Comments

THE QUALIFICATION OF LOAN PARTICIPATIONS AS SECURITIES —THE POTENTIAL FOR LEAD BANK LIABILITY UNDER RULE 10B-5 AND SECTION 12(2): AN IMPACT WITH INTERNATIONAL RAMIFICATIONS

Within the past decade the international banking market has experienced unprecedented growth not only in the scope of international financial intermediation but in the number of banks actively involved.[1] The lure that entices entry into this complex and highly sophisticated financial arena is the promise of big profits and rapid expansion.[2] The name of the game in international banking, and perhaps the one factor which accounts for its success, is its primary founding principle of effectively putting money to work.[3] High

1. In 1960, eight United States banks operated 131 overseas branches. Edwards, *International Banking: An Overview*, 10 COLUM. J. WORLD BUS. 7 (no. 4, 1975). By 1965, this number increased only slightly to 13 United States banks managing 211 foreign offices. Aliber, *International Banking: Growth and Regulation*, 10 COLUM. J. WORLD BUS. 9, 10 (no. 4, 1975). However, in 1975, more than 130 United States banks operated approximately 750 foreign branches together with many more affiliates and subsidiaries engaged in all kinds of related financial activities. Edwards, *supra*, at 7. Foreign assets of United States banks (i.e. assets to foreign branches) constituted just 3.5 billion dollars in 1960, or 1.4% of total United States bank assets; in 1965, these respective figures were approximately 9.0 billion dollars and 2.6% of the assets. Aliber, *supra*, at 10. A phenomenal increase in assets occurred in the subsequent 10 year period, elevating this figure to approximately 200 billion dollars and 15% of the total domestic bank assets. Edwards, *supra*, at 7.

Correspondingly, a notable increase occurred in the number of non-United States banks operating in American financial markets. In 1965, 19 foreign banks operated a total of 36 branches in the United States; total assets were estimated at 5.0 billion dollars. Aliber, *supra*, at 10. In 1975, 175 foreign-owned banking institutions were operating in the United States, with total assets estimated at approximately 58 billion dollars. Edwards, *supra*, at 7-8.

2. In 1975, major United States banks derived from 30% to 60% of their net annual earnings from foreign sources. Between November, 1974, and May, 1975, the assets of United States branches of foreign banks more than doubled. Edwards, *supra* note 1, at 7-8. *See also* Thoman, *International Banking Can Be Profitable for U.S. Regional Banks*, 10 COLUM. J. WORLD BUS. 23 (no. 4, 1975); Klopstock, *Foreign Banks in the United States: Scope and Growth of Operations*, MONTHLY REVIEW OF THE FEDERAL RESERVE BANK OF NEW YORK, June 1973, at 140; *The 75 Most Active Lead Managers in the Euromarkets*, EUROMONEY, Sept. 1976, at 24.

3. International banking is primarily a lender's market. Mendelsohn, *A Lender's Market*, BANKER, Aug. 1976, at 903. International banking originated with the early beginnings of international trade over 4,000 years ago in Egypt and Sumer. Jacobs, *The Development of International and Multinational Banking in Europe*, 10 COLUM. J. WORLD BUS. 33, 36 (no. 4, 1975).

scaled international lending has been the financial intermediary responsible for much of the developing world's industrial growth witnessed within the past decade.[4] And, as far as money lending goes, a substantial portion of this financing has been made with relative ease in the form of participation loans.[5]

In participating a loan generally, the originating or "lead" bank will grant a loan to the borrower and then apportion the credit by offering shares to a large number of other competing banks.[6] In essence, the lead and "participating" banks form a group to share in the risk and reward of granting a single large loan to a foreign corporation or government.[7] The lead bank enters into a separate agreement with each participating bank by which the latter agrees to advance a specified portion of the total loan sum in exchange for a part interest in the original loan made by the lead.[8]

The rationale behind the widespread use of participation loans in the international lending market is but a well-designed strategy intended to satisfy the objectives of both lead and participant

4. Mathews, *Banks v. Banks*, Wall St. J., Sept. 14, 1976, at 1, col. 6. *See also* Agtmael, *Evaluating the Risks of Lending to Developing Countries*, EUROMONEY, Apr. 1976, at 86. The increasing integration of world financial markets followed from the increasing efforts by corporations in manufacturing, resource extraction, and commerce to exploit their advantages in foreign markets. Aliber, *supra* note 1, at 10.

5. Mathews, *supra* note 4, at 1, col. 6. *See also* Lees, *International Lending Strategies of Commercial Banks*, 10 COLUM. J. WORLD BUS. 40 (no. 4, 1975).

6. Armstrong, *The Developing Law of Participation Agreements*, 50 J. COM. BANK LENDING, July 1968, at 45.

7. This type of multibank lending is to be distinguished from true multibank loan syndications in which each bank in the group is active in all phases of negotiation and loan structuring and co-manages the loan on an equal status with all other participants, including the lead bank. Mathews, *supra* note 4, col. 6; *see also* Curran, *How the Medium-Term Market in Euroloans is Changing*, BANKER, Jan. 1976, at 63.

In a participation loan typically the participating banks are not creditors of the borrower. The lead bank alone is named as the secured party in the loan agreement and as payee with respect to notes evincing the borrower's obligation. Only in the event of default does a participant receive a right in secured collateral; even then an action on behalf of a participant against a defaulting borrower must be brought by the lead. Armstrong, *supra* note 6, at 46, 50-51; *see also In re* Yale Express, Inc., 245 F. Supp. 790 (S.D.N.Y. 1965); Riggs, *Participation Agreements in the Eurocurrency Market: An American Legal Analysis*, 3 INT'L BUS. LAW. 93, 102-03 (1975).

8. *See generally* G. MUNN, ENCYCLOPEDIA OF BANKING AND FINANCE 725 (7th ed. 1973). The underlying loan in which the participant acquires an interest will have been originated and closed by the lead bank. All loan documentation and negotiation will have been handled and recorded in its name, and the documents, together with any collateral, retained in its possession. Thus, at the time the lead bank sells or pledges all or part of its interest in the loan, the lead bank remains both the legal and equitable owner of the entire loan. Simpson, *Loan Participations: Pitfalls for Participants*, 31 BUS. LAW. 1977, 1978-79 (1976).

banks. Lead banks commonly seek to realize the opportunities for diversification and spreading of risk through the sale of participations;[9] participating the loan is often required to bring the amount within the legal lending limits.[10] This arrangement allows the lead to maintain an exclusive relationship with the borrower[11] while creating the means to facilitate future borrowing needs in the event of increased costs.[12]

Participations in a loan are often purchased by banks seeking to "break into" the international lending market. Banks use this avenue of participation not only to acquire expertise in the area,[13] but to make valuable connections for future opportunities.[14] For both parties, participation lending is a profitable venture.[15]

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9. Lees, *supra* note 5, at 40; Simpson, *supra* note 8, at 1977.

10. The National Bank Act fixes a limitation on the size of loans that national banks may make to any one person. 12 U.S.C. § 84 (1976). Foreign countries generally have similar legislation in force controlling both foreign and domestic banks; such legislation includes England's Companies Act of 1948 and its 1967 Amendment, Germany's Banking Law of January 1, 1962, and Regulation D in the European Common Market. France, Switzerland, Austria, Italy, Holland, and Denmark are also known to have such legislation in force. *See generally* Armstrong, *supra* note 6, at 45-46; Jacobs, *supra* note 3, at 33; Simpson, *supra* note 8, at 1977.

11. In true multibank syndicates where each participant attains the status of co-manager and hence each appears equally on all documentation, the risk remains that one of the co-lending banks will establish a permanent relationship with the borrower, thereby causing the originating bank to lose a valuable customer. Konrad, *Participations with Finance Companies*, 50 J. COM. BANK LENDING, Apr. 1968, at 33; Robinson, *Finance Companies and Banks Participating in Loans*, 51 J. COM. BANK LENDING, Oct. 1968, at 11. The split-borrowing relationship created in multibank loan syndicates is often times impractical with reference to both administrative handling and sound lending practices because of the secured nature of the credit and the complexities involved in loan documentation. Stivers, *An Analysis of Techniques Utilized to Meet the Loan Participation Needs of Correspondent Banks*, 53 J. COM. BANK LENDING, Dec. 1970, at 31-32. In a participation loan, the lead bank handles all documentation and administrative aspects of the loan. The sale of participations effects no change in the state of record title to the loan and any collateral therefor. The obligor continues to deal solely with the lead bank. Simpson, *supra* note 8, at 1979.

12. Lees, *supra* note 5, at 46.

13. Few regional banks have more than a handful of persons with knowledge of international banking, and few of these persons have solid experience in putting together the large and innovative financing transactions that make the most money for the bank. As well, most regional banks have far fewer specialized activities than the large money-center banks. Thus, lending becomes their key activity for international expansion. Thoman, *supra* note 2, at 25.

14. Though this is often cited as the reason for participation, it was noted that participation seldom builds relationships with borrowers. The banking relationship stays with the bank originating the syndicate. Hence, a bank participating with the hope of getting its "foot in the door" may never have a chance of expanding its relationships with borrowers. Thoman, *supra* note 2, at 25-26. *See also* note 11 *supra*, and accompanying text.

