities and securities activities under dissimilar regulatory schemes.<sup>225</sup> Consequently, a bank-sponsored financial instrument, like a B-tranche loan participation, “may only be subject to laws designed primarily to protect bank depositors and to maintain the safety and soundness of the banking system and thereby avoid application of the federal securities laws, which were designed to protect investors.”<sup>226</sup>

Regulations which provide investment risk protections should be applied to loan participations in order to encompass institutional investors who lack the expertise or resources to assess the risks involved in loan participation. Making loan participations subject to federal securities regulation would “resolve the problems of asymmetric information in the market, address the incentives commercial banks have to shirk their duties in loan monitoring, encourage confidence in the market, and ultimately foster its growth.”<sup>227</sup> Although

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222. Kornegay, *supra* note 25, at 802.

223. *Banco Espanol de Credito v. Security Pac. Nat’l Bank*, 973 F.2d 51, 58 (2d Cir. 1992) (Oakes C.J., dissenting).

224. *See* Roberts & Quinn, *supra* note 4, at 2115-2116 (noting the blurring of distinctions between commercial banking and securities activities)

225. *See id.* at 2116.

226. Roberts & Quinn, *supra* note 4, at 2116.

227. Kornegay, *supra* note 25, at 850.

some parties are concerned that requiring banks to comply with disclosure requirements will increase the cost of loan participations and make them less competitive with other debt instruments,<sup>228</sup> protecting investors should be of primary concern. Investors purchasing investment instruments in different markets should not be subject to different levels of protection based on artificial distinctions between banking activities and securities activities.<sup>229</sup> Originating banks should be required to provide participants, regardless of their institutional status, with enough information to allow them to understand the conditions and risks of the loan participations being sold.<sup>230</sup>

Some might suggest that this goal could be similarly achieved by amending the federal banking regulations to impose disclosure requirements on originating banks and provide purchasers of bank-sponsored financial instruments with remedies for misrepresentation or fraud. However, if regulators and courts are truly dedicated to focusing on the economic realities of a transaction, and not on artificial labels placed on financial instruments, in order to determine which instruments are investment instruments subject to the federal securities laws, then a uniform scheme of regulation should be applied. Ultimately, “[t]ransactions that in substance are securities activities should be governed by a uniform set of rules, consistently applied by a single expert regulator—the SEC—to all market participants, regardless of whether those participants are banks or securities firms.”<sup>231</sup> Thus, the statutory definition of “security” should be amended to include certain loan participations. This will properly arm B-tranche participants, which are often dependent on the originating bank’s assessment of the risk involved in an investment, with investor protections against nondisclosure, misrepresentation, or fraud on the part of the originating bank. Moreover, it will move the regulatory system a step closer to eliminating the artificial distinctions that exist between commercial banking and investment banking activities.

LOUISA C. CRAMPTON

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228. See Murray & Vittone, *supra* note 29, at 415 (asserting that applying the federal securities laws to loan participations would “merely increase the costs in this area and stifle innovation in the banking industry”).

229. See Kornegay, *supra* note 25, at 805 (asserting that courts and regulators “should abandon the artificial and formalistic distinctions between the financial activities of commercial and investment banks”).

230. See Roberts & Quinn, *supra* note 4, at 2130 (noting that applying disclosure requirements on the originating bank in a loan participation would keep them from “marketing a product that potentially exposes purchasers to inadequately exposed risks”).

231. *Id.* at 2131.