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Banking, Antitrust, and Derivatives: Untying the Antitying Restrictions

CHRISTIAN A. JOHNSON†

INTRODUCTION

Banks are increasingly requiring their borrowers to hedge and manage business risks through newly-developed and innovative financial techniques. Banks are concerned that their borrowers are at risk with respect to fluctuations in interest rates or prices for key commodities. In particular, if a bank makes a loan with a variable interest rate, the bank is concerned that the interest rate may increase beyond the borrower's ability to make interest payments. Such increases and fluctuations could spell ruin for the borrower if not properly hedged and managed. To ensure that the borrower hedges such risks, banks are requiring their borrowers to use over-the-counter ("OTC") derivatives.

In addition to making the loan, the bank often wants the borrower to enter into the required OTC derivative with the bank itself. There are significant benefits for both

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parties if the bank not only makes the loan, but also is a party to the OTC derivative. There has been some uncertainty, however, as to whether a bank acting as both the lender and as a party to the OTC derivative violates the antityping provisions of the Bank Holding Company Act ("BHCA").¹ Under the BHCA, a bank is generally prohibited from requiring a borrower, as a condition to granting credit, to purchase additional products or services. Commentators have raised questions and concerns about whether a bank acting as both a lender and a party to the OTC derivative with the same borrower could run afoul of these antityping rules.²

This analysis of the antityping provisions is especially timely as banks begin to offer new and different products to their customers.³ As banks become more aggressive in marketing new products to customers, the temptation to tie the provision of credit either expressly or implicitly to the

1. Bank Holding Company Act, Pub. L. No. 91-607, 84 Stat. 1760 (1956) (amended 1970).

2. L. Clifford Craig et al., *Legal Theories in Lawsuits Against Derivatives Dealers in the Over-the-Counter Markets*, in DERIVATIVES 1996: AVOIDING THE RISK AND MANAGING THE LITIGATION 129, 168-69 (P.L.I. Corp. L. Practice Course, Handbook Series No. B-932, 1996) (stating that "the facts of a particular case may indicate that such a cause of action is viable"); Alan J. Berkeley & Jean E. Minarick, *Disclosure and Developments in Financing Instruments and Techniques*, in ADVANCED SECURITIES LAW WORKSHOP 335, 364-65 (P.L.I. Corp. L. Practice Course, Handbook Series No. 703, 1990) ("Commentators have noted that, although some banks have required their borrowers to purchase the caps from the lenders themselves, this can be risky because such a requirement may violate the antityping provisions of the Bank Holding Company Act."); Marsha E. Simms, *Structuring and Closing of Commercial Loans*, in BANKING AND COMMERCIAL LENDING LAW 163 (A.L.I.-A.B.A., 1997) ("A bank should be careful in requiring a borrower to obtain interest rate protection from it as a condition of making a loan, since some courts have found such conditions to violate the antityping rules of the [BHCA]."); Barry Taylor-Brill, *Negotiating and Opining on ISDA Masters*, in SWAPS & OTHER DERIVATIVES IN 1999 79, 92 (P.L.I. Corp. L. Practice Course, Handbook Series No. B-1147, 1999) (stating that "any U.S. bank(s) which impose the following types of restrictions and requirements should consider their liability under [the antityping rules of the BHCA]").

3. See generally John R. Engen, *E-Brokerage's Integration Challenge*, BANKING STRATEGIES, May & June 2000, at 28 (discussing banks and e-brokerage); Matt Ackermann, *Cross-Seller 1st Union Boosts 401(k) Assets*, AM. BANKER, July 7, 2000, at 6 (discussing asset management); Lynn Striegel, *Training Essential for People Working in Multiple Channels*, AM. BANKER, June 23, 2000, at 16 (stating that "extensive menu of products such as insurance, broker-dealers services, mortgages, mutual funds, investment advice, and new finance-related [services]").

purchase of these new products will increase.⁴ As banks move from traditional lending activities to activities such as acting as securities brokers and insurance agents, among others, it will be crucial to understand the reach of the antitying provisions.

There is no case law under the BHCA that resolves or even discusses the issue with respect to new products such as OTC derivatives. Even more problematic is that the enactment of the BHCA antitying provisions pre-date the OTC derivatives market, making it difficult to determine how Congress would have viewed the issue. This article will argue, however, that expressly requiring a borrower to enter into an OTC derivative with the bank itself as a condition for receiving credit does not violate the antitying restrictions of the BHCA.

Part I of this Article will discuss the nature of OTC derivatives and provide examples as to how OTC derivatives can enable a borrower to minimize various business risks. Part II will examine how banks are encouraging their borrowers to utilize various risk management techniques, such as OTC derivatives, and will discuss the impact of the BHCA on such efforts. Finally, Part III will analyze the elements of a tying claim under the BHCA, and argue that a requirement to enter into an OTC derivative with a bank as a condition to obtaining credit will not constitute a violation of the BHCA. Part III first discusses how a loan combined with an OTC derivative such as an interest rate swap is not really two tied products, but is actually, in substance, a fixed rate loan. Part III then argues that these tied products do not satisfy the "anticompetitive in nature" requirement because typically only the lending bank is willing to enter into the OTC derivative with the borrower. Finally, Part III concludes that the traditional banking practice exception to the antitying rules would exempt such tying arrangements from the antitying provisions.

I. OTC DERIVATIVES

A derivative is a unique transaction designed to hedge business risks. Although some participants in the OTC

4. This process has accelerated as banks have merged and developed nationwide presences.

derivatives market have suffered large losses through the use of derivatives, the OTC derivatives market continues to develop and expand. OTC derivatives provide an opportunity for borrowers to hedge and minimize their business risks.

A. Nature of OTC Derivatives

The term derivative includes a wide variety of financial transactions that are entered into in various financial markets. The transactions can be based on any number of underlying indices, such as an interest rate or currency or commodity prices, and take on a variety of different forms or structures. Derivatives range in complexity from "plain vanilla" interest rate swaps⁵ to more complex transactions involving equities, commodities, and other more exotic transactions.

A derivative is typically defined as "a financial contract whose value depends on the values of one or more underlying assets or indexes of asset values."⁶ In a derivative, parties typically agree to exchange payments based upon the change in the value or performance of an index or asset.⁷ The change in the underlying index or asset is then typically multiplied by an agreed upon amount, commonly referred to as the notional amount,⁸ to determine the total that must be paid by one party to the other.

A derivative can be either a standardized or a customized contract. Standardized contracts are typically

5. For a discussion of plain vanilla swaps, see *infra* notes 31-36 and accompanying text.

6. See BOARD OF GOVERNORS OF THE FED. RESERVE SYSTEM, FEDERAL DEPOSIT INSURANCE CORPORATION & OFFICE OF THE COMPTROLLER OF THE CURRENCY, DERIVATIVE PRODUCTION ACTIVITIES OF COMMERCIAL BANKS: JOINT STUDY CONDUCTED IN RESPONSE TO QUESTIONS POSED BY SENATOR RIEGLE ON DERIVATIVE PRODUCTS 2 (1993) [hereinafter JOINT STUDY]; U.S. GEN. ACCOUNTING OFFICE, FINANCIAL DERIVATIVES: ACTIONS NEEDED TO PROTECT THE FINANCIAL SYSTEM 24 (1994) [hereinafter GAO REPORT]; GROUP OF THIRTY GLOBAL DERIVATIVES STUDY GROUP, DERIVATIVES: PRACTICES AND PRINCIPLES 28-29 (1993) [hereinafter GROUP OF THIRTY].

7. See JOINT STUDY, *supra* note 6, at 10 (noting the definition of "swap" in Appendix III); GROUP OF THIRTY, *supra* note 6, at 31; GAO REPORT, *supra* note 6, at 28.

8. The parties do not actually ever exchange the notional amount, but instead use it as an amount to base the calculations of their payment obligations. See JOINT STUDY, *supra* note 6, at 8 (discussing notional amount).

traded over an exchange such as the Board of Trade, and cleared through a clearinghouse.⁹ The most common types of exchange derivatives are futures and options. In a futures transaction, the parties agree to the sale and purchase of a designated commodity or financial instrument at a set price in the future. An option is similar to a future, with a party purchasing the right to buy or sell property at an agreed-upon price prior to an expiration date.

A huge market has developed, however, in transactions that are customized by large commercial banks, investment banks, and similar financial institutions.¹⁰ This is commonly referred to as the “over-the-counter” market in which various kinds of customized derivative instruments are developed for their customers.¹¹ This article will focus primarily on derivatives entered into in the OTC derivatives market.

The OTC derivatives market has expanded and evolved over the last two decades.¹² It is estimated that the notional amount outstanding as of the end of 1997 in the OTC derivatives market for interest rate swaps, currency swaps, and interest rate options alone was more than \$24 trillion.¹³ Parallel with this growth, the type and number of participants entering the market also have increased.¹⁴ Not only do large financial institutions participate in the OTC derivatives market, but smaller and less sophisticated participants that are involved in all types of businesses and industries also participate.¹⁵

9. *See id.* at 4 (“Exchange-traded contracts are standardized as to maturity, contract size, and delivery terms.”).

10. *See id.* (“OTC markets involve customized derivative products in which the parties negotiate all details of the transactions or agree to certain simplifying market conventions.”). For a general discussion of the development of the derivatives industry, see SATYAJIT DAS, SWAP-DERIVATIVE FINANCING—THE GLOBAL REFERENCE TO PRODUCTS, PRICING, APPLICATIONS AND MARKETS 14-30 (1993).

11. *See* JOINT STUDY, *supra* note 6, at 4.

12. For a general description and discussion of the derivatives market, see DAS, *supra* note 10.

13. ISDA Market Survey, Summary of OTC Derivative Market Data, <http://www.isda.org/d6.html> (April 3, 1998) [hereinafter Market Survey].

14. ISDA, Educational Information on Derivatives, <http://www.isda.org/statistics/recent.htm> (last visited 1/11/01) (“In addition to being used by corporations, swaps and related derivatives are used by banks, state and local governments, government-sponsored enterprises and multilateral lending organizations.”).

15. *See* GROUP OF THIRTY, *supra* note 6, at 34-35 (“Roughly 87% of the

OTC derivatives can be structured in a variety of ways, and be based on a number of different indices. The two most common types of OTC derivatives involve hedging interest rate and currency exposure.¹⁶ As the OTC derivatives market matures and becomes more sophisticated, however, parties can use OTC derivatives to also hedge risks from the movement in the price of commodities, equities, and other types of assets.¹⁷

B. *Benefits of OTC Derivatives*

OTC derivatives can provide significant risk management benefits when used prudently. Although some parties have suffered significant losses due to their misuse,¹⁸ a party can improve its creditworthiness by using OTC derivatives to hedge business risks.¹⁹ The most

reporting private sector corporations use interest rate swaps, while 64% use currency swaps and 78% use forward foreign exchange contracts.”)

16. For a general discussion of interest rate and currency derivative products, as well as other more uncommon derivatives, see ANTHONY C. GOOCH & LINDA B. KLEIN, *DOCUMENTATION FOR DERIVATIVES* 159-320 (1993).

17. See GAO REPORT, *supra* note 6, at 24 (stating that assets include “stocks, bonds, physical commodities, such as wheat, oil and lumber”); Eileen Baecher, *Swaps and the Derivatives Market*, in *THE HANDBOOK OF DERIVATIVES & SYNTHETICS* 114-16 (Robert A. Klein & Jess Lederman eds., 1994) (discussing broad categories of derivative market products).

18. Misuse of OTC derivatives can result in significant losses. Despite their advantages, derivatives can be risky even for large, seemingly secure, publicly traded corporations. There is a growing number of companies that have suffered devastating losses as a result of their derivatives activities. For example, Procter & Gamble Co. lost \$157 million on derivatives tied to movements in the yields “on five-year U.S. Treasury notes and the price of 30-year U.S. Treasury Bonds.” Jeffrey Taylor, *Bankers Trust Faces Inquiry on Derivative Sales*, *WALL ST. J.*, Nov. 1, 1994, at C1. Other companies such as Air Products & Chemicals, Gibson Greetings Inc., and Mead have all lost tens of millions of dollars by entering into derivatives that moved against them. See Timothy L. O’Brien, *Bankers Trust Pays \$67 Million to Settle Derivatives Dispute with Chemical Firm*, *WALL ST. J.*, Jan. 25, 1996, at A5. Although Air Products lost \$107 million in 1994, it did receive a settlement payment of \$67 million after it sued Bankers Trust with respect to the transactions. See *id.*; see also James P. Miller, *Air Products Takes a Charge of \$60 Million*, *WALL ST. J.*, May 12, 1994, at A3; Steven Lipin & Jeffrey Taylor, *Bankers Trust Signs Accord on Derivatives*, *WALL ST. J.*, Dec. 6, 1994, at A3. Although Gibson Greetings eventually only paid \$6.2 million of the \$23 million that it owed to Bankers Trust through a court settlement, the settlement is still indicative of the great potential for losses. See *id.*

19. See GAO REPORT, *supra* note 6, at 25; GROUP OF THIRTY, *supra* note 6, at 36-37; Anatoli Kuprianov, *The Role of Interest Rate Swaps in Corporate*

common risks hedged and managed through OTC derivatives typically include minimizing the risk from changes in interest or currency rates. OTC derivatives can also be used to hedge other business risks such as fluctuations in the price of commodities.

In addition to the hedging benefits of OTC derivatives, they can also serve a number of other functions.²⁰ For example, derivatives can be used to lower the effective cost of a borrower's debt.²¹ Derivatives also can be used to manage existing assets and liabilities.²² Although these other benefits can be of importance to participants in the OTC derivative market, this Article will focus primarily on the benefits of OTC derivatives for a borrower by reducing various business risks that it faces from volatile changes in variable interest rates and commodity prices.

1. *Hedging Variable Interest Rates.* Although many borrowers are able to borrow more readily at a variable rate, most borrowers would prefer to pay a fixed rate of interest.²³ However, by borrowing at a variable rate, the borrower is subject to the risk that the variable interest rate on the loan may increase and exceed the borrower's ability to pay. This risk can be minimized by entering into an OTC derivative referred to as an interest rate swap, swapping a variable rate payment for a fixed rate

Finance, FED. RES. BANK RICHMOND ECON. Q., Summer 1994, at 53-58 (discussing hedging through interest rate swaps); Joseph L. Motes, *A Primer on the Trade and Regulation of Derivative Instruments*, 49 SMU L. REV. 579, 585-87 (1996).

20. For a summary of those benefits, see Leslie Rahl, *What Makes a Good OTC Counterparty?*, in THE HANDBOOK OF DERIVATIVES AND SYNTHETICS 331 (Robert A. Klein & Jess Lederman eds., 1994).

21. See GAO REPORT, *supra* note 6, at 25; GROUP OF THIRTY, *supra* note 6, at 34-35; see also Kuprianov, *supra* note 19, at 53-58 (discussing lowering finance costs through derivatives).