15. A lead bank usually receives a sizeable commitment fee from the borrower for setting up the participation. A commitment fee can run as low as .25% per annum for the

But a burgeoning legal battle under way in the United States,[16] which has aroused the intense interest of the international banking world, threatens to make such lending a more costly, time consuming, and less attractive process than it has been. In seven separate law suits,[17] European-American Banking Corporation (EAB), as lead bank, is accused of exploiting regional American banks by inducing them to participate in loans of millions of dollars to EMJ Colocotronis, a Greek shipping group presently in shaky financial condition.[18]

The pending suits have international ramifications. EAB became the largest foreign-owned bank in the United States when it took over insolvent Franklin National Bank of New York in late 1974.[19] Its shareholders number Britain's Midland Bank, Deutsche Bank, Amsterdam Rotterdam Bank, the French Société Générale, Belgium's Société Générale de Banque, Banca Commerciale Italiana, and the Austrian Creditanstalt Bankverein.[20]

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unused portion of the loan, accruing from the day the loan agreement is signed. The fee is negotiated and, in the case of a participation loan, may be apportioned among participating banks. In such a case, the lead bank usually charges a management fee which is not shared with participants. Lees, *supra* note 5, at 45-46 & n.12. *See also* Curran, *supra* note 7, at 63.

International lending has been a high growth activity for even smaller regional banks active in participations. *See* Thoman, *supra* note 2, at 23-24. As well, all participants and the lead bank receive their proportionate interest shares in the loan. Without directly allocating large sums of money to any one source, participations in loans allow banks to constantly put capital to work in several areas and receive returns in the form of interest profit. Lees, *supra* note 5, at 41, 43-47.

16. Mathews, *supra* note 4, at 1, col. 6. *See also* Fleming & Wyles, *U.S. Legal Russel Raises Basic Banking Issues*, Financial Times, May 27, 1976, at 6; *In and Out of Court*, THE ECONOMIST, Jan. 22, 1977, at 35.

17. In the suits filed in New York, United Virginia is asking for the recovery of \$2.5 million; American National Bank & Trust Co. of New Jersey, \$1.5 million; and City National of Detroit, \$3.6 million. In suits in federal court in Philadelphia, First Pennsylvania Bank is seeking \$2.5 million and Fidelity Bank, \$1.5 million.

> Complaints also have been filed in federal courts in Texas by Republic National Bank of Dallas for a refund of \$5.6 million and Texas Commerce Bank of Houston for \$1.8 million.

Mathews, *supra* note 4, at 1, col. 6. All seven suits have been consolidated in New York federal court. Telephone interview with Mr. Michael Maney, counsel for EAB, in New York, Nov. 3, 1976.

18. Colocotronis suffered a severe liquidity crisis last year and apparently was unable to meet its obligation on banking debts of about 310 million dollars. Some 50 European and American banks were involved in syndicates which provided these loans. In early January, 1976, it was announced that a moratorium on principal due at some of the banks, including EAB, had been agreed upon. In total, EAB arranged over 100 million dollars worth of loans for the Colocotronis group; about 30 United States banks participated in these loans. Fleming & Wyles, *supra* note 16, at 6. *See also* N.Y. Times, Jan. 13, 1976, at 45, col. 6.

19. EAB arranged most of the disputed loans to the Colocotronis group before it took over Franklin National. Mathews, *supra* note 4, at 1, col. 6.

20. Fleming & Wyles, *supra* note 16, at 6. EAB is to be classified a medium-term con-

The seven suits against EAB raise the major issue of whether a lead bank should be held liable to other participating lenders for misstating a borrower's credit standing, general financial condition, and other relevant information.[21] The legal rights of the participating banks, formalized in a document known as a "participation agreement," contained certain provisions absolving the lead lender, EAB, from contractual liability in the event that Colocotronis subsequently experienced financial difficulty.[22] Hence, the bulk[23] of allegations against EAB fall within the terms of the 1933 and 1934 Securities Acts. The participating banks seek to establish the loan participations as securities and consequently place liability on EAB for violation of the antifraud provisions of section 12(2) of the 1933

sortium bank which arranged Euro-financing. THE BANKER, Feb. 1976, at 109-10. Many of these banks were established in the 1970's by groups of internationally oriented banks for the purpose of providing medium-term loans in the Eurocurrency market. These medium-term consortium banks have enjoyed strong connections through their parent institutions, resulting in a rapid growth in their Eurocurrency operations. Lees, *supra* note 5, at 46.

21. The participating banks have no direct cause of action against the borrower Colocotronis. *See* note 8 *supra*, and accompanying text.

22. The agreement further stipulated that any losses incurred on the loan would be shared *pro rata*. Telephone interview with Vincent K. Gilmore, counsel for United Virginia Bank, in New York, Oct. 12, 1976. *See* Armstrong, *supra* note 6, at 45; Silverfeld, *Participations—A Brief Survey of the Case Law*, 50 J. COM. BANK LENDING, July 1968, at 43; and Stivers, *supra* note 11, at 32, 34.

Participation agreements generally contain the lead bank's express disclaimer for the legality, sufficiency, validity, enforceability and collectability of the loan, for the financial condition of the borrower, and for the secured value of any collateral. Riggs, *supra* note 7, at 94-95. The lead bank generally disclaims any liability or responsibility for its administration of the loan except for "bad faith or gross willful misconduct" and covenants only to handle the participation with the same care and diligence as it would loans in which no participations were allotted. Isaac, *Participations and the Securities Laws*, 58 J. COM. BANK LENDING, Oct. 1975, at 50-52. The EAB agreements contained all of the above disclaimers and restrictions. Telephone interview with Vincent K. Gilmore, counsel for United Virginia Bank, in New York, Oct. 12, 1976.

23. Unless the participating banks can qualify the loan participations as securities under the Securities Acts, the only viable cause of action against the lead bank will be in common law deceit. Relief in this situation depends primarily on whether the participant can establish misrepresentation or failure to disclose certain material facts concerning the transaction. *See* W. PROSSER, HANDBOOK OF THE LAW OF TORTS § 105, at 685-86, § 106, at 697-99, 707, 714, 722-23 (4th ed. 1971).

All of the suits brought include a cause of action under common law deceit. Under the doctrine of pendant jurisdiction, a state action is recognized in a federal forum without independent jurisdictional support if it is joined with a claim involving a federal question and arises out of the same transaction. 6 L. LOSS, SECURITIES REGULATION 3869-73 (2d ed. 1961, Supp. 1969).

Securities Act[24] and rule 10b-5.[25]

Should the plaintiffs in the European-American Banking suits successfully establish lead bank liability, the impact upon international finance will be widespread. Not only would it alter the basis upon which much of world finance presently operates, but the current patterns of growth and development in international lending would change dramatically.

After examining the facts and allegations surrounding the pending European-American Banking suits, this comment will attempt to determine whether the loan participations sold to the plaintiffs are securities[26] within the ambit of protection provided by

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24. Securities Act of 1933, § 12(2), 15 U.S.C. § 77*l* (1976). Section 12(2) provides:

> Any person who—
> (2) offers or sells a security (whether or not exempted by the provisions of section 77c of this title, other than paragraph (2) of subsection (a) of said section), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading, (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

25. Securities Exchange Act of 1934, § 10(b), 15 U.S.C. § 78j (1976) and rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5 (1977) [hereinafter cited and referred to as rule 10b-5]. Rule 10b-5 provides:

> It shall be unlawful for any person, directly or indirectly, by use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
> (a) To employ any device, scheme, or artifice to defraud,
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

The Supreme Court formally acknowledged an implied private right of action under rule 10b-5 in Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 n.9 (1971). *See generally The Supreme Court, 1971 Term*, 86 HARV. L. REV. 52, 260-68 (1972). Prior to this ruling, all of the federal circuit courts recognized an implied private right of relief. It has been suggested by many that Congress never intended to grant a private cause of action but that one resulted as a matter of judicial interpretation. Ruder, *Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent?*, 57 NW. U.L. REV. 627 (1963). *See also* Klein, *The Extension of a Private Remedy to Securities Investors Under SEC Rule 10b-5*, 20 U. MIAMI L. REV. 81 (1965); 6 L. LOSS, SECURITIES REGULATION 3869-73 (2d ed. 1961, Supp. 1969). Federal courts have exclusive jurisdiction over claims arising under the Securities Exchange Act of 1934, 15 U.S.C. § 78aa (1976).

26. This issue is to be distinguished from whether loan participations require registration under the Securities Act of 1933. At the present time loan participations are not required to be registered under the registration and prospectus requirements contained in the 1933

rule 10b-5 and section 12(2), and whether EAB, as lead bank, violated these antifraud provisions. Finally, attention will focus on the anticipated impact upon the international lending system of making lead banks vulnerable to prosecution under rule 10b-5 and section 12(2).

I. THE EUROPEAN-AMERICAN BANKING SUITS: FACTS AND ALLEGATIONS

During the world tanker boom of 1972-1973, EAB, an investment company with commercial banking powers, made a number of participation loans to various shipping companies under the ultimate ownership and control of the Colocotronis group.[27] These loans consisted of medium-term Euro-financing[28] arranged primarily to finance the purchase of two supertankers.[29] As a result of this acquisition, and the sudden change in world petroleum demand,[30]

Act. Mathews, *supra* note 4, at 1, col. 6. The question of whether registration is required is not determinative of the security status of the transaction.

> To do so automatically excludes from the definition of security those transactions which possess enough troublesome characteristics to require the liberal anti-fraud protection but which also involve enough balancing safeguards (or too few additional worrisome characteristics) to eliminate the need for registration. An arrangement may well remain a security even though it is offered to a limited number of informed and sophisticated investors so as to be able to be exempt from registration or state approval.

Coffey, *The Economic Realities of a Security: Is There a More Meaningful Formula?*, 18 CASE W. RES. L. REV. 367, 372 (1967).

It appears possible that loan participations might well be exempt under the provisions contained in § 3(a)(2) of the Securities Act of 1933, 15 U.S.C. § 77c(a)(2) (1976). This section provides that the securities of "any banking institution . . . the business of which is substantially confined to banking and is supervised by the State . . . banking commission are exempt from the registration requirements." The court in Lehigh Valley Trust Co. v. Central National Bank, 409 F.2d 989, 993 (5th Cir. 1969) recognized this exemption in regard to loan participation agreements.

The prospect of requiring the registration of loan participations under the United States securities laws is one of the bigger concerns facing the international lending market. Mathews, *supra* note 4, at 1, col. 6. "To subject loan syndications to an expensive registration process," according to C.P. Brauch, president of Chase Manhattan Bank's Chase Asia Ltd., "would kill the international syndication industry. It would certainly drive out the American banks." *Id.*

27. The early 1970's represents a period when high powered international lending financed an expanding "supertanker" market. *See Betting of $20 Billion in the Tanker Game*, FORTUNE, Aug. 1974, at 145-49.

28. *Banks Under Attack*, BANKER, Feb. 1976, at 109-10.

29. N.Y. Times, Jan. 13, 1976, at 45, col. 6.

30. The over-ordering of supertankers during the early 1970's was based on two assumptions which turned out to be false and thus compounded each other. It was assumed primarily that oil consumption would continue to grow in the late 1970's as it had done for the previous 15 years; thus, a second assumption was made that the oil required would need to be transported over very long distances. The quadrupling of oil prices confounded one

the Colocotronis group remains in debt to the sum of 320 million dollars. Most of this amount is owed to syndicates organized and managed by EAB and its affiliate, Deutsche Schiffahrtsbank (DSB).[31]

With respect to ship lending participations, EAB's role as lead bank is said to be unique in comparison with other types of participation loans. In view of the unique conditions in the shipping loan market and in the shipping business, EAB is said to have represented itself as possessing the particular expertise required to evaluate, organize, and administer this kind of participation loan.[32] Further, EAB is believed to have enjoyed a long-standing relationship with the Colocotronis group.[33]

EAB sold participations in separate loans to specific Coloco-

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assumption; the increasing need to rely on sources of oil nearer to the place of consumption, the North Sea, Alaska, and West Africa, confounded the other. Faith, *How the World Tanker Slump May Affect Bank's Balance Sheets*, EUROMONEY, June 1976, at 14-15.

31. *Banks Under Attack, supra* note 28, at 110. EAB and DSB are both affiliates of the Deutsche Bank. *Id.* It is believed that both banks consented to restructuring the loans because it appeared unlikely that they would be able to get their money back in today's market if they foreclosed on the ships secured as collateral and sold them. Vessels valued at 50 million dollars three or four years ago are worth less than 15 million dollars today. N.Y. Times, Jan. 13, 1976, at 45, col. 6. *See also* Barron's, June 2, 1975, at 32.

32. Allegations made by Republic National Bank of Dallas characterize this special knowledge represented by EAB as one entailing a full understanding and appreciation of the peculiarities of ship operations, charters, the multiplicity of laws relating to ship lending, shipping, mortgages, assignments and other collateral, the special operating problems of shipping, as well as the special techniques and experience required to analyze and evaluate charters of vessels and, perhaps most importantly, to analyze facts and assumptions necessary to properly forecast revenue and expenses of a ship operating under charters. Complaints at 4, Republic Nat'l Bank v. European American Bank, No. CA 3-76-1002 (N.D. Tex., filed Mar. 13, 1976).

This representation of "special knowledge" on the part of EAB becomes particularly interesting when viewed in the light of two observations made on the world tanker glut: "It is now generally agreed that many banks bulging with liquidity in 1972-73 made far too many loans which were not properly secured and on the basis of too little experience [in] shipping finance." Fleming & Wyles, *supra* note 16, at 6, col. 3. "The main point . . . is whether international banks were rash in their commitments to ship owners during the tanker boom . . . . It is true that they could not foresee the Middle Eastern war of 1973 and all of its consequences; but they should perhaps have noticed that they were helping to finance a world tanker surplus which is expected to last until 1980." Faith, *supra* note 30, at 110.

Note that this allegation of "special knowledge" will have particular importance in establishing the loan participation agreements as securities. *See* note 121 *infra*. As well, it is of integral importance in determining the reliance and scienter elements requisite to rule 10b-5 liability. *See* note 132 *infra*.

33. Complaint at 5, Republic Nat'l Bank v. European American Bank, No. CA 3-76-1002 (N.D. Tex., filed Mar. 18, 1976). This is supported by the fact that EAB and DSB, both affiliates of Deutsche Bank, contributed approximately 70% of the 320 million dollars in loans that remain outstanding by the Colocotronis group. *Banks Under Attack, supra* note 28, at 110.

tronis companies,[34] each loan constituting a separate group, or syndicate.[35] In organizing each syndicate, EAB typically prepared and circulated written, telexed, or cabled offering circulars. These circulars were preceded and followed by telephone communications.[36]

Telephone communications between the proposed participant and EAB purportedly entailed an in-depth discussion of the transaction. After a short period a decision would be made by the proposed participant to either purchase the participation or reject the lead's offer. Often, documentation of the deal would follow, the participant bank with no apparent choice but to rely on EAB to properly handle and document the transaction.[37]

Throughout the entire negotiation process, EAB allegedly held itself out to the proposed participants directly, as well as impliedly and through the course of dealings, as being an expert in every respect of ship lending, particularly in regard to the Colocotronis companies and the Colocotronis group.[38] Offering circulars sent to proposed participants allegedly characterized the financial conditions of the Colocotronis companies and the Colocotronis group as "excellent and in proper shape to support the loans."[39]

In connection with these representations, EAB periodically published reports concerning the operations of the Colocotronis companies. These reports included financial data and an analysis of the ship charters and their operations — all of which was purportedly based upon careful research and analysis.[40]

34. These loans were secured by a mortgage on a single vessel, assignment of charter hire, insurance claims relating to the vessel, and guaranty by the shareholders of the individual borrowing companies who are the principal shareholders of the parent entities controlling all shipping companies within the Colocotronis group. Answer to the Complaint, United Virginia Bank v. European American Bank, No. 2137 (S.D.N.Y., filed Mar. 21, 1976).

35. Complaint at 6, Republic Nat'l Bank v. European American Bank, No. CA 3-76-1002 (N.D. Tex., filed Mar. 12, 1976).

36. Offering circulars serve as the principal document for interesting other banks in taking part in the participation loan. Mathews, *supra* note 4, at 1, col. 6.

37. Complaint at 7, Republic Nat'l Bank v. European American Bank, No. CA 3-76-1002 (N.D. Tex., filed Mar. 12, 1976).

38. In particular EAB is said to have represented itself as a highly knowledgeable ship lender with equally sufficient knowledge of the financial condition of the companies and the Colocotronis family, the status of their trade debt, insurance and charters, and the condition of the vessels. Complaint at 6, Republic Nat'l Bank v. European American Bank, No. CA 3-76-1002 (N.D. Tex., filed Mar. 12, 1976).

39. Complaint at 37, Republic Nat'l Bank v. European American Bank, No. CA 3-76-1002 (N.D. Tex., filed Mar. 12, 1976).

40. The third annual study of the Colocotronis group of shipping companies, issued by EAB in April, 1975, and sent to all participants, contains the following in its introductory statement: "This report . . . reflects the continuing efforts of both the Colocotronis group

EAB's loans to the Colocotronis companies total over 110 million dollars and are broken up for the most part into separate loans to individual shipowning companies, each of which owns one ship.[41]

As a result of EAB's solicitations, and on the basis of information contained in offering circulars furnished to proposed participants, thirty United States banks joined several EAB syndicates in providing loans that remain unpaid, and hence are the subject of the pending suits.[42] In connection with its sale of certain participations in particular loans, EAB allegedly deceived, manipulated, and intentionally defrauded the plaintiffs and others, all in violation, *inter alia*, of rule 10b-5 and section 12(2).[43] Purportedly, EAB not only made false statements of material facts, but it omitted to state facts which misled the participants.[44] More specifically, EAB allegedly misrepresented the structuring of various loans, and overstated the projected charter income from operations of the ships and the net revenue or cash flow available to service the various loans.[45]

The offering circulars sent to proposed participants allegedly concealed the true financial condition of the Colocotronis group. EAB stated that the financial condition, assets, and charters of the various Colocotronis companies, as parties to different loans, were more than sufficient to support the respective loans.[46] EAB further represented the Colocotronis group as sufficiently affluent to

and EAB to keep the groups' bankers informed on the operations and prospects of the group as well as the environment in which it operates."

41. At least two of the Colocotronis companies are servicing and management companies. One is based in London, England; the other in Pireaus, Greece. Each of the loans was usually secured by a First Preferred Ship Mortgage, usually recorded under Greek law in Greece as the ships were Greek flag ships. The loans were made under agreements which designate English law as applicable. In many cases the shipowning companies are Panamanian corporations. Complaint at 28, Republic Nat'l Bank v. European American Bank, No. CA 3-76-1002 (N.D. Tex., filed Mar. 12, 1976).

42. *See* note 17 *supra*.

43. Complaint, Republic Nat'l Bank v. European American Bank, No. CA 3-76-1002 (N.D. Tex., filed Mar. 12, 1976); Complaint, United Virginia Bank v. European American Bank, No. 9814 (S.D.N.Y., filed Apr. 5, 1975); Mathews, *supra* note 4, at 1, col. 6; and Fleming & Wyles, *supra* note 16, at 6, col. 5.