22. See GROUP OF THIRTY, *supra* note 6, at 36 ("a company may want to change the characteristics of its existing debt portfolio" [through interest rate swaps]); Rahl, *supra* note 20, at 331; Christopher D. Olander & Cynthia L. Spell, *Interest Rate Swaps: Status Under Federal Tax and Securities Law*, 45 MD. L. REV. 21, 23 (1986).

23. See generally Carl R. Beidleman, *The Role of Interest Rate Swaps in Managing Cash Flows*, in INTEREST RATE SWAPS 13-20 (Carl R. Beidleman ed., 1991) ("characteristics of interest rate swap participants"); George Handjinicolaou, *The Place of Interest Rate Swaps in Financial Markets*, in INTEREST RATE SWAPS 41-42 (discussing floating-rate financing) (Carl R. Beidleman ed., 1991).

payment.²⁴ In the early 1980s, this was virtually the only type of OTC derivative available.²⁵ The first real use of interest rate swap agreements began in the late 1970s.²⁶ Since then, activity in this area has exploded. Estimates place the outstanding notional principal amount for interest rate swaps at the end of the first six months of 1997 at \$22 trillion.²⁷ As a comparison, the notional amount outstanding as of December 31, 1995 was \$12.8 trillion.²⁸

An interest rate swap typically involves swapping fixed interest rate payments for variable interest rate payments, or vice versa.²⁹ Parties now, however, enter into various hybrids of the early interest rate derivatives, such as interest rate caps, floors, collars, or corridors.³⁰ In an OTC derivative swap, parties agree to exchange periodic payments. These payments are calculated by multiplying the notional amount of the transaction by a pre-agreed rate, price, or index.

The following example illustrates the hedging benefits that accrue to the borrower: In a plain vanilla interest rate swap, a dealer ("DealCo") and a manufacturing company ("ManCo") agree to exchange payments based upon predetermined interest rates. For example, assume that ManCo has borrowed \$10 million at a variable interest rate equal to prime, but would prefer to pay a fixed rate in order to limit the risk that interest rates will rise to a level that will exceed its ability to pay. ManCo could enter into an interest rate swap with DealCo to hedge that risk.

In an interest rate swap, parties agree to swap payment

24. See JOINT STUDY, *supra* note 6, at 5 (listing interest rate contracts).

25. See DAS, *supra* note 10, at 18-19.

26. See Roberta Romano, *A Thumbnail Sketch of Derivative Securities and Their Regulation*, 55 MD. L. REV. 1, 50 (1996); DAS, *supra* note 10, at 15 (discussing the history of swap development); *A Brief History of Derivatives*, ECONOMIST, Feb. 10, 1996, at 6 ("It is not the idea that is new, it is the volume."). See generally Nasser Saber, *Interest Rate Swaps: Valuation, Trading and Processing* (1994) (discussing the development of interest rate market).

27. See Market Survey, *supra* note 13. For an overall discussion of the size of the derivatives market, see DAS, *supra* note 10, at 4-11. Official statistics, however, may actually underestimate the true size of the market. See *Confused by Rival Estimates of Market Size? Here's Why*, SWAPS MONITOR, Oct. 11, 1993, at 4 (discussing problems of gathering accurate data).

28. See Market Survey, *supra* note 13.

29. *Id.*

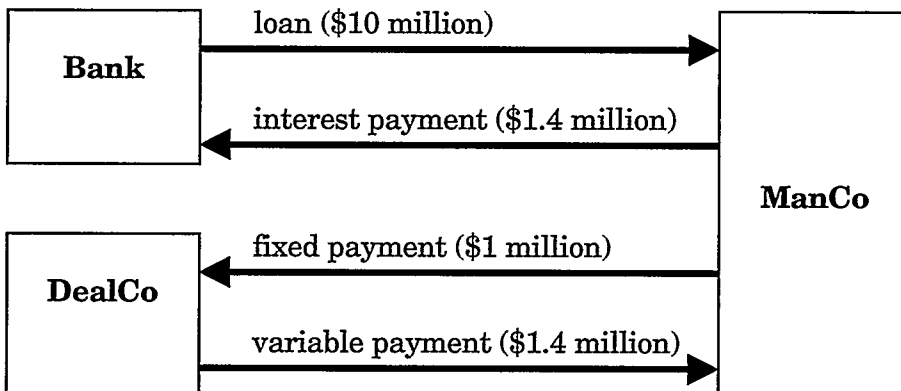
30. For an explanation of each of these transactions, see GOOCH & KLEIN, *supra* note 16, at 211-24.

obligations based upon a specified notional amount. The notional amount is never exchanged between the parties, but is used to calculate the payment amounts. For example, because ManCo wants to hedge its variable interest rate risk under the loan, the parties would probably use \$10 million as the notional amount. In a plain vanilla interest rate swap, ManCo would make a fixed rate payment to DealCo and DealCo would make a variable rate payment to ManCo.

Based on hypothetical current market conditions in this example, ManCo agrees to make a payment to DealCo equal to a fixed interest rate payment of ten percent (10%). DealCo agrees to make a payment to ManCo equal to the prime rate in effect on the payment date. Assume that the parties entered into the swap agreement on January 1st and agreed to exchange payments annually on the last day of each year for five years.

On December 31st of Year One, assume that the prime rate was fourteen percent (14%). DealCo would be obligated to make a payment to ManCo equal to \$1,400,000 (14% multiplied by \$10 million). ManCo would be obligated to make a payment to DealCo in the amount of \$1 million (10% multiplied by \$10 million). Typically, the terms of the swap agreement require that the payments be made on the same day and be netted against each other. In our example, DealCo would make a \$400,000 payment to ManCo. See Diagram 1-1:

Diagram 1-1
Interest Rate Swap Diagram
 (Fixed Rate = 10%, Prime Rate = 14%)

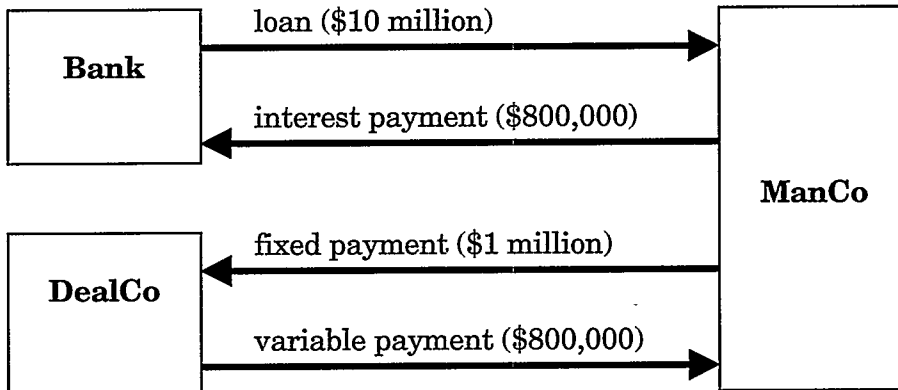


(Only net payment of \$400,000 paid to ManCo)

ManCo has met its hedging goal because it has avoided paying more than a net amount of 10% on its variable rate loan. ManCo would use the \$400,000 that it received from DealCo to meet its variable interest rate payment of 14%.

If the prime rate had gone down to 8% instead, ManCo would still have had an effective interest rate cost of 10% equal to the 8% that it would pay to its lender under the loan and the \$200,000 net payment that it paid to DealCo. See Diagram 1-2:

Diagram 1-2
Interest Rate Swap Diagram
 (Fixed Rate = 10%, Prime Rate = 8%)



(Only net payment of \$200,000 paid to DealCo)

Swaps, similar to the plain vanilla interest rate swap, also can be used to hedge the risk of the movement of a rate, index, or price in other areas such as commodities and equities. For example, if a food processor wanted to hedge the risk against increases in wheat prices, it could enter into a swap in which it would agree to pay a fixed price for a bushel of wheat in exchange for payments based on the same bushel of wheat at the current spot price. Similarly, an investor could hedge the risk of its stock holdings by agreeing to pay a variable amount to a dealer based on increases in a particular stock price in exchange for payments based on changes in a stock index such as the

S&P 500 from the dealer.

2. *Hedging Currency Rate Risks.* Parties doing business in different currencies are subject to risks caused by fluctuations in currency rates.³¹ The problem generally occurs when a party transacts business using a foreign currency. For example, a U.S. corporation may import goods from foreign countries, paying for the goods in the seller's currency. If the foreign currency appreciates in value with respect to the dollar, it becomes more expensive for the U.S. corporation to purchase the goods.³² Similar problems can occur when a party borrows in one currency yet conducts business in another.³³ Currency swaps, however, can provide significant protection against such risks.³⁴

OTC derivatives involving currency evolved around the same time as interest rates swaps. The first currency derivative product to receive widespread publicity involved a currency swap between the World Bank and IBM entered into in 1981.³⁵ These transactions were intended to enable a party to hedge against currency fluctuations and to lower its financing costs.³⁶

The most common type of currency derivative is a currency swap. As of June 30, 1997, there was an outstanding notional amount of \$1.5 trillion with respect to currency swaps.³⁷ The currency swap is very similar to an interest rate swap, but typically will involve the actual

31. As of June 30, 1997, the outstanding notional amount of currency swaps was \$1.5 trillion. *See* Market Survey, *supra* note 13.

32. *See* RICHARD H. FOLSOM & MICHAEL W. GORDON, INTERNATIONAL BUSINESS TRANSACTIONS 632-33 (1995) (discussing an example of buying and paying in pesos and yen).

33. Much of the Asian economic crisis in the late 1990s occurred because parties were unable to repay their U.S. loans because their own domestic currencies had collapsed. *See OTN Explores Asia's Economic Crisis*, at <http://www.megastories.com/seasia/why/why.htm> (Aug. 23, 2000).

34. CARL A. BATLIN, LINKAGES BETWEEN INTEREST RATE SWAPS AND CROSS-CURRENCY SWAPS, IN INTEREST RATE SWAPS 362 (Carl R. Beidleman et. al., ed., 1991); FOLSOM & GORDON, *supra* note 32, at 633-34 (1995).

35. NASSER SABER, INTEREST RATE SWAPS: VALUATION, TRADING AND PROCESSING 18 (1994).

36. *See* GOOCH & KLEIN, *supra* note 16, at 201; Donald Strassheim, UNDERSTANDING FINANCIAL DERIVATIVES: HOW TO PROTECT YOUR INVESTMENTS 121-22 (1997) (discussing how fluctuations in currency complicate "efforts to conduct international business").

37. *See* Market Survey, *supra* note 13.

swapping of principal amounts.³⁸ Other OTC derivatives involving currency transactions include swaptions, forward foreign exchange agreements, and currency options.³⁹

3. *Hedging Commodity Price Fluctuations.* For many parties, the price of the commodity that they purchase, market, or process can be their most significant business expense.⁴⁰ During the 1990s, commodity prices for oil and precious metals, among others, fluctuated wildly.⁴¹ Properly hedging these risks can ensure that a company can not only survive, but also thrive. Some companies have “been a major use of commodity hedging techniques because [their] survival has depended on it.”⁴²

Just as with derivatives designed to minimize interest rate risk, dealers also offer “swaps, options, swaptions and integrated hedges” to minimize the risks of swings in commodity prices.⁴³ The extreme volatility of prices in the commodities area makes OTC derivatives a natural choice to minimize the risks that such volatility can bring.⁴⁴ OTC

38. See GOOCH & KLEIN, *supra* note 27, at 201; Strassheim, *supra* note 36, at 121-22; BATLIN, *supra* note 34, at 374 (discussing structure of currency swaps); JOHN F. MARSHALL & KENNETH R. KAPNER, THE SWAPS MARKET 40-44 (1993).

39. See GOOCH & KLEIN, *supra* note 16, at 226-27 (explaining swaptions); *id.* at 235-36 (explaining forward rate agreements); *id.* at 248-51 (explaining currency options).

40. See David Stropes & Steven Vollmer, *Corporate Risk Management Profiles*, in COMMODITY DERIVATIVES AND FINANCE 123 (Kathleen Tener Smith & Pam Kennison eds., 1996) (discussing examples of companies that rely on commodities).

41. See Jennifer Barrett, *Update: Oil Surges as Inventories Drop*, at <http://www.thestreet.com/brknews/energy/1051369.html> (Aug. 23, 2000) (“The October future contract for crude oil leapt... 5%... on the New York Mercantile Exchange Wednesday.”); Christopher L. Gilbert & Celso Brunetti, *Commodity Price Volatility in the Nineties*, in COMMODITY DERIVATIVES AND FINANCE, *supra* note 40. For example, aluminum was up 72% during 1994 and London coffee was up over 200% during the eighteen month period ending December 1994. See *id.*

42. Stropes & Vollmer, *supra* note 40, at 123 (discussing hedging activities of Forest Oil Corporation).

43. Brian A. Toal, *Derivatives*, OIL & GAS INVESTOR, Apr. 1995, at 26; MARSHALL & KAPNER, *supra* note 38, at 44-46 (discussing an example of commodity swap).

44. See Toal, *supra* note 43, at 26 (“Consider what one money center bank says about market movements in the natural gas business: ‘Annualized price volatility can be greater than 50% in nearby months.’”); Daniel Yu, *Here Come Commodity Swaps*, ASIAMONEY, Mar. 1990, at 10; GOOCH & KLEIN, *supra* note 16, at 281 n.166 (discussing volatility).

derivatives have been designed to hedge the risk of volatile prices in everything from pulp and paper⁴⁵ to natural gas and electricity.⁴⁶

Parties can enter into commodity swaps just like interest rate swaps.⁴⁷ Assume, for example, that a natural gas producer ("NatCo") is concerned about natural gas prices.⁴⁸ In the event that natural gas prices were to fall, NatCo faces the risk that it may not be able to cover its marginal production prices, affecting its ability to meet its debt payments, among other expenses. Speculator Corp ("SpecCo"), on the other hand, believes that natural gas prices are going to increase. NatCo could hedge its risk by entering into a commodity swap with SpecCo.

Assume that natural gas prices are currently \$3.80 per million BTU ("MMBTU"). In a commodity swap, NatCo would agree to pay the market price on the payment date of natural gas multiplied by the required notional amount and SpecCo would agree to make a fixed payment to NatCo of \$4.00 per MMBTU. If natural gas prices fell to \$3.50 per MMBTU, and assuming that the payments were to be exchanged and netted on the same date, SpecCo would make a payment equal to \$0.50 multiplied by the notional amount.

NatCo, through the commodity swap, has limited its risk to price decreases below \$4.00 per MMBTU. In this case, NatCo would produce natural gas and sell it in the open market for \$3.50 per MMBTU. However, its effective net sales price of natural gas would be \$4.00 per MMBTU (\$3.50 + \$0.50 paid by SpecCo), enabling it to earn a profit sufficient to pay its debt services and other expenses. SpecCo, however, has suffered a loss on the commodity

45. See *Commodities: Utilities, Energy Companies Expand Risk Management*, DERIVATIVES WEEK, Jan. 5, 1998, at 6 (discussing trades involving "cash-settled pulp and paper collars").