44. Complaint, Republic Nat'l Bank v. European American Bank, No. CA 3-76-1002 (N.D. Tex., filed Mar. 12, 1976); Complaint, United Virginia Bank v. European American Bank, No. 9814 (S.D.N.Y., filed Apr. 5, 1975); Mathews, *supra* note 4, at 1, col. 6; and Fleming & Wyles, *supra* note 16, at 6, col. 5.

45. Common allegations made by all plaintiffs involved in the European-American Banking Suits. Mathews, *supra* note 4, at 6, col. 1.

46. Complaint, Republic Nat'l Bank v. European American Bank, No. CA-3-76-1002 (N.D. Tex., filed Mar. 12, 1976); Complaint, United Virginia Bank v. European American Bank, No. 9814 (S.D.N.Y., filed Apr. 5, 1975).

serve as guarantor for the loans.[47] During a period when participations were being sold in certain loans, EAB and DSB were negotiating a substantial multimillion dollar working capital loan to the Colocotronis companies.[48] EAB failed to inform participants of this fact at, or prior to, the sale of the participation.[49]

Participants now bringing suit against EAB say they were misled into believing that the charter income of the supertankers they financed for the Colocotronis group would be used to repay the loans.[50] EAB apparently represented that pre-existing charter agreements had been made when, in fact, it appears quite to the contrary.[51] Representations made by EAB in regard to the high standard of care and competence exercised during the analysis, credit evaluation, management, and administration of the shipping loans and credits are also in issue.[52]

II. THE EAB LOAN PARTICIPATION CERTIFICATES AS SECURITIES

Determining whether the loan participation certificates sold by defendant EAB constitute securities for the purposes of rule 10b-5 and section 12(2) is of primary importance in the pending European-American Banking suits. This determination is crucial because the preliminary task in every case seeking to invoke liberal antifraud protections created by the securities laws requires establishing the existence of some "security" that is the object of the activities in question.[53] The statutory definition of the term

47. Complaint, Republic Nat'l Bank v. European American Bank, No. CA 3-76-1002 (N.D. Tex., filed Mar. 12, 1976); Complaint, United Virginia Bank v. European American Bank, No. 9814 (S.D.N.Y., filed Apr. 5, 1976); *See* Mathews, *supra* note 4, at 1, col. 6; and Fleming & Wyles, *supra* note 16, at 6.

48. Complaint, Republic Nat'l Bank v. European American Bank, No. CA-3-76-1002 (N.D. Tex., filed Mar. 12, 1976); Complaint, United Virginia Bank v. European American Bank, No. 9814 (S.D.N.Y., filed Apr. 5, 1975).

49. Complaint, Republic Nat'l Bank v. European American Bank, No. CA 3-76-1002, at 45 (N.D. Tex., filed Mar. 12, 1976).

50. *Id.*

51. Complaint, Republic Nat'l Bank v. European American Bank, No. CA-3-76-1002 (N.D. Tex., filed Mar. 12, 1976); Complaint, United Virginia Bank v. European American Bank, No. 9814 (S.D.N.Y., filed Apr. 5, 1975). *See also* N.Y. Times, Jan. 13, 1976, at 45, col. 6.

52. Complaint, Republic Nat'l Bank v. European American Bank, No. CA 3-76-1002 (N.D. Tex., filed Mar. 12, 1976); Complaint, United Virginia Bank v. European American Bank, No. 9814 (S.D.N.Y., filed Apr. 5, 1976); *See* Mathews, *supra* note 4, at 1, col. 6; and Fleming & Wyles, *supra* note 16, at 6.

53. Woodward v. Metro Bank of Dallas, 522 F.2d 84, 90-91 (5th Cir. 1975). The antifraud protection afforded under federal law is generally greater than that enjoyed by a

"security," as provided by section 3(a)(10) of the Securities Exchange Act of 1934, includes "any certificate of interest or participation in any profit sharing agreement . . . or investment contract . . . or participation in any [note]."[54]

The question of loan participation certificates as securities has faced the courts on two prior occasions. In *Lehigh Valley Trust Co. v. Central National Bank*,[55] the court, finding the loan participation

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comparable action for common law deceit. *See* note 23 *supra*. A federal action, by the terms of section 12(2) and rule 10b-5, reaches factual omissions and half-truths as well as actual misrepresentations. *See* notes 24-25 *supra*. In contrast, common law fraud consists only of active misrepresentations and, ordinarily, there is no imposition on the actor of a duty to voluntarily disclose information. *See* W. PROSSER, HANDBOOK OF THE LAW OF TORTS § 105, at 685-86, § 106, at 697-99, 707, 714, 722-23 (4th ed. 1971).

Moreover, two essential elements of common law fraud, reliance and causation, are significantly relaxed under rule 10b-5 and section 12(2). In "omission" cases, as opposed to a federal action for "misrepresentation," reliance is presumed where the materiality of the omitted information is established. *See* text accompanying note 134 *infra*. Although proof of causation remains an essential prerequisite to establishing liability under rule 10b-5, doubt exists as to what degree proximate causation must be shown. 6 L. LOSS, SECURITIES REGULATION 3880-83 (2d ed. 1961, Supp. 1969). As for section 12(2), the plaintiff need not prove causation to recover. *See, e.g.*, Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680, 696 (5th Cir. 1971); Gilbert v. Nixon, 429 F.2d 348, 357 (10th Cir. 1970); Johns Hopkins Univ. v. Hutton, 422 F.2d 1124, 1129 (4th Cir. 1970). *But cf.* Jackson v. Oppenheim, Fed. Sec. L. Rep. (CCH) ¶ 95,497, at 99,529-30 (2d Cir. 1976) (in order for an action for fraud to exist under § 12(2), a communication must be instrumental in the sale).

54. 15 U.S.C. § 78c(10) (1976). The full text reads:

> (a) When used in this chapter, unless the context otherwise requires—
> (10) The term "security" means any note, stock, treasury stock, bond, debenture certificiate of interest or participation in any profit sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate, or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt of warrant or right to subscribe to purchase any of the foregoing; but shall not include currency or any note, draft, bill of exchange, of banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

Section 2(1) of the Securities Act provides that:

> When used in this title, unless the context otherwise requires—
> (1) The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

15 U.S.C. § 77b(1) (1976).

Although distinctions have been noted between the definitions provided in the two acts, the judiciary has recognized them to be "virtually identical." United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 847 n.12 (1975); Tcherepnin v. Knight, 389 U.S. 332, 342 (1967). *See* S. REP. No. 792, 73d Cong., 2d Sess. 14 (1934).

55. 409 F.2d 989 (5th Cir. 1969). Central National, appellant Florida Bank, sold Lehigh

certificate to be within the parameters of section 3(a)(10), held the lead bank liable for nondisclosure and material misrepresentation under rule 10b-5. Based on the Supreme Court's policy of giving a broad reading to the definition of security,[56] and its generally expansive construction of the antifraud provisions of the 1934 Act,[57] the *Lehigh* court read the statute literally to include the participation within the security category.[58]

However, stronger and conceptually more viable grounds than those used by *Lehigh* exist for supporting the conclusion that a loan participation constitutes a security.[59] In *NBI Mortgage Investment*

Valley, appellee Pennsylvania Bank, a participation agreement in a loan originated by the former. The loan was guaranteed by certain individuals and secured by shares of stock in another company. Central National represented the debtor and the guarantors on the loan to be "outstanding citizens" and "high" type individuals. Lehigh Valley relied on these representations in purchasing the loan participation from Central National. The Florida Bank failed to disclose a number of significant facts. When the loan subsequently became uncollectable, Lehigh sued Central National under rule 10b-5 alleging misrepresentation and failure to disclose. *Id.* at 90-91.

56. *Id.* at 992. *See* SEC v. National Securities, Inc., 393 U.S. 453 (1969); Tcherepnin v. Knight, 389 U.S. 332, 338 (1967).

57. 409 F.2d at 992. *See* SEC v. National Securities, Inc., 393 U.S. 453 (1969).

58. The *Lehigh* court substantiated its holding by stating that the definition of a security has been "literally read by the judiciary to the extent that almost all notes are held to be securities." 409 F.2d at 991-92. Therefore, since the definition of a security includes any certificate of participation in a note, and in view of the strict interpretation given to "any note," the court held that it was bound to read the rest of the statute literally, and thus concluded that the loan participation constituted a security. *Id.* at 992.

This view was subsequently criticized by the court in Avenue State Bank v. Tourtelot, 379 F. Supp. 250 (N.D. Ill. 1974). The statement made by the *Lehigh* court was depicted as "an inaccurate summary of the views of the entire judiciary." *Id.* at 154. However, the *Avenue* court went on to state that "while the note itself in *Lehigh* may not be a security, a loan participation agreement in the note is." *Id. See* United Housing Foundation v. Forman, 421 U.S. 837, 849 n.14 (1975) ("with the exception of the Second Circuit, every Court of Appeals recently to consider the issue has rejected the literal approach").

59. The impact of the *Lehigh* decision was to allow for the recognition that a loan participation may be a security. *See* Epstein, *Bank Participation Agreements as Securities*, 87 BANKING L.J. 99 (1970). However, in view of judicial developments in this area of the law, the continuing viability of *Lehigh*, in so far as its holding was based on a literal reading of the definition of a security, becomes questionable. *See* note 57 *supra*. *Lehigh's* literal approach has been rejected, and the courts have recognized that not all notes constitute securities. *See, e.g.*, Great Western Bank & Trust v. Kotz, 532 F.2d 1252 (9th Cir. 1976); McClure v. First Nat'l Bank, 497 F.2d 490 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975); and Lino v. City Investing Co., 487 F.2d 689 (3d Cir. 1973). The pertinent definitional language of both acts appears to be explicit by the inclusion of the term "any note" to include all notes. *See* note 53 *supra*. Hence, the courts rejecting the *Lehigh* approach were confronted with the problem of how Congress, by providing its broad definiton for the term "security," and by allowing for only tightly drawn exceptions for particular types of notes, could *not* have intended for almost all notes to be securities. *See, e.g.*, Movielab, Inc. v. Berkey Photo, Inc., 321 F. Supp. 806, 808-09 (S.D.N.Y. 1970), *aff'd*, 452 F.2d 662 (2d Cir. 1971). The courts resolved this problem by giving legal impetus to the statutes' definitional preface, which

Corp. v. Chemical Bank,[60] the defendant's motion for partial summary judgment was dismissed on the grounds that "a loan participation may be a security if the transaction was coupled with the necessary indicia under the *Howey* test."[61] The language used by this court is clearly in line with the Supreme Court's adoption of the "context-over-text" approach in determining whether a specific instrument or transaction constitutes a security within the meaning of section 3(a)(10).[62]

This concept embodies the basic principles established by the Supreme Court in *SEC v. W.J. Howey Co.*,[63] and later reaffirmed in *Tcherepnin v. Knight*.[64] Under the so-called *Howey* test,[65] courts first are to be guided by the familiar canon of statutory construction that remedial legislation should be construed broadly to effectuate its purpose.[66] Second, "in searching for the meaning and scope of

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provides for application of the federal law "unless the context otherwise requires." *See* note 53 *supra* and note 61 *infra*.

60. NBI Mortgage Investment Corp. v. Chemical Bank, [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,632, at 90,145 (1976) (the only case after *Lehigh* to consider the question of whether a loan participation is a security).

61. *Id.* at 90,147. *See* note 68 *infra*.

62. The term "context over text" is derived from the single introductory clause which prefaces both section 3(a)(10) of the 1934 Act and section 2(1) of the 1933 Act: "unless the context otherwise requires." *See* note 53 *supra*. Initially the Supreme Court prescribed the context over text method to construe the definition of the term "security" within the purview of the 1933 Act:

> [C]ourts will construe the details of an act in conformity with its dominating general purpose, will read the text in the light of context and will interpret the text so far as the meaning of the words fairly permits as to carry out in particular cases the generally expressed legislative intent.

SEC v. C.M. Joiner Leasing Co., 320 U.S. 344, 350-51 (1943). *See* C.N.S. Enterprises v. G. & G. Enterprises, 508 F.2d 1354, 1357 (7th Cir.), *cert. denied*, 423 U.S. 825 (1975); Avenue State Bank v. Tourtelot, 379 F. Supp. 250, 253 (N.D. Ill. 1974). The definition of a security, as provided for in both acts, is judicially recognized to be the same. *See* note 53 *supra*. The use of the context over text approach has been considerably long standing, and is recognized as an approach attuned to economic realities. United Housing Foundation v. Forman, 421 U.S. 837, 846-48 (1975); Tcherepnin v. Knight, 389 U.S. 332, 336 (1967); SEC v. Capital Gains Research Bureau, 375 U.S. 180, 186 (1963).

63. 328 U.S. 293 (1946). The SEC sued to enjoin W.J. Howey Co. from using the mails and instrumentalities of interstate commerce in the offer and sale of alleged unregistered and nonexempt securities in violation of the 1933 Act. Howey owned citrus groves in Florida, which it offered and sold small interests in; these land sale contracts were coupled with long term service contracts which allowed Howey to operate the property exclusively and provided that the interest holders would share *pro rata* in Howey's annual profits. *Id.* at 296. Thus, the issue in *Howey* turned upon a determination of whether, under the circumstances, the land sales contract, the warranty deed, and the service contract together constituted a security within the meaning of the 1933 Act.

64. 389 U.S. 332 (1967).

65. *See* note 69 *infra*.

66. Tcherepnin v. Knight, 389 U.S. 332, 336 (1967). The Securities Act and the Securi-

the word 'security' in the Acts, form should be disregarded for substance and the emphasis should be placed on economic reality."[67]

In order to determine the essential economic characteristics that create a need for the special antifraud protection afforded by the 1934 Act, the *Howey* test must be used to distinguish a securities transaction from a regular commercial transaction. This classic test, set down by the Supreme Court in 1946, and adopted by subsequent courts when faced with this problem,[68] focuses on "*[w]hether the scheme involves an investment of money in a common enterprise premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others*."[69]

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ties Exchange Act clearly fall within the category of remedial legislation. One of the central purposes of the Federal Securities Acts is to protect investors through the requirement of full disclosures by issuers of securities; thus, the definition of security provided for under the Acts necessarily determines the classes of investments and investors which will receive federal protection. United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 847-49 (1974); Tcherepnin v. Knight, 389 U.S. 332, 336 (1967); SEC v. W.J. Howey Co., 328 U.S. 293, 298-99 (1945).

67. United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 848 (1974); Tcherepnin v. Knight, 389 U.S. 332, 336 (1967). As was stated by the court in *United Housing Foundation*: "Because securities transactions are economic in character Congress intended the application of these statutes to turn on the economic realities underlying a transaction and not on the name appended thereto." 421 U.S. 837, 849.

68. The *Howey* test was applied by the Supreme Court in Tcherepnin v. Knight, 389 U.S. 332 (1967), and later reaffirmed in United Housing Foundation, Inc. v. Forman, 421 U.S. 837 (1975). For lower court decisions utilizing the *Howey* test, *see, e.g.,* Daniel v. Int'l Brotherhood of Teamsters, 561 F.2d 1223 (7th Cir. 1977), *cert. granted,* 98 S. Ct. 1232 (1978) (No. 77-752); Miller v. Central Chinchilla Group, Inc., 494 F.2d 414 (8th Cir. 1974); El Khadem v. Equity Securities Corp., 494 F.2d 1224 (9th Cir. 1974); Lino v. City Investing Co., 487 F.2d 689 (3d Cir. 1973); SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476 (9th Cir.), *cert. denied,* 414 U.S. 821 (1973).

69. United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 852 (1975) (emphasis added). The original test prescribed by the Supreme Court in SEC v. W.J. Howey Co. was written in the context of whether the contracts between the parties were "investment contracts" and hence securities subject to the federal securities laws. 328 U.S. 293, 298-99 (1946). The *Howey* Court stated: "The test for [an investment contract] is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others." *Id.* at 299. *See* Tcherepnin v. Knight, 389 U.S. 332, 338 (1967). Subsequently, the Supreme Court, in *United Housing Foundation*, extended the *Howey* test to encompass not only those essential economic attributes of investment contracts, but also those salient features of all securities:

> This test, in shorthand form, embodies the essential attributes that run through all of the Court's decisions defining a security. The touchstone is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.

421 U.S. at 852. The Court, in reformulating the *Howey* test, replaced the "solely from the efforts of others" requirement with the "entrepreneurial or managerial efforts of others" requirement. In so doing, it appears that the *United Housing Foundation* Court precluded promoters from eluding the reach of the Securities Acts by involving their investors in some insignificant way, without permitting those investors to have any actual *managerial* input in

Accordingly, it is appropriate to distinguish the investment characteristics involved in the transactions between defendant EAB and the plaintiffs from the qualities of commercial lending that would inevitably free EAB from liability under rule 10b-5. Therefore, a complete analysis of the circumstances surrounding the sale of loan participation certificates by EAB under the scrutiny of the *Howey* test is imperative.[70]

The *Howey* test is comprised of four identifiable elements: (1) an investment; (2) a common enterprise; (3) a reasonable expectation of profits; and (4) the derivation of profits from the promotional or managerial efforts of others. Each element will be considered in its corresponding order.

A. The Investment Element

Although the participating banks advanced substantial sums of money to EAB upon the promise of a fixed return, the plaintiffs must show that the advancement made to EAB was in the nature of an investment, and not in the plaintiffs' capacity as commercial lenders.[71] The argument can be made that in reality no difference exists between the initial issuance of the shipping loans, which is a commercial transaction,[72] and the sale of participations at a later date. This, however, overlooks several important distinctions. Though the underlying loans, pursuant to which the participations were sold, may not be an investment, that factor alone does not determine the status of the loan participation certificates.[73] The underlying loans and the loan participations are to be considered

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the enterprise. *See, e.g.*, SEC v. Glenn Turner Enterprises, Inc., 474 F.2d 476, 481-83 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973).

70. Defendant EAB denies that any of the participations or participation agreements are securities. Answer to Complaint, United Virginia Bank v. European American, No. 3137 (S.D.N.Y., filed Mar. 2, 1976). By contending that the sale of loan participations does not constitute a sale and purchase of securities within the purview of the 1933 and 1934 Acts, EAB challenges the jurisdictional basis upon which this action is founded.

71. *See, e.g.*, Great Western Bank & Trust v. Kotz, 532 F.2d 1252, 1259-60 (9th Cir. 1976); McClure v. First Nat'l Bank, 497 F.2d 490, 493-95 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975); Bellah v. First Nat'l Bank, 495 F.2d 1109, 1112 n.3, 1113-14 (5th Cir. 1974); Lino v. City Investment Co., 487 F.2d 689, 694-96 (3d Cir. 1973); and Avenue State Bank v. Tourtelot, 379 F. Supp. 250, 254 (N.D. Ill. 1974).