46. See Toal, *supra* note 43, at 26 (discussing examples of commodity transactions involving natural gas); Jonathan Ratzesberger, *New Kid on the Grid; Energy Company Readies Electricity Trading, Plans Massive Hiring*, DERIVATIVES WEEK, Jan. 5, 1998, at 1 (discussing electricity trading).

47. Many of the more common types of commodity swaps include plain vanilla swaps, participation swaps, basis swaps, refining margin swaps, double up swaps, and extendible swaps. See Anthony Lerner & Dinsa Mehta, *Controlling Energy Price Risk*, in COMMODITY DERIVATIVES AND FINANCE, *supra* note 40, at 31.

48. See other examples of commodity swaps in Lerner & Mehta, *supra* note 47 (discussing examples involving oil prices & jet fuel).

swap because natural gas prices did not increase as anticipated, but rather decreased.

II. TYING AND THE BANK HOLDING COMPANY ACT

Banks have become increasingly active in the OTC derivatives market, often entering into OTC derivatives with their borrowers. Increasingly banks are requiring their borrowers to enter into OTC derivatives to hedge not only any interest rate risk, but also general business risks. Banks also would prefer that any hedges be done with the bank itself. Requiring the borrower to enter into an OTC derivative with the bank as a condition of receiving credit, however, may subject the bank to liability under the Bank Holding Company Act.

A. *Banks and the OTC Derivative Market*

Some of the largest banks in the world are also dealers in OTC derivatives. Because of their large OTC derivative operations, banks trade not only with the general public, but often with their own customers. When dealing with its own borrowers, banks would prefer that the borrower be obligated to enter into OTC derivatives with the bank itself.

1. *Role as a Dealer.* Unlike the option, futures, and stock exchanges, large banks tend to dominate the OTC derivatives market. These banks are not only those headquartered in the United States such as Citibank, Chase Manhattan Bank, and Bankers Trust Company,⁴⁹ but are also large foreign banks headquartered in Switzerland, Japan, Britain, and other large financial centers around the globe.⁵⁰ In fact, more than 100 of ISDA's 185 primary members are banks.⁵¹

49. See *Rankings of U.S. Commercial Banks at December 31, 1994*, SWAPS MONITOR, Mar. 14, 1994, at 8. For a discussion of the derivative activity of the major U.S. banks, see Gerald A. Edwards, & Gregory E. Eller, *Derivatives Disclosures by Major U.S. Banks, 1995*, FED. RES. BULL. 791 (Sept. 1, 1996); JOINT STUDY, *supra* note 6, at 11 (reviewing the chart in Exhibit 2 of the exposure of U.S. commercial banks).

50. See summary of the primary members of ISDA (listing majority of worlds largest commercial banks), at <http://www.isda.org/membership/index.html> (last visited Jan. 11, 2001).

51. See *id.*

The banks in these areas earn trading revenue by attempting to take advantage of changes in market rates or prices through derivatives.⁵² They have been particularly aggressive in the interest rate swap area. For example, Bank of America's "portfolio includes over 26,000 interest rate swaps having a total notional amount exceeding \$690 billion."⁵³ One study estimates that the top ten U.S. bank dealers in derivatives had trading revenue of more than \$35.9 billion for the ten-year period ending in 1993.⁵⁴ For example, one-third of Bank One's profits of \$1 billion in 1993 related to their derivative trading activities.⁵⁵ These lenders also earn significant fees through their derivative operations.⁵⁶ Even smaller banks have earned significant profits from their involvement with OTC derivatives.⁵⁷

2. *Acting as a Dealer with a Borrower.* As the OTC derivatives market has become more competitive, banks have begun to enter into OTC derivatives with not only the largest and most sophisticated financial institutions, but

52. See GAO REPORT, *supra* note 6, at 25; GROUP OF THIRTY, *supra* note 6, at 43; JOINT STUDY, *supra* note 6, at 7 (discussing "trading profits"); see also Steven Lipin & Gabriella Stern, *Bankers Trust Gets Big Boost from Sale of Derivatives*, WALL ST. J., Apr. 21, 1994, at A3 (stating that "almost three-fourths of [Bankers Trust's] first quarter profit came from the sale of derivative products."). The majority of the largest traders and dealers in the derivative market are commercial banks. See Carol Loomis, *The Risk That Won't Go Away*, FORTUNE, Mar. 7, 1994, at 49 (listing by notional amounts the largest dealers in the OTC market).

53. Bank of America's Response to Thrifty Oil Co.'s Claim Objection, at 7, *In re Thrifty Oil Co.*, 212 B.R. 147 (Bankr. S.D. Cal. 1997) (No. S.D. 92-09132-A11).

54. See Kenneth H. Bacon, *Congress is Getting Serious About Rules for Derivatives*, WALL ST. J., Nov. 23, 1993, at C1.

55. Loomis, *supra* note 52, at 50.

56. Banks and investment firms also had \$5 billion in revenue from their swap dealings in 1994. T. C. Hagamam, *Derivatives and the Banks*, MGMT. ACCT., June 1, 1995, at 16; Bruce S. Darringer, *Swaps, Banks and Capital: An Analysis of Swap Risks and a Critical Assessment of the Basle Accords Treatment of Swaps*, 16 U. PA. J. INT'L BUS. L. 259, 275 (1995) (stating that "[s]waps account for a growing share of revenues and profits for banks and securities firms"); JOINT STUDY, *supra* note 6, at 6 (stating that firms "expect to generate income from transaction fees, bid-offer spreads, and their own trading positions").

57. See Christopher Rhoads, *By the Numbers: Some Small Banks Church Out Derivatives Profits*, AM. BANKER, Feb. 9, 1996, at 6 ("Despite the scare over derivatives, some community banks say they have turned out to be big money-makers.").

also with their smaller and less creditworthy borrowers.⁵⁸ Although a large bank may have hundreds of parties with whom it enters into OTC derivatives, it may have several times that many borrowers to whom it lends money. Banks already have begun to tap their borrowers as OTC derivative counterparties.⁵⁹

Banks are integrating provisions relating to the use of OTC derivatives by their borrowers into their loan documentation. A review of loan documentation by the author of 200 different multi-lender agented loan transactions indicates that banks are integrating provisions into their loan documentation relating to their borrowers' OTC derivative activities.⁶⁰ Of the 200 different loan transactions reviewed, more than 180 of these loan agreements contained detailed provisions regarding the borrower's derivative activities.⁶¹

Although this review is admittedly nonrandom and

58. See *Triple-A Vehicles Provoke Suspicion Among Users*, EUROMONEY, Mar. 1994, at 58 ("The shrinking universe of triple-A banks cannot satisfy demand for the top credit rating among derivatives' users.").

59. "It is not uncommon, in these cases, for the lender itself to offer the swap, or, in the case of a syndicated facility, for more than one of the lenders or an affiliate of a lender, to be listed among the counterparties approved of in advance to provide the required swaps." GOOCH & KLEIN, *supra* note 16, at 374-75; see also George Melloan, *Global View: Leeson's Law: Too Much Leverage Can Wreck a Bank*, WALL ST. J., Mar. 6, 1995, at A15 ("Most large banks have set up trading floors to offer customers opportunities to hedge risks with derivatives."). For an example of a customer relationship in which a commercial bank has both lent money to its borrower and entered into derivatives, see *In re Thrifty Oil Company*, 212 B.R. 147 (Bankr. S.D. Cal. 1997), *aff'd* 49 B.R. 537 (S.D. Cal. 2000). For a discussion of *Thrifty Oil*, see *infra* notes 99-119 and accompanying text..

60. For a discussion of the documentation and bankruptcy issues associated with a bank acting as a dealer with its customers, see generally CHRISTIAN A. JOHNSON, OTC DERIVATIVE DOCUMENTATION: A PRACTICAL GUIDE FOR EXECUTIVES 77-78 (Bowne 2000); Christian A. Johnson, *At the Intersection of Bank Finance and Derivatives: Who Has the Right of Way?*, 66 TENN. L. REV. 1 (1998); Christian A. Johnson, *Risky Business: OTC Derivatives Risk Can Be Minimized Through Proper Loan Documentation*, J. LENDING CREDIT RISK MGMT., Sept. 1999, at 72; Christian A. Johnson, *Risky Business: Acting as Lender and OTC Derivative Dealer with the Same Customer*, J. LENDING & CREDIT RISK MGMT., Oct. 1999, at 66.

61. The author reviewed the loan documentation for 200 large multi-lender agented loan transactions that were entered into between 1995 and 1999 [hereinafter referred to as "Review of Loan Documentation"]. Over thirty eight different agents (and probably an equal number of law firms) were involved in the 200 transactions. See JOHNSON, OTC DERIVATIVE DOCUMENTATION, *supra* note 60, at 99.

anecdotal, it is indicative of the aggressive efforts currently being made by banks to confront the risks and opportunities that OTC derivatives may present for their borrowers and themselves. It is also important to note that the review was done with respect to loans made by syndicates of the largest and most sophisticated banks in the world. These banks are typically on the leading edge of financial risk management techniques, and their reference to and usage of OTC derivatives is indicative of their importance for hedging risks.

Entering into OTC derivatives with their borrowers is a natural progression for banks. Banks have already conducted much of the due diligence with respect to the creditworthiness of the borrower, permitting the banks to do OTC derivatives with their borrowers without having to do additional due diligence.⁶² In addition, the lender's familiarity with the financial affairs of the borrower also results in a highly accurate understanding of the borrower's potential needs for OTC derivatives. Finally, and probably most importantly, the bank as a lender has already developed a relationship of trust and understanding with the borrower,⁶³ resulting in the bank being a natural choice for the borrower with whom to do OTC derivatives.

Although the banks that are also dealers in the OTC derivatives market are probably the most likely to act as both a lender and a counterparty in the OTC derivative with their borrower, smaller banks also participate. Even if a smaller bank does not have a trading floor, they could enter into OTC derivatives with their borrower by using a correspondent dealer bank to provide any trading and back office support they need. They could also enter into a "back-to-back trade" with a dealer to hedge any risk they have taken with their borrower. Finally, they could also make an

62. See DOUGLAS A. HAYES, *BANK LENDING POLICIES* 82 (1971) ("[W]ithout exception, large banks maintain credit files on all business borrowers.") "As in all credit-sensitive agreements, '[k]now your counterparty.' There is no substitute for good, fundamental credit analysis and firsthand knowledge of the counterparty and its principals." Rahl, *supra* note 20, at 336; see also Bruce A. Baird, et al., *Recent Developments in Litigation Involving Derivative Contracts*, 90 A.L.I.-A.B.A 295, at 302-03 (May 10, 1996) (due diligence regarding the borrower's financial situation is not just important for the lender but also for the dealer acting as the borrower's counterparty).

63. See HAYES, *supra* note 62, at 81 ("The relationship between banks and their commercial borrowers has the following characteristics: (1) There are usually close and confidential relations between the bank and the borrower").

investment in modeling and information software to be able to price and monitor the OTC derivative themselves.⁶⁴

3. *Mandating the Use of OTC Derivatives.* Banks are requiring their borrowers to enter into OTC derivatives to hedge business risks. Banks commonly use affirmative covenants in their loan documentation with a borrower to require a borrower to hedge interest rate risk.⁶⁵ In the author's review of two hundred (200) loan agreements that contain provisions relating to the borrowers' OTC derivative activities, sixty-two (62) of them had affirmative covenants requiring borrowers to enter into OTC derivatives, typically to hedge the borrower's variable interest rate risk.⁶⁶ Several loan agreements with oil producers also had provisions requiring the borrower to hedge the risk that variable oil prices may decrease. Many borrowers may deal extensively with commodities such as grain or oil, which are transactions that can be easily, and often are, hedged.⁶⁷

Bank antitying provisions and antitrust law restrictions against anticompetitive tying arrangements have been an important part of antitrust law since its inception.⁶⁸

64. Interview with Matt Bayless, Vice President of Bank One (Sept. 13, 2000).

65. An example of an affirmative covenant requiring a borrower to enter into an interest rate swap was Bank of America's loan transaction with Great Western Refining Company ("GWR"). It provided that the GWR shall: "[n]ot later than six months following the Closing Date, enter into one or more Approved Swap Agreements with respect to an aggregate principal amount not less than \$43,000,000 and deliver to Agent copies of such Approved Swap Agreement." Reply Brief of Thrifty Oil Co. at 9, *In re Thrifty Oil*, 212 B.R. 147 (Bankr. S.D. Cal., 1997) (No. S.D. 92-09132-A11); see also B. Taylor, *Swap Risk*, 4 REV. OF FIN. SERVICES REG. 17, at 24 (Feb. 3, 1988) ("Loan agreements not only define the scope of permissible swaps; in many cases, they might also contain a 'positive swap clause,' requiring the borrower to hedge the loan's floating rate.").

66. See Review of Loan Documentation, *supra* note 61.

67. See *supra* note 48 and accompanying text for NatCo/SpecCo example.

68. For a general discussion of the restrictions against tying, see William M. Hannay & William A. Montgomery *Tying Arrangements: Practice Under Federal Antitrust, Patent, and Banking Law*, 39-2nd (Bureau of Nat'l Aff., Inc. 1997); HERBERT HOVENKAMP, *ECONOMICS AND FEDERAL ANTITRUST LAW* 216-46 (student ed. 1985); HERBERT HOVENKAMP, *FEDERAL ANTITRUST POLICY: THE LAW OF COMPETITION AND ITS PRACTICE* 350-91 (2nd ed. 1999); SPENCER WEBER WALLER, *INTERNATIONAL TRADE AND U.S. ANTITRUST LAW* § 1 (Jeffrey L. Kessler rev., West Group 1999); LAWRENCE A. SULLIVAN & WARREN S. GRIMES, *THE LAW OF ANTITRUST: AN INTEGRATED HANDBOOK* § 7 (2000).

Antitying provisions are part of both the Sherman Act⁶⁹ and the Clayton Act,⁷⁰ demonstrating Congressional concerns over the anticompetitive effects of tying.⁷¹ Antitying claims have also been permitted to be brought under Section Five of the Federal Trade Commission Act.⁷² In response to concerns that there were special considerations with respect to tying arrangements and banking, Congress has enacted special federal antitying provisions under the Bank Holding Company Act.⁷³

The Bank Holding Company Act⁷⁴ was enacted by Congress in 1956 in response to concerns that the antitrust provisions under the Clayton and Sherman Acts might be insufficient to curb the anticompetitive behavior of banks and their affiliates. The legislative history indicates that Congress was concerned that, "because of the importance of the banking system to the national economy, adequate safeguards should be provided against undue concentration of control of banking activities."⁷⁵

The BHCA generally governs the activities of "banks"⁷⁶ and has been extended by the Federal Reserve Board to

69. Sherman Act, § 1 (codified as amended at 15 U.S.C. §1 (1994)).

70. Clayton Act, § 3 (codified as amended at 15 U.S.C. § 14 (1994)).

71. See H.R. REP. NO. 63-627, at 10-13; S. REP. NO. 63-698, at 6-9 (1914).

72. 15 U.S.C. § 45 (1997).

73. For a history of the Bank Holding Company Act and the amendments, see Carl A. Sax & Marcus H. Sloan III, *Legislation Note: The Bank Holding Company Act of 1970*, 39 GEO. WASH. L. REV. 1200 (1971). For a discussion of the policy concerns, see Joseph C. Chapelle, *Section 1972: Augmenting the Available Remedies for Plaintiffs Injured by Anticompetitive Bank Conduct*, 60 NOTRE DAME L. REV. 706 (1985) (discussing policies underlying antitying provisions); Earl W. Kintner & Joseph P. Bauer, *Competition at the Teller's Window?: Altered Antitrust Standards for Banks and Other Financial Institutions*, 35 U. KAN. L. REV. 657 (1987); Daniel R. Fischel et al., *The Regulation of Banks and Bank Holding Companies*, 73 VA. L. REV. 301, 329-330 (1987); Austin & Solomon, *A New Antitrust Problem: Vertical Integration in Correspondent Banking*, 122 U. PA. L. REV. 366, 390 (1973).

74. Bank Holding Company Act of 1956, ch. 240, 70 Stat. 133 (codified as amended at 12 U.S.C. §§ 1841-1850 (1994)).

75. S. REP. NO. 1095, at 1 (1955), *reprinted in* 1956 U.S.C.C.A.N. 2482.

76. 12 U.S.C. § 1841(c). The definition defines a "bank" as any institution organized under the laws of the United States, any State of the United States, the District of Columbia, any territory of the United States, Puerto Rico, Guam, American Samoa, or the Virgin Islands which (1) accepts deposits that the depositor has a legal right to withdraw on demand, and (2) engages in the business of making commercial loans.

include bank holding companies and their nonbank subsidiaries.⁷⁷ The BHCA is enforced by the attorney general, who may “institute proceedings in equity to prevent and restrain” violations of the statute.⁷⁸ Remedies and damages under the BHCA include civil penalties,⁷⁹ private treble-damage actions,⁸⁰ and suits for injunctive relief by either the U.S. government or private parties.⁸¹

The BHCA was amended in 1970 to include what are commonly referred to as the “antitying” provisions now found in 12 U.S.C. § 1972 (“Section 1972”).⁸² The most important provision provides that “a bank shall not in any manner extend credit . . . on the condition or requirement . . . that the customer shall obtain some additional credit, property, or service from such bank other than a loan, discount, deposit or trust service.”⁸³ The statute also encompasses products or services that might be offered

77. 12 C.F.R. § 225.7(a) (1994).

78. 12 U.S.C. § 1973.

79. 12 U.S.C. § 1972(2)(F).

80. 12 U.S.C. § 1975; *Kabealo v. Huntington Nat'l Bank*, 17 F.3d 822 (6th Cir.) (1994), *cert. denied*, 115 S. Ct. 64 (1994); *Lancianese v. United Bank of Mt. Hope*, 783 F.2d 476 (4th Cir. 1986).

81. 12 U.S.C. § 1976.

82. Bank Holding Company Act Amendments of 1970, Pub. L. No. 91-607, § 106(b), 84 Stat. 1760, 1766-67 (codified as amended at 12 U.S.C. § 1972(1) (1994)). In addition to the antitying provisions, the amendments also prohibited reciprocal and exclusive dealing arrangements. *See id.*

83. 12 U.S.C. § 1972(1)(A). The entire provision reads as follows:

A Bank shall not in any manner extend credit, lease or sell property of any kind, or furnish any service, or fix or vary the consideration for any of the foregoing, on condition or requirement—

(A) that the customer shall obtain some additional credit, property, or service from such bank other than a loan, discount, deposit or trust service;

(B) that the customer shall obtain some additional credit, property, or service from a bank holding company or such bank, or from any other subsidiary of such bank holding company;

(C) that the customer provide some additional credit, property or service to such bank, other than those related to and usually provided in connection with a loan, discount, deposit, or trust service;

(D) that the customer provide some additional credit, property, or service to a bank holding company of such bank, or to any other subsidiary of such bank holding company; or

(E) that the customer shall not obtain some other credit, property, or service from a competitor of such bank, a bank holding company of such bank or any subsidiary of such bank holding company, other than a condition or requirement that such bank shall reasonably impose in a credit transaction to assure the soundness of the credit.

by a subsidiary or affiliate of the bank.⁸⁴ Typically, the borrower would be viewed as entering into an OTC derivative with, or purchasing an OTC derivative from, the bank.

Conceivably, it could be argued that a companion subprovision might also apply. Under 12 U.S.C. § 1972(1)(C), there can also be a tying issue when the borrower, as a condition for receiving credit from the bank, is required to provide to the bank "some additional credit, property or service."⁸⁵ For example, by entering into the OTC derivative with the bank, is the borrower the provider or the recipient of the OTC derivative? The bank could require the borrower to sell an OTC derivative such as a cap to the bank, which might be viewed as selling a product.

To establish a violation of the antitying provisions of the BHCA, a claimant generally must show that: (1) there was a tying arrangement between two products or services; (2) the practice was anticompetitive; (3) there was a benefit to the bank; (4) there was damage to the claimant; and (5) the tying arrangement was unusual and not subject to an exception.⁸⁶ Each of these elements must be demonstrated in order to establish liability.

III. UNTYING THE ANTITYING RULES

The antitying rules should not be applicable to situations in which a bank makes it a condition of extending credit that the borrower enter into an OTC derivative with the bank. A careful analysis of the required elements that constitute a violation of the antitying provisions demonstrates that the statute should be

84. 12 U.S.C. § 1972(1)(E) (from "a bank holding company of such bank, or [from] any subsidiary of such bank holding company").

85. *Id.* at § 1972(1)(C). It is also applicable if the customer is required to provide such credit property or service to the bank holding company of the bank or a subsidiary of the bank holding company. *Id.* at § 1972(1)(D).

86. For a general discussion of the elements that a claimant must show, see James L. Rigelhaupt, Jr., *Annotation: What Constitutes Violation of Provisions of Bank Holding Act Prohibiting Tying Arrangements*, 74 A.L.R. FED. 578 (1999); Daniel Aronowitz, *Retracing the Antritrust Roots of Section 1972 of the Bank Holding Company Act*, 44 VAND. L. REV. 865 (1991); Joseph C. Chapelle, *Section 1972: Augmenting the Available Remedies for Plaintiffs Injured by Anticompetitive Bank Conduct*, 60 NOTRE DAME L. REV. 706 (1985); Robert Finke & Daniel G. Hildebrand, *Antitrust Compliance in the Banking Industry*, C880 A.L.I.-A.B.A. 179, 181 (1994).

inapplicable to this banking practice.

A. *Tying Arrangement*

To constitute a violation of the BHCA, the borrower is required to show that there was a tying arrangement. Under this analysis, the borrower would need to show that, in order to obtain credit from the bank, the borrower was required to purchase another product or service from the bank such as an OTC derivative.

1. *Express Tie.* The most straight-forward case for demonstrating a tying arrangement would be for the loan documentation to require that the OTC derivative be done with the bank extending the credit. It appears to be rare, however, for a bank to expressly require the borrower to enter into the OTC derivative with the bank itself. In fact, the author noted no express requirement that a required OTC derivative be done only with a member of the bank group in the 200 loan agreements that were reviewed.⁸⁷ It is unclear to the extent that banks acting as the sole lender to a borrower require that an OTC derivative be done with the bank itself.

Regardless of current market practice, however, banks would strongly prefer that the OTC derivative be done with the bank. Apart from any profit that a bank may earn on the OTC derivative itself, there are important reasons why the OTC derivative should be done with the bank. If a borrower were to enter into an OTC derivative with a third party, that would subject the borrower to the risk that the third party would not perform under the transaction. This is commonly referred to as "credit risk."⁸⁸ In the event that

87. For a discussion of the author's review of various loan agreements, see JOHNSON, OTC DERIVATIVES DOCUMENTATION, *supra* note 60, at 99.

88. See JOINT STUDY, *supra* note 6, at 12; GAO REPORT, *supra* note 6, at 52 (explaining "the possibility of financial loss resulting from a counterparty's failure to meet its financial obligations"); *id.* at 23 (discussing the aggregation or interconnection of risk); GROUP OF THIRTY, *supra* note 6, at 47; Adam R. Waldman, *OTC Derivatives & Systemic Risk: Innovative Finance or the Dance into the Abyss*, 43 AM. U.L. REV. 1023, 1047 (1994) ("The 'credit risk' in a derivative transaction is the risk that the participant will default on contractual obligations to a counterparty, resulting in loss."). In understanding credit risk, however, it is important to distinguish credit risk from "systemic risk." "System risk" is the risk that the failure of a major participant in the market could lead to a domino effect on the entire market. See *id.* at 1047. Although a party may

the third party were to default on the OTC derivative, the borrower may actually end up being less creditworthy as a result of the trades. By serving as both the counterparty and the lender, no such additional risks are introduced into the banking relationship.

The bank would also be able to best structure the OTC derivative and monitor its results. Because of its knowledge of the borrower and the credit to be extended, the bank would be able to develop a transaction that would provide the best opportunity to hedge the targeted business risks. For example, the bank would best understand the amount of notional amount that should be used, the tenor, and other unusual characteristics that should be in the transaction. The bank would also probably be more flexible in restructuring the OTC derivative than an independent dealer if the risks to be hedged were to change because of its concerns with respect to the overall credit worthiness of the borrower.

The importance of there being an “express” tie was reinforced in two decisions⁸⁹ involving what is commonly referred to as “collateral protection insurance” or “force-placed” insurance.⁹⁰ These cases analyzed whether a requirement that borrowers purchase comprehensive and collision auto insurance when financing an auto purchase through a bank violated the BHCA antitying provisions. These auto loans provided that if the borrowers did not purchase auto insurance, the bank was authorized to purchase it for them, and add the premium cost to the borrower’s loan balance.

In both *Kenty*⁹¹ and *McLain*,⁹² the court failed to find a tying relationship. The courts held that, because the borrower was free to buy their own auto insurance from a

be unable to control systemic risk, it does have the ability to minimize its credit risk through carefully selecting its counterparties or by requiring collateral.

89. See *Kenty v. Bank One, Columbus*, 92 F.3d 384 (6th Cir. 1996); *McLain v. S.C. Nat’l Bank*, 105 F.3d 898 (4th Cir. 1997).

90. Michael P. Malakoff & David W. Snyder, *An Update of Forced-Placed Insurance Suits* 227, 230 (P.L.I. Corp. Law & Practice, Practice Course Handbook Series No. B4-7188, 1997); James M. Cain & Leonard A. Bernstein, *Functional Regulation of Bank Sales of Insurance—A Complicated Matrix is Developing with Potential Pitfalls*, 52 BUS. LAW. 1057, 1070-71 (1998); Eugene J. Kelley Jr. et al., *Collateral Protection Insurance: Current Issues and Defenses*, 54 CONSUMER FIN. L. Q. REP. 14, 17 (2000).

91. *Kenty*, 92 F.3d at 384.

92. *McLain*, 105 F.3d at 898.

company of their choosing, there was no tying arrangement—in spite of the fact that the bank bought the insurance itself after the borrower failed to do so.⁹³ Extending the courts' analysis to OTC derivatives, it could be argued that so long as the bank did not require the OTC derivative to be done with the bank, there could not be a violation.

It is unclear, however, whether the collateral protection insurance cases are necessarily applicable. First, banks in the collateral protection insurance cases were not in the business of providing the required auto insurance, and it was unclear if the bank profited from purchasing the insurance on behalf of the borrower. Second, the nature of the products are very different. The auto insurance is a standardized product provided by multiple insurance companies. In contrast, the OTC derivative is a highly specialized and stylized product.⁹⁴

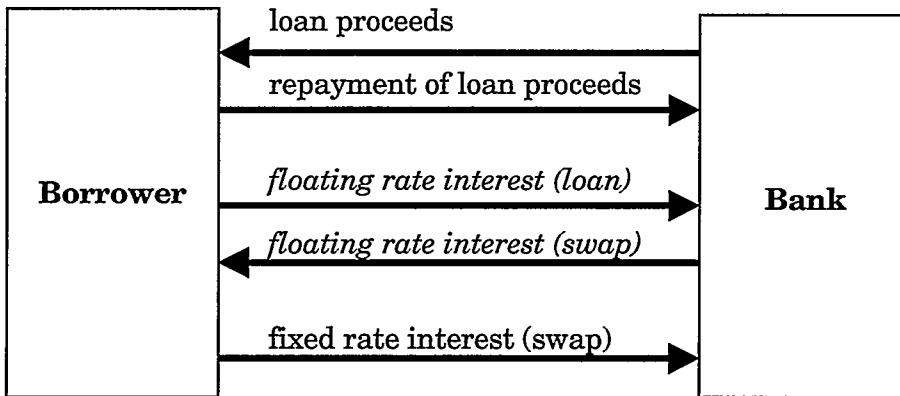
2. *One Product Versus Two.* Assuming that there is a tie in form between the loan and the OTC derivative, there may not be a tie in substance. Instead of two tied products, there is probably only one integrated loan. At least in the context of OTC interest rate derivatives,⁹⁵ the tied products should be characterized as a single one. When the borrower simultaneously enters into a variable rate loan and an OTC derivative, it can be shown that the bank has actually made a fixed rate loan to the borrower. If the lender has actually made what amounts in substance to a fixed rate loan, there would appear to be no tying arrangement. In other words, although the lender has "tied" the OTC derivative to the loan, the interest rate swap was just one component or part of a fixed rate loan.

It can be demonstrated graphically that a bank concurrently making a loan and entering into an interest rate swap with the borrower may actually be making a fixed rate loan:

93. *Kenty*, 92 F.3d at 395; *McLain*, 105 F.3d at 902.

94. See *supra* notes 10–11 and accompanying text.

95. This argument would be inapplicable to a situation in which the bank is requiring a commodity or other type of OTC derivative to hedge business risks as part of it extending credit.



With respect to the two transactions, typically the outstanding principal amount of the loan will be a multiple of, or the same amount as, the aggregate notional amount under the OTC derivatives.⁹⁶ Under this scenario, the amount of the variable rate interest payment of the loan would be calculated on the same notional amount as the variable rate swap payment under the swaps.⁹⁷ As can be seen from the chart, after offsetting the floating rate payments, the borrower in essence is left making a fixed rate interest payment to the lender.

The argument becomes even stronger when coupled with an understanding that the bank could actually have offered a fixed rate loan to the borrower by using derivatives as a component of the fixed rate loan to hedge its risks. For example, the bank could offer a fixed rate loan and then hedge its exposure either on a portfolio basis, or by entering into an interest rate swap itself with another party, swapping fixed rate payments for variable rate payments with another counterparty. The antitying rules

96. See *In re Thrifty Oil Co.*, 212 B.R. 147, 149 (Bankr. S.D. Cal. 1997), *aff'd* L49 B.R. 537 (S.D. Cal. 2000).

97. However, as a factual matter in the case, the two payments varied slightly because the variable interest rate under the loan was based on Bank of America's "reference rate," an amount typically equal to prime, and the floating rate payment under the swap was based on the London interbank offering rate, (LIBOR). LIBOR "refers to the interest banks have to pay other banks in order to borrow money in the London money market." *Id.* at 149 n.2. The difference in payments, however, did not appear to influence the court's decision in that this difference is never commented upon by the court.

should not be invoked merely because a bank chooses to make a variable rate loan (coupled with an interest rate swap) as opposed to a fixed rate loan.