72. *See, e.g.*, Great Western Bank & Trust v. Kotz, 532 F.2d 1252 (9th Cir. 1976); Bellah v. First Nat'l Bank, 495 F.2d 1109 (5th Cir. 1974). *But see* Exchange Nat'l Bank v. Touche Ross and Co., 544 F.2d 1126 (2d Cir. 1976); and Young v. Seaboard Corp., 360 F. Supp. 490 (D. Utah 1973).

73. *See, e.g.*, Avenue State Bank v. Tourtelot, 379 F. Supp. 250, 251 (N.D. Ill. 1974).

individually; each constitutes a separate transaction.[74] Congress intended that the term "security," as used in the Securities Act of 1933 and the Securities Exchange Act of 1934, should embody a flexible, rather than a static, principle; one capable of adaptation to meet the countless and variable schemes devised by those who seek to use the money of others on the promise of profits.[75]

The purchasers of participations acquired none of the legal rights characteristic of the creditor-debtor relationship established between EAB and the Colocotronis companies.[76] Participants did not receive interest in property taken as collateral to secure the loan.[77] Furthermore, the participating lenders acquired no contractual rights against EAB in the event of mismanagement, insolvency, or the borrower's subsequent default.[78] As the lead bank, EAB offered proposed participants an opportunity to contribute money and share in the profits of large participation loans managed and

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74. *Id.* This distinction is of ultimate importance to the plaintiffs' action for, with few exceptions, the courts have ruled that notes given by borrowers to banks in commercial loan transactions are not securities. *See, e.g.*, Great Western Bank & Trust v. Kotz, 532 F.2d 1252 (9th Cir. 1976); C.N.S. Enterprises, Inc. v. G. & G. Enterprises, Inc., 508 F.2d 1354 (7th Cir.), *cert. denied*, 423 U.S. 825 (1975); Bellah v. First National Bank, 495 F.2d 1109 (5th Cir. 1974); City National Bank v. Vanderboom, 290 F. Supp. 592, 608 (W.D. Ark. 1968), *aff'd*, 422 F.2d 221 (8th Cir.), *cert. denied*, 399 U.S. 905 (1970). *But see* Exchange National Bank v. Touche Ross & Co., 544 F.2d 1126 (2d Cir. 1976); Young v. Seaboard Corp., 360 F. Supp. 490 (D. Utah 1973). This distinction was noted by the *Lehigh* court in stating that the lead bank was "not charged with the sale of the Larso Development note, but rather with the sale of the loan participation." 409 F.2d at 992. In rejecting the *Lehigh* court's use of the literal approach, the court in Avenue State Bank v. Tourtelot, 379 F. Supp. 250 (N.D. Ill. 1974), held that an ordinary commercial note is not a security. *Id.* at 255. Confronted with the *Lehigh* court's statement that almost all notes are securities, the *Tourtelot* court observed the essential factual distinction found in *Lehigh* in stating that although "the note itself in *Lehigh* may not be a security . . . , a loan participation agreement in the note is." *Id.* at 254. Hence, both courts recognized the original note, and the subsequent loan participation sold in the note, as separate instruments, and that as such, the status of one is not determinative of the status of the other.

75. United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 847-49, 851-52 (1974); Tcherepnin v. Knight, 389 U.S. 332, 338 (1967); SEC v. W.J. Howey Co., 328 U.S. 293, 297-98 (1946); SEC v. C.M. Joiner Corp., 320 U.S. 344, 351 (1943). *See* S. REP. No. 792, 73d Cong., 2d Sess. 14 (1934); H.R. REP. No. 85, 73d Cong., 1st Sess. 11 (1933).

76. *See* note 7 *supra*.

77. Under the EAB loan participation agreement, participants receive proportionate shares in secured collateral only upon foreclosure by EAB. Until that time, a participant has no interest in any property taken as security. Telephone interview with Vincent K. Gilmore, counsel for United Virginia Bank, in New York City, Oct. 12, 1976. *See also* Armstrong, *supra* note 6, at 50-51; Simpson, *supra* note 8, at 1977-1979.

78. Under the EAB loan participation agreements, EAB has disclaimed all liability except for that which could arise in an instance of bad faith or wilful misconduct. *See* note 22 *supra*.

controlled solely by the defendant.[79] In its capacity as the lead bank, EAB received not only a substantial commitment fee from the borrower for each participation loan arranged, but EAB also received a management fee for administering and servicing the individual loans.[80]

EAB solicited banks, widely distributed throughout the United States and Europe,[81] that purportedly lacked the financial sophistication and expertise required in making shipping loans.[82] When participants advanced money to EAB in purchasing participations, they provided the capital necessary for EAB to operate in its capacity as the lead bank.[83] Beyond advancing their share of the loan proceeds, participant banks had no active role in loan surveillance or management; the only purpose for their participating interest in the loans was to receive the expected return of their initial investment and their share of the profits.[84] Therefore, a strong argument

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79. None of the participating banks possess the special expertise required to arrange and manage the shipping loan participations. EAB allegedly did. *See* note 32 *supra*, and accompanying text. *See* SEC v. W.J. Howey, 328 U.S. 293, 300 (1945); SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 349 (1943).

80. Telephone interview with Vincent K. Gilmore, Counsel for United Virginia Bank, in New York City, Oct. 12, 1976. *See* Lees, *supra* note 5, at 45-46 & n.12.

The EAB managerial fee arrangement can be likened to the service contract in SEC v. W.J. Howey, 328 U.S. 293, 296 (1945). In line with *Howey*, it is therefore to be contended that EAB, as loan manager, must essentially fulfill its obligation in that capacity with adequate personnel and equipment if the participants are to achieve their paramount aim of a return on their investment. *Id.* at 300.

81. Fleming & Wyles, *supra* note 16, at 6. Assuming that the absence of a creditor-debtor relationship, between the participants and the borrower, does not necessarily indicate the presence of an investment, it becomes important to observe that the courts have emphasized an offering made to a class of investors in finding notes to be securities. *See, e.g.*, C.N.S. Enterprises, Inc. v. G. & G. Enterprises, Inc., 508 F.2d 1354, 1362-63 (7th Cir.), *cert. denied*, 423 U.S. 825 (1975); McClure v. First National Bank, 497 F.2d 490, 493 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975). Congressional concern with the potential for fraud when interest in an enterprise is offered and sold to those seeking an investment opportunity mandates that such emphasis should be given by the judiciary. *See* S. REP. No. 47, 73d Cong., 1st Sess. 1 (1933). In view of the fact that EAB solicited the participation of the plaintiffs, and in recognizing the managerial and administrative responsibilities of these loans as solely resting upon EAB, the role of the plaintiffs becomes passive in nature, and can well be considered that of an investor. *See* notes 32 and 80 *supra*, and note 83 *infra*.

82. *See* notes 32 and 77 *supra*; Fleming & Wyles, *supra* note 16, at 6; Mathews, *supra* note 4, at 1, col. 6.

83. The lead bank is responsible for organizing the syndicate as well as for handling and negotiating all terms of the original underlying loan. Once the loan is made and participations are sold, the lead bank administers the loan and bears the responsibility of insuring that the loan provisions are observed. Lees, *supra* note 9, at 46-47. The lead bank enjoys the liberty to restructure the loan at any time without the prior consent or knowledge of participants. Curan, *supra* note 7, at 63; Riggs, *supra* note 7, at 94-95.

84. This factor clarifies the economic realities of the transaction by indicating that the

can be made that such a transaction constitutes an investment.[85]

In view of the investment character of loan participations, a policy argument can be made on the grounds that the securities laws only provide protection for innocent, uninformed investors who buy and sell securities from well-informed, knowledgeable investment institutions. Since the purchasers and the seller involved were banks with considerable investment expertise that were dealing at arm's length, the purchaser arguably should not be accorded the protection afforded to an unsophisticated investor.[86]

However, this policy argument has neither statutory[87] nor case law authority.[88] Neither Congress nor the Securities Exchange Commission has indicated that the unsophisticated and unwary alone are provided the protection of rule 10b-5 and section 12(2).[89] "Fraud also may be perpetrated upon the powerful and the sophisticated."[90]

B. The Common Enterprise Element

Once the investment character of a transaction is established, the analysis turns its attention to the element of common enterprise. Common enterprise arises from the interweaving of economic interests.[91] The requisite of "commonality" is established in the case

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plaintiffs' position was created for one purpose: to participate in earnings resulting from the use of their funds. Thus, the transaction could well be classified as one of investment. United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 850 (1975); Tcherepnin v. Knight, 389 U.S. 332, 339 (1967); SEC v. W.J. Howey, 328 U.S. 293, 300 (1946); SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 349 (1943). *See* note 15 *supra*, and accompanying text.

85. *See, e.g.*, cases cited in note 81 *supra*.

86. This argument was presented without success to the *Lehigh* court by defendant Central National. Lehigh Valley Trust Co. v. Central National Bank, 409 F.2d 989, 992-93 (5th Cir. 1969). This same policy argument will also be made in the pending EAB suits. Mathews, *supra* note 4, at 18, col. 2.

87. The (Securities Exchange) Act (of 1934) makes no general exception for transactions between financial institutions . . . . [T]hat Congress made no express general exemption for banks under the fraud provisions of either the Securities Act of 1933 or the Securities Exchange Act of 1934 indicates that Congress did not intend any such exemption.

Lehigh Valley Trust Co. v. Central National Bank, 409 F.2d 989, 992-93 (5th Cir. 1969).

88. *See, e.g.*, Sanders v. John Nuveen & Co., Inc., 524 F.2d 1064, 1073 (7th Cir. 1975); Hill York Corp. v. American International Franchises, Inc., 448 F.2d 680, 683 (5th Cir. 1971); Lehigh Valley Trust Co. v. Central National Bank, 409 F.2d 989 (5th Cir. 1969).