Many banks prefer to enter into a variable rate loan combined with an interest rate swap as opposed to a fixed rate loan. First, at many banks the lending group and the derivatives group operate independently, each with its own credit policies and profit and loss concerns. The lending group will make the loan, and the derivatives group will enter into the OTC derivative with the borrower if it can make money doing so. Second, the variable rate loan coupled with an OTC derivative is much more flexible than a fixed rate loan.

For example, if the OTC derivative were offered separately, the parties could tailor the transaction to reflect their requirements. The borrower and the banker may only see a need to enter into an interest rate swap with a notional amount equal to one-half of the outstanding loan balance. Several different interest rate swaps could also be entered into to reflect different pricing and risk possibilities. The tenor of the interest rate swap could also be shorter than the tenor of the loan.⁹⁸

Third, there may be legal concerns with collecting damages for the termination of the swap upon the bankruptcy of the borrower. If the interest rate swap were considered to be a component of the fixed rate loan, it could be argued that any damages from terminating the swap may constitute "unmatured interest," and would therefore be uncollectible under the U.S. bankruptcy code.⁹⁹

3. *Thrifty Oil*. There is no authority under the BHCA antityping rules pursuant to which a lender has argued that it actually made a synthetic fixed rate loan as opposed to entering into a separate and distinct loan transaction followed by an interest rate swap. In a different legal context, however, this argument was made in a bankruptcy court decision entitled *In re Thrifty Oil Co.*,¹⁰⁰ involving a

98. Interview with Matt Bayless, Vice President of Bank One (Sept. 13, 2000).

99. See Johnson, *At the Intersection*, *supra* note 60, at 67.

100. 212 B.R. 147 (Bankr. S.D. Cal. 1997), *aff'd*, L49 B.R. 537 (S.D. Cal. 2000) *Thrifty Oil* has not yet appealed the bankruptcy court's decision. For a brief summary of the decision, see *Court Considers Damages Under Interest Rate Swap Agreement*, BCD NEWS & COMMENT (Sept. 23, 1997); *Court*

loan in which Bank of America acted as both a lender and the dealer. Although the court did not discuss, or even mention, the antitying restrictions, its decision did turn on whether the lender had actually made a fixed rate loan for purposes of the U.S. bankruptcy code.

The issue concerned whether the damages claimed by a bank upon termination of an OTC derivative with a bankrupt or insolvent borrower could be characterized as a claim for "unmatured interest," a claim generally denied by bankruptcy courts. The court in *Thrifty Oil* dealt with this issue by holding that the damages claimed by Bank of America, as the bank/counterparty in the case, under the derivatives entered into with its borrower, were not unexpired interest, and thus Bank of America was entitled to recovery because the transactions were not characterized as a fixed rate loan.

In *Thrifty Oil*, Golden West Refining Company ("GWR") negotiated a \$75 million loan with Bank of America ("BofA").¹⁰¹ The term sheet outlining the transactions indicated that both parties would enter into an interest rate-syndicated swap as part of the loan.¹⁰² BofA eventually made a variable rate loan of \$45 million to GWR.¹⁰³ Concurrent with the loan, BofA entered into three plain vanilla interest rate swaps¹⁰⁴ with GWR.¹⁰⁵ Thrifty Oil Company ("Thrifty") guaranteed the interest rate swaps.¹⁰⁶ It is important to note that, although Thrifty was not required to enter into the interest rate swaps with BofA,

Considers Damages Under Interest Rate Swap Agreement, 10 COMM. LENDING LITIG. NEWS, No. 9, Sept. 19, 1997.

101. *Thrifty*, 212 B.R. at 149.

102. *See id.*

103. *See id.* GWR borrowed an additional \$7 million approximately fifteen months later.

104. *See supra* notes 29-42 and accompanying text (discussing plain vanilla interest rate swaps).

105. *See Thrifty*, 212 B.R. at 149. The swaps were composed of three transactions entered into over a forty day period with an aggregate notional amount of \$45 million, the same as the loan. In the swaps, the fixed rates were 9.125%, 8.96%, and 8.66%, respectively. *See* Declaration of Leslie Reuter In Response to Claim Objection, Confirmations attached as exhibits, Case No. 92-09132-A11 (Oct. 31, 1996).

106. *Id.* Thrifty also agreed to guarantee the loan obligations of GWR. *Id.* Thrifty became involved because, one day before the loan closing, it executed an agreement to guarantee GWR's obligations in both the loan and also the derivative transaction. Thrifty's relationship to GWR, or its reasons for the guarantee, are undisclosed in the case.

both parties had indicated that the interest rate swaps were to occur concurrently with the closing of the loan.

GWR filed for bankruptcy approximately two years after closing the loan. Pursuant to the terms of the swaps, BofA terminated the swaps and filed a claim in bankruptcy for damages.¹⁰⁷ Thrifty, as the guarantor of GWR's obligations under the interest rate swaps with BofA, objected to BofA's claim for damages.¹⁰⁸ Thrifty, in its capacity as guarantor, rejected BofA's claim and argued that the loan agreement and the swap agreement should be characterized together as a "fixed rate loan." Under such a characterization, the termination payments under the swap would constitute a claim for "post-petition interest," which is disallowed as unmatured interest under the Bankruptcy Code.¹⁰⁹

Thrifty's argument can be demonstrated through a numerical example. Assume that both the principal amount of the loan and the aggregate notional amount of the interest rate swaps were \$50 million. Also, assume that the variable interest rate charged by BofA was 8%.¹¹⁰ Further, assume that the fixed rate payable by GWR was 10%. Finally, assume that both interest payments and swap payments were only made at the end of the year.

On the payment date in Year One, GWR would make

107. The damages were in the amount of \$5,428,500. *See Thrifty*, 212 B.R. at 149. The calculation of the termination payment under the ISDA Master Agreement was not contested by Thrifty, other than Thrifty's characterization of the payment as unmatured interest.

108. *See id.* at 150. Thrifty also made an argument based on California law.

109. *Id.* Thrifty's claim was that the termination amount violated the Bankruptcy Code's prohibitions on post-petition or unmatured interest. Thrifty argued that the loan and interest rate swaps should be integrated into one synthetic fixed rate loan. Under this characterization, any claim for damages under the swaps would be characterized as unmatured interest. Under the Bankruptcy Code, a creditor cannot claim post petition or unmatured interest against a bankrupt party that accrues after the debtor has filed for bankruptcy. Section 502 of Bankruptcy Code prohibits a claim for "unmatured interest" if a valid objection is made to the claim. 11 U.S.C. § 502(b)(2) (1994). For a general discussion of Section 502, see 4 COLLIER ON BANKRUPTCY ¶ 502.01 (Lawrence P. King ed., 15th ed. rev. 1999); 2 WILLIAM L. NORTON, JR., NORTON BANKRUPTCY LAW AND PRACTICE § 28 (2d ed. 1991); DANIEL R. COWANS, COWANS BANKRUPTCY LAW AND PRACTICE § 12 (1994). Unmatured interest is interest that has accrued on claims after the date of the filing of the bankruptcy petition. *See COLLIER, supra*, ¶ 502.03[3][a].

110. The facts in the case do not set forth what LIBOR or the reference rate was at the date of bankruptcy filing. *See Thrifty*, 212 B.R. at 149.

an interest payment to BofA of \$4 million.¹¹¹ Under the interest rate swap, GWR would make a net payment of \$1,000,000.¹¹² Taken together, GWR has made a total payment of \$5 million to BofA with respect to the combined loan and swap transaction. This is the same amount that GWR would have paid BofA if they had merely taken a loan within a fixed interest rate of 10%, the same fixed rate payable by GWR under the swaps. GWR argued that, if the two transactions are integrated together, the economic effect is identical with a fixed rate loan.

In considering Thrifty's argument, the court determined that Thrifty would need to establish that the swap payments were in substance interest payments paid on borrowed money.¹¹³ Thrifty needed to demonstrate that the swap agreement was actually a part of the loan agreement, and not a separate transaction. In considering whether there was in substance a fixed rate loan, the court analyzed the objective intent of the parties when the two transactions were negotiated. The court measured this objective intent based upon two factors: (1) the loan documents; and (2) the "extrinsic evidence of intent, such as the books and records of the parties, accounting practices, regulatory treatment of the transaction, and trade custom and usage."¹¹⁴ After analyzing these factors, the court determined that the objective intent of the parties was to enter into two separate transactions.¹¹⁵ As a result, the court found that the termination payments under the swap were not unmatured interest.¹¹⁶

After *Thrifty*, it has become extremely difficult in a bankruptcy context to argue that a loan coupled with a separate interest rate swap should be integrated into a single synthetic fixed rate loan. Although unstated in the

111. \$50 million multiplied by the reference rate of 8% equals \$4 million.

112. \$50 million multiplied by the floating rate of 8% equals \$4 million. \$50 million multiplied by the fixed rate of 10% equals \$5 million. The net payment of \$1 million payable by GWR under the swap would be the difference between the fixed payment of \$5 million payable by GWR less the variable rate payment payable by BofA of \$4 million.

113. "Interest is money 'paid to compensate for the delay and risk involved in the ultimate repayment of monies loaned.'" *Thrifty*, 212 B.R. at 150 (quoting *In re Pengo Indus., Inc.*, 962 F.2d 543, 546 (5th Cir. 1992)).

114. *Thrifty*, 212 B.R. at 151 (citing *In re Comark*, 145 B.R. 47, 53 (B.A.P. 9th Cir. 1992)).

115. *See id.* at 154.

116. *See id.*

opinion, the U.S. Bankruptcy Code is extremely friendly towards OTC derivatives, providing substantial protections for the provider of an OTC derivative to bankrupt debtor.¹¹⁷ The legislative history is indicative of the lengths to which Congress has gone to protect creditors who have entered into OTC derivatives and the OTC derivative market.¹¹⁸ Had the bankruptcy court held against BofA, many of these concerns and statutory changes would have been eviscerated, possibly even harming the OTC derivative market.

It would, however, probably be inappropriate to apply the *Thrifty* holding in the antitying context. Courts have taken an aggressive stance in the antitrust area by looking to the substance of transaction.¹¹⁹ They may be much more willing to integrate the loan and OTC derivative for purposes of determining the applicability of the antitying provisions as they look to the general market and the broad goals and purposes of antitrust law.

117. For a general discussion of the treatment of derivatives under the U.S. Bankruptcy Code, see Cravath, Swaine & Moore, Memorandum of Law for the International Swaps and Derivatives Association, *Over-the-Counter Derivatives Transactions: Netting Under the U.S. Bankruptcy Code, FIRREA, and FDICIA* (June 22, 1993); Martin J. Bienenstock, *Understanding the Business, Bankruptcy and Securities Aspects of Derivatives*, in *DERIVATIVES UNDER THE BANKRUPTCY CODE 11* (P.L.I. Com. L. & Practice, Practice Course, Handbook Series No. 721, 1995); Moody's Investors Service, *Global Credit Research, The Status of Swap Agreements Under the U.S. Bankruptcy Code* (June 1994) (general discussion); MOODY'S INVESTORS SERVICE, *Derivatives Claims Under the U.S. Bankruptcy Code: Implications for Counterparty Ratings* (Oct. 1994); John C. Dugan, *Derivatives: Netting, Insolvency, and End Users*, 112 *BANKING L. J.* 639 (1995); Scot Tucker, *Interest Rate Swaps and the 1990 Amendments to the United States Bankruptcy Code: A Measure of Certainty Within Swap Market Contracts, Interest Rate Swaps and the 1990 Amendments to the United States Bankruptcy Code: A Measure of Certainty with Swap Market Contracts*, 1991 *UTAH L. REV.* 581.

118. *Bankruptcy: Swap Agreements and Forward Contracts*, House Report No. 101-484 (May 14, 1990), 4 *U.S.C.C.A.N.* 223 (1990); see also *Bankruptcy Treatment of Swap Agreements and Forward Contracts*, H.R. Rep. No. 484, 101st Cong., 2d Sess. 1, reprinted in 1990 *U.S. Code Cong. & Admin. News* 223 (discussing uncertainties); J. C. Dugan, *Derivatives: Netting, Insolvency, and End Users*, 112 *BANKING L. J.* 638 (1995) (discussing the legal risks for a participant in bankruptcy without swap friendly provisions); Tucker, *supra* note 117, at 581.

119. See *Eastman Kodak Co. v. Image Technical Servs.*, 504 U.S. 451 (1992); *Timken Roller Bearing Co. v. United States*, 341 U.S. 593, 597 (1951).

4. *Implied Tie*. One commentator has suggested that an implied tie-in requirement might constitute a violation of the BHCA antitying provisions.¹²⁰ Although a borrower's decision to voluntarily purchase a second product or service from a bank would not trigger liability,¹²¹ an implied or implicit tie may be indicative of an illegal tying arrangement. In an implied tie-in, it is understood by the borrower that it should enter into the OTC derivative with the bank even if it is not expressly required—failure to do so could result in a bank not extending credit the next time.

Bankers may put implied pressure on the borrower to enter into the OTC derivative with the bank itself. There is currently tremendous pressure on bankers to cross-sell products that their banks offer to customers.¹²² Bonuses and other compensation might be tied to the banker's ability to put these transactions into place. The banker could imply to the borrower that if the borrower were to shop around for the OTC derivative, there may be adverse consequences

120. See CHARLES G. BLAINE, FEDERAL REGULATION OF BANK HOLDING COMPANIES § 12.16 (1973) ("While . . . it would be difficult to prove [an implied] condition or requirement, . . . assuming that the exact discussion [implying a condition] could be proved, might tend to indicate that a condition or requirement was part of the arrangement. . . [Banks should] avoid transactions . . . creating factual circumstances from which a court might infer an impliedly prohibited transaction.").

121. See *id.* ("It seems clear for a number of reasons that such [voluntary] tying effects are not prohibited . . . , but principally because by definition they are voluntary on the part of the customer and are not part of any 'condition or requirement' of the bank.").

122. See Brian Nixon, *De-Commoditizing Mortgage Lending*, COMMUNITY BANKER, May 2000, at 22-25 (discussing cross-selling); Heike Wipperfurth, *HSBC Bites Big Apple Again: Ad Campaign Touts New New York Holding*, INVESTMENT NEWS, Apr. 24, 2000, at 34; Kenneth Cline, *Revenue Play*, BANKING STRATEGIES, May 2000, at 19 ("The edifice of cross-selling must be built on a foundation of tremendous persistence and discipline."); Gerald C. Vigneron, *Where Banking and Insurance Meet*, U.S. BANKER, Nov. 1999, at 7, 14 ("Insurance sales is a natural fit for community banks looking to expand their offerings and increase revenues and profits."); Investment Products, AM. BANKER (Sept. 1, 2000), at 1 (stating that a bank competes "by cross-selling products"); Mathew A. Riebel, *Partners Can Help Banks Sell Small-Biz Retirement Plans*, AM. BANKER, Aug. 25, 2000, at 12 ("Barriers have come down at these banks. Their trust departments are more willing to share customers, allowing cross-selling of products."); Liz Moyer, *Citi Puts Lipp at Helm of Cross-Selling Efforts*, AM. BANKER, July 24, 2000, at 1 ("[C]ross-selling of products and services for corporations . . . has come more easily than expected.").

with respect to their banking relationship.

For example, it may become clear to the borrower that the pricing of the loan may not be as favorable if the OTC derivative were not done with the bank. The bank could also make clear that it might be less flexible with respect to future negotiations or problems. Although there may be difficulty proving such an understanding, there would appear to be little substantive reason to distinguish between this and an express requirement to enter into the OTC derivative with the bank for purposes of establishing liability under the BHCA antitying provisions.

5. *Inadvertent Tie*. Apart from either an express or implied tie, a borrower may still discover that the bank is the only party willing to enter into the OTC derivative.¹²³ Whether that creates an inadvertent tying arrangement for purposes of the BHCA is unclear. It may depend upon whether the bank structured the relationship and documentation with the intent that the borrower could only enter into the OTC derivative with the bank. Again, it would be inappropriate to distinguish between an express requirement to enter into the OTC derivative with the bank versus one in which a bank structured its dealings in such a way that the bank was the only derivative counterparty available to enter into the transaction.

B. *Anticompetitive Practice*

To constitute a violation of the antitying provisions under the BHCA, courts have generally required a plaintiff to show an *anticompetitive* tying arrangement. This is demonstrated by showing that a practice is "anticompetitive in nature" or an "anticompetitive practice."¹²⁴ Courts, however, have not required a plaintiff to show an anti-competitive effect from the tying arrangement. This makes it potentially easier to establish that a bank has violated the antitying provisions when it requires the borrower to

123. A bank that is also a borrower's dealer has developed a special relationship with the borrower that may not be easily replicated by another dealer. See *supra* notes 62-63 and accompanying text.

124. *Kenty v. Bank One, Columbus, N.A.*, 92 F.3d 384, 394 (6th Cir. 1996); *Palermo v. First Nat'l Bank & Trust Co. of Oklahoma City*, 894 F.2d 363, 368 (10th Cir. 1990); *Johnstone v. First Bank Sys., Inc.*, 947 F. Supp. 1220, 1225 (N.D. Ill. 1996).

enter into an OTC derivative with the bank as a condition for receiving credit.

The BHCA has commonly been distinguished from the Sherman and Clayton Acts "in its focus on the interests of the individual credit consumer, rather than on competition at large. The antitying provisions broadly proscribes tying... without requiring proof of economic power or a significant effect on commerce."¹²⁵ In passing the BHCA, Congress recognized the unique nature of the banking industry and the role it plays in the economy.¹²⁶ It also recognized the difficulties in establishing an antitrust violation where a bank is involved.¹²⁷

Under the Sherman Act, to show a tying arrangement violation, the plaintiff must show that the tie had an anti-competitive effect. This is done by establishing that: (1) the defendant possesses market power over the tying product to force the purchase of the tied product; and (2) "a substantial volume of commerce is foreclosed thereby."¹²⁸

Unlike a plaintiff bringing a cause of action under the Sherman Antitrust Act, however, a plaintiff bringing a claim under the BHCA does not need to prove anti-competitive effects or appreciable market share in the market for the tying product.¹²⁹

The Tenth Circuit differentiated between "anticompetitive effects" and "anticompetitive practice." The court explained that anticompetitive effects include such things as a bank's dominance or control over the tying product market, or that a substantial volume of commerce

125. William M. Hannay & William A. Montgomery, *Tying Arrangements: Practice Under Federal Antitrust, Patent, and Banking Law*, in The Bureau of National Affairs, Inc. (Corp. Practice Series No. 39-2nd, Feb. 1997, at A-49).

126. See *S & N Equip. Co. v. Casa Grande Cotton Fin. Co.*, 97 F.3d 337, 346 (9th Cir. 1996); *Dibidale of La., Inc. v. Am. Bank & Trust Co.*, 916 F.2d 300, 305 (5th Cir. 1990); *JST Properties v. First Nat'l Bank of Glencoe*, 701 F. Supp. 1443, 1449 (D. Minn. 1988); S. REP. NO. 91-1084, reprinted in 1970 U.S.C.C.A.N. 5519, 5558.

127. See *JST Properties*, 701 F. Supp. at 1449 (quoting Timothy Naegele, *The Antitying Provision: Its Potential is Still There*, 100 BANKING L. J. 138, 143 (1983)) (footnotes omitted).

128. *Jefferson Parish Hosp. Dist. No. 2 v. Hyde*, 466 U.S. 2, 13-16 (1984).

129. See *JST Properties*, 701 F. Supp. at 1449; *Doe v. Norwest Bank, Minn., N.A.*, 107 F.3d 1297, 1305 (8th Cir. 1997); *Dibidale of La., Inc.*, 916 F.2d at 305; *Bruce v. First Fed. Sav. & Loan Assoc. of Conroe, Inc.*, 837 F.2d 712, 717 (5th Cir. 1988); *Amerifirst Properties, Inc. v. Fed. Deposit Ins. Corp.*, 880 F.2d 821, 825 (5th Cir. 1989); *Gage v. First Fed. Sav. & Loan Ass'n of Hutchinson, Kan.*, 717 F. Supp. 745, 752 (D. Kan. 1989); *S & N Equip. Co.*, 97 F.3d at 346.

is affected.¹³⁰ These examples are, for all intensive purposes, the same as the elements that must be shown in a general antitrust case.¹³¹

Only having to show an anticompetitive practice versus an anticompetitive effect is an important distinction for plaintiffs suing under the BHCA. By the very nature of the elements to be proven, showing an anticompetitive practice is far easier than showing anticompetitive effects. One court explained why there is a less stringent standard in proving a violation of the antitying provisions of the BHCA.

In enacting the antitying provision of the BHCA, Congress recognized that tying arrangements in the banking industry generally involve such small dollar amounts that they do not justify expensive and time-consuming antitrust litigation. Congress also recognized the difficulties in establishing an antitrust violation, since it is doubtful whether a bank customer could adduce sufficient evidence of the bank's market power and the effect on interstate commerce to recover under the Sherman Act. Thus, even if evidence of market power and the effect on interstate commerce are insufficient to state a cause of action under the Sherman Act, a litigant can still recover under Section 1972 of the BHCA.¹³²

The different standards can be demonstrated with respect to a transaction in which a borrower is required to enter into an OTC derivative as condition to receiving credit from a bank. Under the Sherman Act, the plaintiff has to show that the bank has enough power in the loan market (tying product) to force the borrower to accept the OTC derivative (tied product). Second, the plaintiff must establish that the bank's power in the loan market caused other lenders to be unable to compete in that market.

In contrast, under the BHCA, a plaintiff needs only to establish that the tying arrangement was anticompetitive in nature.¹³³ Therefore, in a situation involving OTC

130. See *Palermo v. First Nat'l Bank & Trust Co. of Oklahoma City*, 894 F.2d 363, 368 (10th Cir. 1990); *Davis v. First Nat'l Bank of Westville*, 868 F.2d 206, 208 (7th Cir. 1989); *Doe*, 107 F.3d at 1305.

131. See *Palermo*, 894 F.2d at 368; *Doe*, 107 F.3d at 1305.

132. See *JST Properties*, 701 F. Supp. at 1449 (quoting *Naegele*, *supra* note 127, at 143).

133. See *Palermo*, 894 F.2d at 368; *Kenty v. Bank One, Columbus*, 92 F.3d 384 (6th Cir. 1996); *Johnstone v. First Bank Nat'l Ass'n*, 1998 WL 565193 at *5 (N.D. Ill. 1998).

derivatives, the plaintiff would need to show: (1) that requiring the borrower to obtain a swap along with his loan is a tying arrangement; and (2) that the tying of the loan and the swap is anticompetitive in nature. To establish the latter requirement, the plaintiff only needs to show that the tying arrangement was intended to be anticompetitive or that such a relationship could possibly lessen competition.¹³⁴ For example, the plaintiff would probably only need to show that there were other banks willing to enter into the OTC derivative in order to show that the tying was anticompetitive in nature.

Some courts have made it even more simple by employing a per se approach to determine if there was a violation of the antitying provisions of the BHCA.¹³⁵ This approach merely requires that the plaintiff show the existence of a conditional transaction in the extension of credit by a bank.¹³⁶ The courts have explained the need for a per se approach because the economic power of banks is such that "even small banks could misuse their economic power to the detriment of bank customers."¹³⁷ The presumption is that a tying arrangement involving a bank is anticompetitive. The court in *S&N Equipment Co. v. Casa Grande Cotton Fin. Co.* shows their belief in a presumption of anticompetitiveness by stating, "while our test speaks in terms of an 'anti-competitive' tying, the modifier either drops out or is presumed to exist."¹³⁸

This per se approach would be more difficult to defend against by a bank that tied an OTC derivative to the extension of credit to the borrower. The plaintiff borrower would only need to show that there was a tying transaction and would not need to show that there were other banks willing to enter into the OTC derivative. This would seriously weaken the bank's defense in that it conceivably could have shown that it was in fact the only bank willing to extend credit while at the same time providing an OTC

134. See *Palermo*, 894 F.2d at 368; *Doe*, 107 F.3d at 1305.

135. See *JST Properties*, 701 F. Supp. at 1449; *Dibidale of La., Inc. v. Am. Bank & Trust Co.*, 916 F.2d 300, 305-06 (5th Cir. 1990); *S & N Equip. Co. v. Casa Grande Cotton Fin. Co.*, 97 F.3d 337, 346 (9th Cir. 1996); *Sharkey v. Security Bank & Trust, Co.*, 651 F. Supp. 1231, 1232 (D. Minn. 1987).

136. See *Dibidale of La., Inc.*, 916 F.2d at 305.

137. *JST Properties*, 701 F. Supp. at 1449.

138. *S & N Equip. Co.*, 97 F.3d at 346.

derivative to the borrower.¹³⁹

There are several situations in which the antityping provisions should not apply because such a tie would not be anticompetitive in nature. This would occur when only the bank making the loan would be willing to enter into the OTC derivative with the borrower. To the extent that the borrower could not go elsewhere to obtain the OTC derivative, the tie should not be anticompetitive in nature. It would be inappropriate to prohibit the bank from providing an otherwise useful hedging arrangement through the use of OTC derivatives solely because it was the only dealer in the OTC derivatives market willing to enter into the transaction.

There are several reasons why the lender bank may be the only bank willing to enter into an OTC derivative with the borrower. Other dealers may be unwilling to trade with a borrower if the borrower has already pledged or encumbered all of its assets for the benefit of the lending bank. Many banks will require a borrower to pledge assets or grant a security interest in their property prior to making a loan to the borrower. In fact, a bank may take a blanket lien on all of the borrower's property if the bank feels it is at risk. Often, this blanket lien would secure not only the loan made to the borrower, but would also include any other obligations and liabilities of the borrower to the bank, including any OTC derivative obligations.

The absence of any collateral that a borrower could pledge to a third party derivative dealer may seriously narrow the number of dealers willing to trade with a borrower.¹⁴⁰ Before entering into an OTC derivative with a potential customer, a dealer will ascertain if it needs to, or will be able to, secure with collateral the credit exposure of the borrower under the OTC derivative. A dealer entering into a transaction with the borrower assumes the risk of the possibility that the borrower may fail to perform.¹⁴¹ This

139. See *supra* notes 10–11 and accompanying text.

140. See Peter Thompson, *Learning Curve, Collateralization Agreements*, DERIVATIVES WEEK, July 10, 1995, at 10 (collateralization allows highly rated counterparties “to trade with counterparties that do not meet their typically high counterparty credit rating criteria.”); Romano, *supra* note 26, at 51 (“[L]ow credit counterparties typically must post collateral or provide other security guaranteeing payment in order to participate in the market.”).

141. See Saul S. Cohen, *The Challenge of Derivatives*, 63 FORDHAM L. REV. 1993, 2011 (1995) (identifying credit risk as one of thirteen risks in the

risk is referred to as "credit risk."

Although there are other methods to reduce credit risk, there appears to be a general perception in the marketplace that pledging collateral is the best solution to the problem.¹⁴² Requiring collateral to be pledged does not completely eliminate credit risk, but it may provide a sufficient reduction of risk that the lender will be willing to enter into a transaction with the borrower.¹⁴³ Thus, the pledging of collateral by counterparties to each other is becoming increasingly important in the derivatives area.¹⁴⁴ Both dealers and non-dealers are beginning to insist on the collateralization of OTC derivatives,¹⁴⁵ with many anticipating that eventually all OTC derivatives will be secured by collateral.¹⁴⁶ Many bank dealers also may be unwilling to deal with the borrower on an unsecured basis for bank regulatory reasons.¹⁴⁷ Certain financial institutions

derivative area).

142. See Thompson, *supra* note 140, at 10 ("Collateralizing transactions with counterparties allows credit risk to be quantified and nullified."); Meigs, *supra* note 90, at 11; *Bank Regulators Offer a Way to Reduce the Capital Requirement for Derivatives*, SWAPS MONITOR, Sept. 11, 1995, at 3 ("To date, the market has decided that collateral is the superior means of reducing credit risk and economizing on capital."); Suzanne McGee, "Plain Vanilla" Derivatives Can Also Be Poison, WALL ST. J., Mar. 20, 1995, at C1 (noting that parties are reducing counterparty credit risk by requiring collateral).

143. If the borrower has an "unquestioned" credit rating, it may not be required to post any collateral. See Thomas Moers Mayer, *Derivatives in Default: Getting Collateral*, in UNDERSTANDING THE BUSINESS, BANKRUPTCY AND SECURITIES ASPECTS OF DERIVATIVES 123 (P.L.I. Com. L. & Practice, Practice Handbook Series No. 721, 1995).

144. See *Collateral Usage Continues to Grow, But Standards Remain Elusive*, SWAPS MONITOR, Nov. 22, 1993, at 1.

145. The posting of collateral has been around for a decade, ever since the thrift industry began using swaps. However, in recent years the emphasis has moved away from dealers protecting themselves from customers. Today, the emphasis of collateral arrangements is on dealers protecting themselves from each other, and on end-users protecting themselves from dealers. See JOINT STUDY, *supra* note 6, at 15 ("Counterparties routinely reduce exposures to weakening institutions by . . . requiring margin to reduce risk").

146. See *Collateral Usage Continues to Grow, But Standards Remain Elusive*, *supra* note 144, at 5 ("Some dealers expect that, within a few years, all trades between professionals will be collateralized."); J. A. Gluck, *Measuring and Controlling the Credit Risk of Derivatives*, in DERIVATIVES RISK AND RESPONSIBILITY 156-57 (R.A. Klein & J. Lederman eds. 1996); J. A. Ratcliffe, *U.S. OTC Market Seen Looking to Collateralize Swaps*, REUTERS, Nov. 3, 1994.