89. Lehigh Valley Trust Co. v. Central National Bank, 409 F.2d 989, 992 (5th Cir. 1969).

90. *Id. Cf.* Roquemore v. Ford Motor Co., 400 F.2d 255 (5th Cir. 1968) (brother's breach of fiduciary duty to his principal corporation).

91. Hannan & Thomas, *The Importance of Economic Reality & Risk to Defining Federal Securities*, 25 HAST. L.J. 219, 236 (1974). This is in accord with the view expressed in SEC v. Glenn Turner Enterprises, Inc., 474 F.2d 576 (9th Cir.), *cert. denied*, 474 U.S. 821 (1973): "A

of loan participations because the participants' financial interests are inextricably intermeshed with those of EAB.[92] The participants, as a group, are dependent upon the efforts of the lead bank in making and administering a sound loan, and on the success of the borrower in repaying the loan.[93] The value furnished by participants is subject to all the risks of the enterprise *pro rata*. Correspondingly, the percentage of total profits to be anticipated by a participant is based on the ratio of value the participant supplied to the total value of the loan.[94] Generally, any multibank loan retains the aspects of commonality,[95] and perhaps the circumstances of the EAB participation, and the manner in which they operate, more adequately establish the existence of a common enterprise than most multibank loans or a true lending syndicate.[96]

C. *The Expectation of Profits Element*

Once the plaintiffs establish that the transaction between the lead and participant banks was one involving the "investment of money in a common enterprise,"[97] the profit element follows the implied fact that a reasonable expection of profit accompanies the decision of a bank to join the lending syndicate.[98] "Profits" has been interpreted to mean a participation in earnings resulting from the use of the investor's funds.[99] The designation of profits as fixed serves merely to identify the type of profit anticipated.[100] Profits fixed in terms of interest do not make it any less of a profit.[101]

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common enterprise is one in which the fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment or of third parties." *Id.* at 482 n.7. *See* Continental Market Corp. v. SEC, 387 F.2d 466 (10th Cir. 1967) for an exhaustive discussion of the common enterprise element.

92. *See* notes 7, 8 & 11 *supra*, and accompanying text.

93. *See* note 80 *supra*.

94. Riggs, *supra* note 7, at 94-95. The EAB participation agreements contained the same stipulations. Telephone interview with Mr. Vincent K. Gilmore, counsel for United Virginia Bank, in New York City, Oct. 12, 1976. *See also* Armstrong, *supra* note 6, at 49; Silverfeld, *supra* note 22, at 43; Stivers, *supra* note 11, at 32, 34.

95. *See generally* 3 H. BLOOMENTHAL, SECURITIES AND FEDERAL CORPORATE LAW § 2.19(10). *See also* Armstrong, *supra* note 6, at 46-50.

96. *See* note 7 *supra*.

97. United Housing Foundation v. Forman, 421 U.S. 837, 852 (1975), *quoting* SEC v. W.J. Howey Co., 328 U.S. 293, 301 (1946).

98. *See* note 15 *supra*, and accompanying text.

99. United Housing Foundation v. Forman, 421 U.S. 837, 852 (1975); Tcherepnin v. Knight, 389 U.S. 332, 339 (1967).

100. *See, e.g.*, Los Angeles Trust Deed & Mortgage Exchange v. SEC, 285 F.2d 162 (9th Cir. 1960).

101. *Id.*

Even if the expectation of profits did not accompany the plaintiffs' decision to join in the participation, it is possible that the concept of risk capital[102] will be recognized in its place.[103] The risk capital concept focuses on the type and degree of risk allocated to the investor.[104] If the investor bears the principal risk of loss for capital supplied to the venture, and if that risk is contingent upon the managerial efforts of the promoter, then, for the purpose of the antifraud protection afforded under the 1933 and 1934 Acts, the transaction is deemed qualified as a security.[105]

A direct relationship exists between the success of the enterprise and the preservation or deterioration of the value which loan participants originally furnished. Prior to every participation loan being made to the Colocotronis group, EAB granted participations in the loan and formed its respective syndicate group.[106] The participating banks were initially allocated the principal risk of loss for their investment.[107] As lead bank, EAB handled all negotiations regarding the loan terms, loan documentation, and the securing of collateral.[108] Once a loan was made, EAB had the sole responsibil-

102. The "risk capital" approach was first articulated by the California Supreme Court in Silver Hills Country Club v. Sobieski, 55 Cal. 2d 811, 361 P. 2d 906 (1961). *See generally* Coffey, *supra* note 26, at 367; Long, *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation*, 24 OKLA. L. REV. 135, 167 (1971); Hannan & Thomas, *supra* note 91, at 242-49.

103. The Supreme Court recognized the risk capital approach in United Housing Foundation v. Forman, 421 U.S. 887 (1975), but since this concept did not apply to the situation at hand, the Court did not comment on the validity of the risk capital approach. *Id.* at 857 n. 24. Prior cases have displayed elements of risk and risk capital analysis. *See* SEC v. Variable Annuity Life Ins. Co., 359 U.S. 65 (1959) (variable annuities which placed all investment risks on the annuitant were held to be securities); SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344 (1943) (oil leaseholds sold as a promotion scheme to raise capital to drill the well held to be securities since investors responsible for financing the venture would bear the risk of loss); SEC v. Glenn Turner Enterprises, Inc., 474 F.2d 476 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973) (self-improvement contracts held to be securities where the purchaser's risk of loss was contingent on the seller's selling scheme and selling efforts). *See also* Hannan & Thomas, *supra* note 91, at 242-49.

104. Silver Hills Country Club v. Sobieski, 55 Cal.2d 811, 814, 361 P.2d 906, 908 (1961). *Cf.* El Khadem v. Equities Securities Corp., 494 F.2d 1224 (9th Cir.), *cert. denied*, 419 U.S. 900 (1974) (note held to be a security).

105. Silver Hills Country Club v. Sobieski, 55 Cal. 2d 811, 815, 361 P.2d 906, 908 (1961). *See generally* Coffey, *supra* note 26, at 381-94; Hannan & Thomas, *supra* note 91, at 242-49.

106. Telephone interview with Mr. Vincent K. Gilmore, counsel for United Virginia Bank, in New York City, Oct. 12, 1976. Loan participations arranged in this way are known as the *best effort syndicate*. The lead bank agrees to make the loan only if the necessary number of participations are purchased. Failure to sell results in withdrawal of the offer, and the borrower is forced to seek funds from another source. Lees, *supra* note 5, at 47.

107. *See* note 22 *supra*.

108. *See* notes 8, 32 & 83 *supra*.

ity of loan management.[109]

In substance, EAB, as the promoter, conducted its business of making commercial loans with the participants' money and at the participants' risk. The analysis of the EAB transaction under the capital risk approach indicates that this method is a viable alternative for any plaintiffs unable to establish the requisite element of "profits."

D. Managerial Efforts Element

The finding of profit expectation leads to the final prong of the *Howey* test which requires that the investor's profit come from the managerial efforts of others. "The Securities Acts are designed to protect those who are not in the position to protect their own investment."[110] Unlike a multibank loan arrangement where each member of the syndicate appears equally on all loan documentation and can fend for itself,[111] the participants in the EAB loans had no alternative but to accept the terms negotiated by the lead lender and rely on its credit evaluation and loan administration.[112] As a general rule, participant banks have no access whatsoever to the borrower and are unable to conduct their own credit and investment

109. *See* note 80 *supra*.

110. SEC v. W.J. Howey Co., 328 U.S. 293, 295 (1946).

111. Each member of the lending syndicate has a proportionate right not only to determine the terms under which the loan will be made, but also to participate as co-manager. *See* notes 7 and 11 *supra*. The agreement between the co-lending banks carries the characteristics of a joint venture. Armstrong, *supra* note 6, at 46, 50; Strivers, *supra* note 11, at 32-34. A joint venture, by definition, is generally formed to carry out a particular venture. The essential ingredients of a joint venture are: (1) agreement between the parties (express or implied); (2) right to share in profits made; (3) joint interest; and (4) a mutual right to control. H. HENN, LAW OF CORPORATIONS § 49, at 78 (2d ed. 1970). Since each participant in a true multibank syndicate attains the status of co-manager, the element of "managerial efforts of others" appears to be lacking. Hence, it appears questionable whether the existence of a security could be established in a true multibank syndicate. *But see* Long, *supra* note 102, at 135.

112. EAB acted as the entrepreneur of the entire lending scheme; it solicited from the participants the capital needed to support the actual loan, as well as negotiated the loan terms and directly managed the loan with the borrower. *See* 91 BANKING L.J. 767 (1974). The lead bank, further, has complete discretion with respect to the exercise or refraining from the exercise of any rights granted to it in its credit arrangements with the borrower; no responsibility enures from the lead bank to the participants as a result of this exercise of discretion. Riggs, *supra* note 7, at 94-95.