147. See *Risk-Based Capital Standards: Derivative Transactions*, 60 Fed. Reg. 46, 170, 46, 172 (Sept. 5, 1995) (to be codified at 12 C.F.R. pts. 3, 208, 225, 325). For a discussion of the rules, see Michael T. Cowhig & Seema A. Misra,

are able to reduce the capital that they are required to hold against certain OTC derivatives if their OTC derivative exposure is collateralized.¹⁴⁸

A borrower may also discover that other banks or dealers are unwilling to enter into OTC derivatives with it if the borrower is a smaller company that will only enter into OTC derivatives on an infrequent basis. This is because the dealer is unable to assess the credit quality of the borrower. In contrast, a bank that is already a lender has already conducted much of the due diligence with respect to the creditworthiness of the borrower¹⁴⁹ in conjunction with its lending activities to the borrower. A derivatives dealer may not be willing to invest the time and energy necessary to do sufficient due diligence to assess the borrower's credit quality. Finally, an outside dealer will not have the relationship of trust and understanding with the bank's loan and credit officers,¹⁵⁰ resulting in it being unable to gain the trust of the borrower.

Even if the dealer is willing to enter into an OTC derivative with the borrower, it may be unable to offer it a competitive price because the transaction is not secured, and due to its inadequate understanding of the borrower's credit quality. The presence of collateral securing an obligation will typically result in the secured party being able to provide better terms and pricing for the derivative

Derivatives, 15 ANN. REV. BANKING L. 28 (1996); see also *Fed Rules Benefit Collateralized Deals, But Banks Lobby for Other Changes*, SWAPS MONITOR, Dec. 26, 1994, at 1 ("[T]his provision is likely to spur growth in the use of collateral for counterparties.").

148. See *Risk-Based Capital Standards: Derivative Transactions*, 60 Fed. Reg. 46, 172 (Sept. 5, 1995) (to be codified at 12 C.F.R. pts. 3, 208, 225, 325); *Fed Rules Benefit Collateralized Deals, But Banks Lobby for Other Changes*, *supra* note 144, at 1 (summarizing rules); *US Bank Regulators Have Different Policies on Collateral*, SWAPS MONITOR, Sept. 11, 1995 (discussing the use of collateralization to reduce capital requirements).

149. See HAYES, *supra* note 62, at 82 ("[W]ithout exception, large banks maintain credit files on all business borrowers."). "As in all credit-sensitive agreements, '[k]now your counterparty.'" There is no substitute for good, fundamental credit analysis and first hand knowledge of the counterparty and its principals." Rahl, *supra* note 20, at 336; see also Baird, *supra* note 62, at 302-03. (stating that due diligence regarding the borrower's financial situation is not just important for the lender but also for the dealer acting as the borrower's counterparty).

150. See HAYES, *supra* note 62, at 81 ("The relationship between banks and their commercial borrowers has the following characteristics: (1) There are usually close and confidential relations between the bank and the borrower.").

obligation.¹⁵¹

C. *Benefit to the Bank*

Courts have generally held that the plaintiff must establish that there was a benefit to the bank from the sale of the tied product or service to the borrower.¹⁵² There is a distinction, however, “between anticompetitive benefits and the ordinary benefits derived from the protection of a bank’s security in a customer loan.”¹⁵³ The type of benefit referred to in the antitying statute is “one which results not from the legitimate protection of an investment, but from a ‘misuse of the economic power of a bank.’”¹⁵⁴ A number of cases have agreed that a banking practice intended to protect the bank’s investment interest is permissible under the BHCA because it is not considered to be a benefit under the various judicial holdings.¹⁵⁵ The courts have held that a number of conditions are legitimate to protect the Bank’s investment interest, and are therefore not violations of the BHCA.¹⁵⁶

The principal benefit to the bank would appear to be

151. See William C. Tompsett, 101 *BANKING L. J.* 31, 36 (1984) (noting that most commercial loans are intended to pass on interest rate risk to the borrower. The borrower may negotiate certain provisions, such as collateral, to improve the pricing and get the lowest possible rate.)

152. *Swerdloff v. Miami Nat’l Bank*, 584 F.2d 54 (5th Cir. 1978); *McCoy v. Franklin Sav. Ass’n.*, 636 F.2d 172, 174 (7th Cir. 1980); *Continental Ill. Nat’l Bank & Trust Co. v. Stanley*, 585 F Supp. 1385 (N.D. Ill. 1984); *Rae v. Union Bank*, 725 F.2d 478 (9th Cir. 1984); *Parsons Steel, Inc. v. First Ala. Bank, N.A.*, 679 F.2d 242 (11th Cir. 1982); see also James L. Rigelhaupt, Jr., *What Constitutes Violation of Provisions of Bank Holding Company Act Prohibiting Tying Arrangements*, 74 *A.L.R. FED.* 578, § 4(c) (1985).

153. *Cont’l Bank of Pa. v. Barclay Riding Acad., Inc.*, 459 A.2d 1163, 1170 (N.J. 1983).

154. *Id.* (quoting *Swerdloff*, 584 F.2d at 58).

155. See *New England Co. v. Bank of Gwinnett County*, 891 F. Supp. 1569, 1575 (N.D. Ga. 1995); see also *Parsons Steel*, 679 F.2d at 246; *Pappas v. NCNB Nat’l Bank*, 653 F. Supp. 699, 706 (M.D.N.C. 1987).

156. *Alpine Elec. Co. v. Union Bank*, 776 F. Supp. 486, 490 (W.D. Mo. 1991) *aff’d*, 979 F.2d 133 (8th Cir. 1992) (finding that act of bank in using money in depositor’s checking account to reduce debt of related corporation was not actionable); see also *Bieber v. State Bank of Terry*, 928 F.2d 328, 330 (9th Cir. 1991) (requiring officers of corporation to personally guaranty loan of corporation); *Palermo v. First Nat’l Bank & Trust Co.*, 894 F.2d 363, 370 (10th Cir. 1990) (requiring officers to personally guaranty loan of corporation); *Davis v. First Nat’l Bank*, 868 F.2d 206, 209 (7th Cir. 1989) (describing a bank requiring debtor to provide a business liquidation service).

the its investment in the borrower. As discussed earlier, the protection of OTC derivatives can result in significant benefits in reducing various business risks of the borrower.¹⁵⁷

Apart from the benefit enjoyed by the bank from an improvement in the creditworthiness of its counterparty because of the OTC derivative, a bank could benefit other ways. First, the bank could potentially charge fees for providing the transaction, or could receive an up-front premium payment for providing a transaction such as a cap.¹⁵⁸ Second, the tied transaction may help the bank hedge risks that it has taken as an intermediary with a different counterparty. For example, the bank may have previously done the opposite of the OTC derivative with a different counterparty. By entering into the OTC derivative with the borrower, it is able to offset the risk taken under a different OTC derivative with a different party. Finally, to the extent that the relevant index or rate moves in the favor of the bank, the bank will benefit by receiving payments from the borrower under the tied transaction.

Two cases have directly discussed the benefit to the bank beyond the permissible benefit of protecting the bank's investment interest. For example, in *Gage v. First Fed. Sav. & Loan Ass'n*, the bank required the borrower to grant the bank an option to purchase a portion of the plaintiff's building.¹⁵⁹ The court determined that the bank did indeed benefit by purchasing a portion of the building at the borrower's expense.¹⁶⁰ In addition, the bank did not need any additional protection for its loan. Furthermore, the option did not in fact give the bank any more protection.

With respect to tying credit to OTC derivatives, it is arguable that any ancillary, outside benefit to the bank should be secondary to the benefit provided of protecting the bank's investment in the borrower. Although a bank may benefit financially from the tied product as discussed above, this benefit is only incidental and flows from the actions taken to protect the bank's investment.

It would be unreasonable to prohibit this important

157. See *supra* notes 18-22 and accompanying text.

158. For a discussion of a premium payment with a cap, see *infra* note 174 and accompanying text.

159. See *Gage v. First Fed. Sav. & Loan Ass'n*, 717 F. Supp. 745, 754 (D. Kan. 1989).

160. See *id.*

banking practice under the antitying rules if the bank's primary motivation were to protect its investment in the borrower, as opposed to earning income. As noted in the above case law, in cases where a benefit to the bank was found, requiring the tied product had nothing to do with protecting the bank's investment in the borrower.

D. Damages

To recover under the antitying provisions, the borrower must demonstrate that "damages flow[ed]"¹⁶¹ as a result of the product being tied to the extension of credit.¹⁶² There appears, however, to be no judicial authority as to how damages are actually calculated for a violation of the BHCA antitying provisions. Because the language providing for damages under the BHCA is almost identical to language in the Clayton Act, it would be reasonable to look to the same analysis.¹⁶³

The Fourth Circuit summarized what must be established for a private plaintiff to prove damages under the antitying provisions of the Clayton Act:

[I]njury resulting from a tie-in must be shown by establishing that payments for both the tied and the tying product exceeded their combined fair market value . . . Unless the fair market value of both the tied and tying products are determined and an overcharge in the complete price found, no injury can be claimed; suit, then, would be foreclosed.¹⁶⁴

Under this analysis, the plaintiff would need to

161. *Sterling Coal Co. v. United Am. Bank*, 470 F. Supp. 964, 965 (E.D. Tenn. 1979).

162. *Swerdloff v. Miami Nat'l Bank*, 584 F.2d 54, 59 (5th Cir. 1978); *Costner v. Blount Nat'l Bank*, 578 F.2d 1192, 1195 (6th Cir. 1978). For a discussion of damages under the BHCA, see Fredrick A. Nicoll & Robert W. Delventhal, *The Antitying Provisions of the Bank Holding Company Act: Lenders Beware*, 109 BANKING L.J. 4, 18-24 (1992); James L. Rigelhaupt, Jr., Annotation, *What Constitutes Violation of Provisions of Bank Holding Company Act Prohibiting Tying Arrangements*, 74 A.L.R. FED. 578, § 4[e] (1985).

163. Compare 12 U.S.C. § 1975 (1989) (BHCA), with 15 U.S.C. § 15(a) (1994) (Clayton Act).

164. *Kypta v. McDonald's Corp.*, 671 F.2d 1282, 1285 (11th Cir. 1982); see also *Siegel v. Chicken Delight, Inc.*, 448 F.2d 43, 49-50 (9th Cir. 1971). For a general discussion of damages under the Clayton Act for a violation of the antitying provisions, see SPENCER WEBER WALLER, *INTERNATIONAL TRADE AND U.S. ANTITRUST LAW* § 1 (Jeffrey L. Kessler ed., West 1999).

compare the combined cost on a net present value basis of the bank loan and the OTC derivative with the cost of obtaining a bank loan and an OTC derivative separately from third parties. It is not enough to show that the bank offered expensive OTC derivatives if the bank loan was sufficiently inexpensive to offset the higher cost.

The cost of the loan could probably be calculated by comparing, on a net present value basis, how much more (or less) interest, fees, and other expenses the borrower might have paid under the loan in question versus a loan that it could have obtained from another bank. The calculation of the cost of the OTC derivative would probably be more complicated.

Typically the overall cost of the OTC derivative would be measured by determining what would be the net termination amount for the OTC derivative upon the date the OTC derivative was terminated. The net termination amount is the amount that the borrower would be required to pay to the bank if its agreement with the bank were terminated.¹⁶⁵ Under the standard documentation in the OTC derivative area,¹⁶⁶ the net termination amount is typically measured by determining the "replacement cost" of the transaction should the borrower default.¹⁶⁷ In other words, how much would a new participant be required to pay or be paid to assume the obligations of the defaulting party in the transaction?¹⁶⁸ This amount is measured by

165. This amount is determined under the ISDA Master Agreement pursuant to Section 6(e). This amount may vary depending upon the method of calculating these damages selected by the parties. See ISDA Master Agreement, § 6(e)(i)-(ii) (1992).

166. Ninety percent of the notional amount of interest rate swaps entered into between dealers were documented using an ISDA Master Agreement. See *G30 Resurveys Dealers*, SWAPS MONITOR, Dec. 12, 1994, at 9; Thomas K. Patton, *Hedging Debt with Derivatives: Using Swaps and Options to Manage Interest Rate Risk*, CORP. CASHFLOW MAG., Aug. 1995, at 16 ("Most swaps are written with an ISDA agreement."); Christian A. Johnson, *Derivatives and Rehypothecation Failure: It's 3:00p.m., Do You Know Where Your Collateral Is?*, 39 ARIZ. L. REV. 949 n.37 (1997).

167. JOINT STUDY, *supra* note 6, at 9 ("[T]he replacement cost or the positive market value (if any) of the swap is the preferred measure for assessing the amount of credit exposure if the counterparty to the agreement defaults."). For a discussion of the calculation of replacement cost, see Waldman, *supra* note 88, at 1048. For a discussion of modeling credit risk in the derivatives area, see SABER, *supra* note 26, at 83-93.

168. This is the underlying concept of "Market Quotation" in the Master Agreement. Market Quotation is the method of calculating the amount to be

determining the present value of the net cash flow that the new participant expects that it will have to pay (or receive) during the life of the OTC derivative contract.¹⁶⁹

Presumably, in analyzing the respective costs, the cost of providing the OTC derivative would need to take into account the facts or circumstances of that particular plaintiff's situation. For example, an OTC derivative entered into with a third party might be more expensive because the third party would be unsecured in the event that the plaintiff had previously pledged all available collateral to the defendant bank as part of its loan transaction.¹⁷⁰

E. *Traditional Banking Practice Exception*

The final requirement is that tying of an OTC derivative to the extension of credit does not constitute a traditional banking practice.¹⁷¹ In addition, if liability is predicated under subsection (1)(C) of Section 1972, it does not constitute an unusual banking practice. Requiring a borrower to enter into an OTC derivative, even with the bank itself, as a condition to the extension of credit should be considered a traditional banking practice because of the benefits that an OTC derivative can have in making the borrower more creditworthy.

1. *Traditional Banking Practice.* The BHCA antitying provisions were not intended to prohibit transactions and relationships involving what are now referred to as

paid by the parties to the Master Agreement upon its termination caused, for example, by a payment default. See ISDA Master Agreement § 14 (1992) (defining Market Quotation); ISDA User's Guide 24-26 (1993).

169. See Waldman, *supra* note 88, at 1048; see also JOINT STUDY, *supra* note 6 at 9; Meigs, *supra* note 90 ("The amount of the credit risk can be measured [for an interest rate swap] using the present values of net cash flows given specific interest rate assumptions."); Jamroz, *supra* note 90.

170. See *supra* notes 142-48 and accompanying text.

171. There is also an exception to liability if, under the BHCA, the Federal Reserve permits by order "such exceptions to the [antitying provisions] as it considers will not be contrary to the purposes" of the BHCA. 12 U.S.C. § 1972(1) (1994) (last clause). It has exercised such authority sparingly however, and not with respect to OTC derivatives. See Nicoll & Delventhal, *supra* note 162, at 6; see also Bank Holding Companies and Change in Bank Control, 12 C.F.R. § 225 (1990) (discussing limited exception for credit card transactions).

traditional banking practices.¹⁷² The exception has grown out of the language found in statute providing that antitying prohibitions will not cover tied products such as "a loan, discount, deposit or trust service."¹⁷³ Requiring a borrower to hedge its business risks by using OTC derivatives provided by the lending bank is a prototypical example of a traditional banking practice.¹⁷⁴

Courts have refused to limit the traditional banking practice exception to the specified tied products such as "a loan, discount, deposit or trust service." The federal district court in *Flags I, Inc. v. Boston Five Cents Sav. Bank*,¹⁷⁵ explained the reach of the traditional banking practice exemption.¹⁷⁶ The court noted that committee members drafting the statute were not satisfied with the statute as it stood because it prohibited all tying arrangements even though these arrangements were not anticompetitive.¹⁷⁷ In response, the exemptions were added several months later to permit legitimate banking practices that have no

172. See *Flags I, Inc. v. Boston Five Cents Sav. Bank*, 831 F. Supp. 928, 936 (D.N.H. 1993); see also *Sanders v. First Nat'l Bank & Trust Co.*, 936 F.2d 273, 278 (6th Cir. 1991); *B.C. Recreational Indus. v. First Nat'l Bank*, 639 F.2d 828, 832 (1st Cir. 1981); *Clark v. United Bank of Denver N.A.*, 480 F.2d 235, 238 (10th Cir. 1973); *Libby v. Firststar Bank of Sheboygan*, 47 F. Supp. 2d 135, 139 (D. Mass. 1999); *Alpine Elec. Co. v. Union Bank*, 776 F. Supp. 486, 489 (W.D. Mo. 1991) *aff'd*, 979 F.2d 153 (8th Cir. 1992); *Pappas v. NCBN Nat'l Bank*, 653 F. Supp. 699, 705 (M.D.N.C. 1987).

173. 12 U.S.C. § 1972 (1)(A) (1994) (emphasis added).

174. For a discussion the traditional banking practices exception, see Chappelle, *supra* note 73, at 719-22 (discussing exceptions); Finke et al., *supra* note 86, at 184-85 (discussing the "traditional banking practice" exception); see also Alan J. Berkeley & Jean E. Minarick, *Disclosure and Developments in Financing Instruments and Techniques*, in 703 PLI/CORP ADVANCED SECURITIES LAW WORKSHOP 335, 364 (1990) ("Many lenders are requiring borrowers to buy interest caps in order to hedge at least some of their debt. The cap would protect the borrower, and therefore the bank, in the event of a general increase in interest rates. . . . Some degree of lender control over the choice of the counterparty seems necessary, however, since the counterparty must be exceptionally creditworthy for large transactions.").

175. 831 F. Supp. at 936.

176. The exception involved a claim under the Home Owner's Loan Act, 12 U.S.C. § 1464(q)(1) (1989). HOLA is considered to be the savings association equivalent of the BHCA and therefore its analysis should be applicable to the BHCA. See *id.* at 934; see also *Integon Life Ins. Corp. v. Browning*, 989 F.2d 1143, 1150 (11th Cir. 1993); *Bruce v. First Fed. Sav. & Loan*, 837 F.2d 712, 716 (5th Cir. 1988).

177. See *Flags I*, 831 F. Supp at 934-35.

anticompetitive effect.¹⁷⁸

In analyzing the judicial history of the exemption, the court in *Flags I, Inc. v. Boston Five Cents Sav. Bank* noted that courts should look broadly to the effect of the arrangement instead of determining whether the arrangement was common in the banking industry.¹⁷⁹ The key factor for the court in *Flags* was whether the tie occurred where the bank was protecting its interest in the investment.¹⁸⁰ The *Flags* court also believed after analyzing the case law that an overly narrow definition of the traditional banking practice exemption was not appropriate. Instead, the court interpreted the exemption in light of the legislative purpose of the anti-tying provision.¹⁸¹ The court found there needed to be an unusual banking practice, a tying arrangement and a benefit to the bank.¹⁸²

Next, the court explained that the definition of the traditional banking practice exemption should be a broad one.¹⁸³ In *Flags*, the borrower had to relinquish control over his business. The court stated that although there may have been tied products, "the imposition was directly related to protecting the bank's investment."¹⁸⁴ Lastly, the *Flags*' court determined that the reciprocal dealing exemption would be over-inclusive if the exemption only applies "where lenders commonly and traditionally require borrowers to surrender the specific property interest at issue in exchange for additional credit."¹⁸⁵

The court directs one to focus on the general nature of the arrangement instead of the property interest transferred to determine if the arrangement fits within the exemption.¹⁸⁶ The court concluded that this method of analysis is more consistent with other components of the traditional banking practice exemption which focus on the nature and effect of the transaction rather than on whether

178. *See id.* at 935.

179. *See id.* at 936-37.

180. *See id.* at 939; *see also* *Tose v. First Pa. Bank*, 648 F.2d 879, 897 (3rd Cir. 1981), *Pappas v. NCNB Nat'l Bank*, 653 F. Supp. 699, 706 (M.D.N.C. 1987); *Interchange State Bank v. Rinaldi*, 696 A.2d 744, 753 (N.J. Super. Ct. App. Div. 1997).

181. *See Flags I*, 831 F. Supp. at 934-35.

182. *See id.* at 937-39.

183. *See id.* at 937; *see also Tose*, 648 F.2d at 897.

184. *Flags I*, 831 F. Supp at 936 (citing *Tose*, 648 F.2d at 897).

185. *Id.* at 937.

186. *See id.*

a particular practice was traditional in the banking industry.¹⁸⁷

In analyzing the reach of the traditional banking practice exception, the courts appear willing to permit arrangements that protect the bank's investment in their loan by improving the creditworthiness of the borrower.¹⁸⁸ In other words, the courts appear to assume or consider the purpose of a traditional banking practice as one intended to protect the bank's investment in its loan. For example, courts have found that a bank's attempts to control a borrower's operations, actions, or personnel are traditional banking practices if such requirements protect the bank's investment in the loan by making the borrower more creditworthy.¹⁸⁹ The courts have reached similar conclusions with requirements requiring the borrower or related entities to pledge collateral or guarantee the repayment of the borrower's debt to the bank.¹⁹⁰

187. *See id.*

188. *See Tose*, 648 F.2d at 897; *B.C. Recreational Indus. v. First Nat'l Bank*, 639 F.2d 828, 832 (1st Cir. 1981).

189. *See Graue Mill Dev. Corp. v. Colonial Bank & Trust Co.*, 927 F.2d 988, 990 (7th Cir. 1991) (requiring borrower to use bank employee as a construction manager); *Parsons Steel, Inc. v. First Ala. Bank*, 679 F.2d 242, 244 (11th Cir. 1982) (requiring a change of corporate management and majority stock ownership); *Tose*, 648 F.2d at 897-98 (designating corporation's financial advisor); *B.C. Recreational Indus.*, 639 F.2d at 832 (requiring corporation to hire a financial advisor); *Marchelle Corp. v. Nat'l State Bank*, No. 92-5111, 1993 WL 39661, at * 1 (D.N.J. Feb. 16, 1993) (requiring borrower to follow certain directives of the bank including selling equipment and firing employees); *Interchange State Bank v. Rinaldi*, 696 A.2d 744, 753-54 (N.J. Ct. App. Div. 1997) (requiring borrower to replace its accountants).

190. *Sanders v. First Nat'l Bank & Trust Co. in Great Bend*, 936 F.2d 273, 278 (6th Cir. 1991) (requiring borrower to provide additional collateral in exchange for forbearance on collection of defaulted loan); *Bieber v. State Bank of Terry*, 928 F.2d 328, 330-31 (9th Cir. 1991) (requiring additional security for the borrower-ranch to be put up by a second ranch (owned by the same people as the borrower-ranch)); *Palermo v. First Nat'l Bank & Trust Co.*, 894 F.2d 363, 367 (10th Cir. 1990) (requiring borrower to guarantee note of a related entity); *New England Co. v. Bank of Gwinnett County*, 891 F. Supp. 1569, 1572 (N.D. Ga. 1995) (requiring president of borrower corporation and his wife to personally guarantee the extension of further credit to the borrower corporation); *Alpine Elec. Co. v. Union Bank*, 776 F. Supp. 486, 490 (W.D. Mo. 1991), *aff'd*, 979 F.2d 133 (8th Cir. 1992) (requiring the borrower to assume its affiliate's loan); *Blue Line Coal Co. v. Equibank*, 683 F. Supp. 493, 495 (E.D. Pa. 1988) (requiring corporation's collateral pledged because of a default of a personal loan of the individual borrowers); *Cont'l Bank v. Barclay Riding Acad.*, 459 A.2d 1163, 1170-71 (N.J. 1983) (requiring a mortgage on the property of another corporation solely owned by a major shareholder in the borrower-

In contrast, courts have found tying arrangements in fact situations that required a borrower to purchase a product or service that had nothing to do with the loan or that did not improve the creditworthiness of the borrower as a condition for a loan.¹⁹¹ Similarly, courts also found a tying arrangement with respect to requirements to sell something to the bank that was not related to the loan or did not further protect the banks's investment.¹⁹² These tying arrangements typically provided a benefit to the bank outside of protecting the bank's investment. In contrast, further protecting a bank's investment is not considered to constitute a benefit to the bank that could result in liability under the antitying provisions.¹⁹³

Tying an OTC derivative to the extension of credit should constitute a traditional banking practice. The principal purpose of requiring the use of an OTC derivative is to hedge particular business risks incurred by the borrower. By using OTC derivatives, the borrower is less likely to be subject to unexpected fluctuations in interest rates or prices, and should therefore be more creditworthy and more likely to be able to repay the amount lent to them by the bank.¹⁹⁴ As expressed above, the OTC derivative is required by the bank in order for the bank to protect its investment in the borrower.

Although the use OTC derivatives post-date the enactment of the antitying provisions, this should not preclude it from qualifying as a traditional banking practice. The *Flags*⁷ court explained that too narrow a

corporation).

191. See *Amerifirst Props., Inc. v. Fed. Corp.*, 880 F.2d 821, 824 (5th Cir. 1989) (requiring borrower to purchase certain ORE properties of the bank); *JST Props. v. First Nat'l Bank*, 701 F. Supp. 1443, 1447 (D. Minn. 1988) (requiring borrower to purchase property owned by the bank); *Sharkey v. Sec. Bank & Trust, Co.*, 651 F. Supp. 1231, 1233 (D. Minn. 1987) (requiring borrower to purchase real estate from the bank).

192. See *Costner v. Blount Nat'l Bank*, 578 F.2d 1192, 1194 (6th Cir. 1978) (requiring borrower to sell a substantial share of its retail commercial automobile installment paper to the bank); *Norte Car Corp. v. Firstbank Corp.*, 25 F. Supp. 2d 9, 15 (D.P.R. 1998) (requiring borrower to give a right-of-first-refusal to purchase retail property to the bank); *Gage v. First Fed. Sav. & Loan Ass'n*, 717 F. Supp. 745, 755 (D. Kan. 1989) (requiring borrower to grant the bank an option to purchase a portion of borrower's building).

193. See *Graue Mill*, 927 F.2d at 992 (holding that bank must not benefit "beyond its attempt to protect its investment").

194. See *supra* notes 20-30.

reading of the exception would be inappropriate: "[T]hey would preclude many newly established banking practices which serve legitimate banking interests without adversely affecting competition."¹⁹⁵ If the exemption were so construed, it would have a negative impact on the lending industry in particular because of the need to develop creative ways for the lender to loan to the borrower while still protecting its interest.¹⁹⁶

2. *Unusual Banking Practice.* The unusual banking practice element appears to only be a requirement if the tying relationship in question violates 12 U.S.C. § 1972 (1)(c).¹⁹⁷ As explained, it is possible, but probably unlikely, that this provision would be applicable to a tie involving the extension of credit and an OTC derivative.¹⁹⁸ It appears from case law that a practice considered to be a traditional banking practice cannot be an unusual practice.¹⁹⁹

In order to determine if a banking practice is unusual, the courts have considered the opinions of experts in the banking field and the testimony of people involved in such transactions.²⁰⁰ When the bank's requirement is intended to protect its investment interest, the courts will view the practice as usual.²⁰¹ As discussed above, given the frequent

195. *Flags I, Inc. v. Boston Five Cents Sav. Bank*, 831 F. Supp. 928, 937 (D.N.H. 1993).

196. *See id.*

197. *See Dibile of La., Inc. v. Am. Bank & Trust Co.*, 916 F.2d 300, 304 n.2 (5th Cir. 1990).

198. *See supra* note 171 and accompanying text.

199. *See New England Co. v. Bank of Gwinnett County*, 891 F. Supp. 1569, 1575 (N.D. Ga. 1995); *Interchange State Bank v. Rinaldi*, 696 A.2d 744, 753 (N.J. Super. Ct. App. Div. 1997).

200. *See Gage v. First Fed. Sav. & Loan*, 717 F. Supp. 745, 754 (D. Kan. 1989) (considering testimony that the bank had never before included an option agreement such as involved in this loan); *JST Props. v. First Nat'l Bank*, 701 F. Supp. 1443, 1450 (D. Minn. 1988) (considering expert testified that it was unusual as a condition of a loan to require the customer to purchase property out of the bank's real estate portfolio); *Pappas v. NCNB Nat'l Bank*, 653 F. Supp. 699, 705 (M.D.N.C. 1987) (considering testimony of bank's loan officer that the bank required some of its other customers to maintain minimum balances).

201. *See Tose v. First Pa. Bank*, 648 F.2d 879, 897-98 (3rd Cir. 1981) (designating corporation's financial advisor); *New England Co.*, 891 F. Supp. at 1572 (requiring President of borrower corporation and his wife to personally guarantee the extension of further credit to the borrower corporation); *Alpine Elec. Co. v. Union Bank*, 776 F. Supp. 486, 490 (W.D. Mo. 1991) (requiring

occurrence of OTC derivatives being used to hedge business risks, the practice should not be considered unusual.²⁰²

CONCLUSION

Banks are aggressively requiring their borrowers to enter into OTC derivatives to hedge their business risks. Although this may potentially constitute a violation of the antitying provisions of the Bank Holding Company Act, there are several reasons why such an argument would fail to satisfy the elements of antitying claim. First, the combination of a variable rate loan with an OTC derivative such as an interest rate swap more closely resemble a fixed rate loan than two separate products. Second, the tied transactions would not be anticompetitive in nature because it is likely that only the bank would be willing to enter into the OTC derivative with the borrower. Finally, combining a loan with an OTC derivative probably constitutes a "traditional banking practice," and would therefore be exempt from the reach of the antitying provisions.

borrower to provide additional collateral); *Pappas*, 653 F. Supp. at 705 (requiring borrower to maintain available balance); *Cont'l Bank v. Barclay Riding Academy, Inc.*, 459 A.2d 1163, 1170 (N.J. 1983) (bank requiring a mortgage on the property of another corporation solely owned by a major shareholder of the borrower-corporation).

202. See *infra* Part IA.