An analogy is to be drawn between this situation and that found in Tcherepnin v. Knight, 389 U.S. 332 (1967). There, withdrawable capital shares in a state chartered savings and loan association were held to be securities; the Court found the petitioners to be "participants in a common enterprise; a money lending operation dependent for its success upon the management of City Savings in making sound loans." *Id.* at 338. *But see* Epstein, *supra* note 58, at 102.

analysis.[113] The plaintiffs cannot be charged with constructive knowledge of the borrower Colocotronis' financial condition since this Greek company is a privately owned foreign corporation for which no public financial information exists.[114] In this case, even if a participating bank were to employ outside consultants and advisors, it could never put itself in the position of the informed lead lenders who work closely with the borrower in developing and supervising the loans.[115] Furthermore, the United States banks participating in the loans are located in various parts of the country.[116] Thus, the participants had no choice but to rely on EAB, as lead lender, for their credit evaluation and their ability to negotiate loan convenants and restrictions. Subsequent to the purchase of participations and the loan being made, reliance on EAB necessarily continues for loan surveillance and administration.[117] This common enterprise managed by EAB required an adequate staff and the proper exercise of care if the participants were to achieve their paramount aim of a return on their investment.[118] Allegedly, EAB's staff was grossly inadequate, resulting in a failure, on the part of EAB, to exercise the requisite care necessary to accomplish this goal.[119]

The finding of a common enterprise fulfills the four-element requirement necessary to establish a profit seeking venture. The participants, as investors, supply the capital and share in the profits while EAB manages, controls, and operates the enterprise. It follows that the arrangements whereby the investors' interests were made manifest involved investment contracts, regardless of the le-

113. "Only the very biggest banks have the staff and money to verify information contained in the offering circulars." Mathews, *supra* note 4, at 18, col. 3. For additional factors inducing the reliance of participants on the accuracy of information supplied by the lead bank, *see* Thuleen, *Survey of Practice and Procedure of Banks in Taking Participations from Correspondent Banks*, 50 J. COM. BANK LENDING, May 1968, at 12, 13; *Ways to Improve Loan Participations*, 66 BANKING, Sept. 1974, at 140.

114. Complaint, Republic Nat'l Bank v. European American Bank, No. CA 3-76-1002 (N.D. Tex., filed Mar. 12, 1976).

115. *See* notes 13 and 14 *supra*.

116. *See* note 17 *supra*.

117. This factor has been recognized as an important and necessary duty on the part of the promoter. SEC v. W.J. Howey Co., 328 U.S. 293, 300 (1946); SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 351 (1943); *see* Coffey, *supra* note 26, at 396-98.

118. SEC v. W.J. Howey Co., 328 U.S. 293 (1946); SEC v. C.M. Joiner Leasing Co., 320 U.S. 344 (1943); Silver Hills Country Club v. Sobieski, 55 Cal. 2d 811, 361 P. 2d 905 (1961). *See* H.R. Rep. No. 85, 73rd Cong., 1st Sess. 11 (1933).

119. Complaint, Republic Nat'l Bank v. European American Bank, No. CA 3-76-1002 (N.D. Tex., filed Mar. 12, 1976); Complaint, United Virginia Bank v. European American Bank, No. 9814 (S.D.N.Y., filed Apr. 5, 1976).

gal terminology in which such contracts were clothed. Therefore, in applying the *Howey* test, it may be argued that the participation certificates purchased by the plaintiffs in connection with various EAB loans constituted "securities" under the 1933 and 1934 Acts.

III. RULE 10B-5 & SECTION 12(2)

Assuming the participation certificates in the European-American Banking suits constitute securities protected by the antifraud provisions of the United States securities laws, an issue is raised as to whether EAB violated rule 10b-5 or section 12(2), or both. The question of rule 10b-5 liability is addressed first.

Plaintiffs seeking recovery under rule 10b-5 must initially satisfy the *Birnbaum*[120] "purchaser-seller" limitation sustained recently in the *Blue Chip Stamps*[121] decision. Rule 10b-5 prohibits

120. Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir. 1952). *See* note 122 *supra*, and accompanying text.

121. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975). There is no language in either section 10(b) or rule 10b-5 which expressly provides for a private right of action for persons injured by violations of those provisions. *See* note 25 *supra*. Federal courts implied a private right of action under the provisions of section 10(b) and rule 10b-5, and the Supreme Court confirmed the existence of such a private right of action under the particular circumstances found in Superintendent of Insurance v. Banker's Life & Casualty Co., 404 U.S. 6 (1971) and Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972). As noted by the Court in its recent decision in *Blue Chip Stamps*, those two cases had confirmed such a private right of action "with virtually no discussion" of the issue. 421 U.S. at 730.

In *Blue Chip Stamps*, the plaintiff, on the basis of misleading pessimistic statements in a 1933 Act registration statement, sought to assert a private remedy under rule 10b-5 on the ground that he had been misled into not purchasing the securities being offered. *Id.* at 726-27. Hence, in *Blue Chip Stamps* the Supreme Court was confronted for the first time with the stark anomaly presented by the implication of a private right of action, not on behalf of plaintiffs who were sellers of securities, as in both *Superintendent* and *Affiliated Ute*, but rather for conduct which the express civil remedies of the 1933 Act addressed. *Id.* at 730.

At the outset, the *Blue Chips Stamps* Court noted that rule 10b-5 prohibits fraud in connection with the purchase or sale of securities. Citing the parallel antifraud provisions of section 17(a) of the Securities Act of 1933, which uses broader language, prohibiting fraud in the offer or sale of securities, the Court noted that "[w]hen Congress wished to provide a remedy to those who neither purchase nor sell securities, it had little trouble doing so expressly." *Id.* at 734. The Court noted that the principal express nonderivative private civil remedy provided under section 12(2) of the 1933 Act is limited expressly by its terms to purchasers of securities, and concluded that the court would not impute to Congress an intention to expand the plaintiff class for a judicially implied cause of action beyond the bounds it delineated for a comparable express cause of action. *Id.* at 736. The Court also cited the fact that in 1957, and again in 1959, the SEC had unsuccessfully sought to have Congress amend the wording of section 10(b) to explicitly cover any attempt to purchase or sell securities. *Id.* at 732. Thus, the Court found that no private right of action could be implied under rule 10b-5 on behalf of such a plaintiff, who was not a "purchaser" or a "seller" of securities.

Since its decision in *Blue Chip Stamps*, the Supreme Court has made it clear that a fraud in connection with the purchase or sale of securities.[122] The plaintiffs in the EAB suits satisfy this requirement as evidenced by their purchase of participations.

Once it is determined that a plaintiff satisfies the purchaser-seller requirement, three basic elements are required in 10b-5 actions: (1) conduct by the defendant within the proscribed rule; (2) a purchase or sale of securities by the plaintiff *in connection with* proscribed conduct; and (3) resultant damages to the plaintiff.[123]

Within the first element of "proscribed conduct," several distinct factors of independent significance are subsumed. First, some sort of fraud in the special 10b-5 sense of the word must have been committed.[124] This alleged fraud must involve, according to rule 10b-5 standards, "misleading or deceptive activities"[125] carried on

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private right of action is not to be automatically implied under rule 10b-5 in all circumstances in which the rule has been allegedly violated. *See* Santa Fe Industries, Inc. v. Green, 430 U.S. 462.

122. "[T]he plaintiff class for purposes of a private damage action under § 10(b) and Rule 10b-5 [is] limited to actual purchasers and sellers of securities." Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730 (1975), *citing* Birnbaum v. Newport Steel Corp., 193 F.2d 461, 463 (2d Cir. 1952).

123. Woodward v. Metro Bank of Dallas, 522 F.2d 84, 93 (5th Cir. 1975); Sargent v. Genesco, Inc., 492 F.2d 750, 759 (5th Cir. 1974). Mere possession and nondisclosure of material facts do not alone create liability under rule 10b-5; there must be, in addition, some relation which generates a duty to inform. Gold v. DCL, Inc., 399 F. Supp. 1123, 1127 (S.D.N.Y. 1973). The relationship between EAB and the plaintiffs, as seller and buyer, respectively, imposed a duty on EAB (at the time of the sale) to disclose all material information. *See* McGraw v. Matthaei, 388 F. Supp. 84, 91 (E.D. Mich. 1972).

The extent of the duty of disclosure imposed upon EAB per the application of rule 10b-5 is defined by the situation and knowledge of the parties at the time they committed themselves. Radiation Dynamics, Inc. v. Goldmuntz, 464 F.2d 876, 890 (2d Cir. 1972). Hence, the scope of "material" information EAB was under a duty to disclose is to be ascertained in light of the knowledge and circumstances of the parties at the time of the transaction. *See* text accompanying notes 32-41 *supra*.

124. Woodward v. Metro Bank of Dallas, 522 F.2d 84, 86 (5th Cir. 1975). *See, e.g.*, Blackie v. Barrack, 524 F.2d 891 (9th Cir. 1975); SEC v. Management Dynamics, Inc., 515 F.2d 801 (2d Cir. 1975); Kubik v. Goldfield, 479 F.2d 472 (3d Cir. 1973); SEC v. Galaxy Foods, Inc., 417 F. Supp. 1225 (E.D.N.Y. 1976).

In establishing guidelines by which the scope of a defendant's duty can be ascertained, the courts have carefully recognized that the situation as it existed between the parties, and respectively, their individual knowledge, and access to information are the controlling factors by which the scope of a defendant's duty of disclosure is defined. Lane v. Midwest Bancshares Corp., 337 F. Supp. 1200 (E.D. Ark. 1972). Thus, if EAB's position as lead bank lender placed it in a superior position in regard to its knowledge and access to information, as opposed to that of the purchasing participating banks, EAB's status as lead bank will be of obvious importance in defining its duty of disclosure. However, the real issue of fact necessary to resolve will be what information was known or readily available to EAB at the time the sale of participations took place. *See* note 32 *supra*.

125. To establish a cause of action under rule 10b-5 there must be some sort of fraud or deceit in the sale of securities. Miller v. San Sebastian Gold Mines, Inc., 540 F.2d 807, 809

in connection with the purchase or sale of securities. Although rule 10b-5 offers this guideline, it fails to specify particular acts or practices that constitute manipulative or deceptive devices or contrivances.[126] Rather, the rule is designed to encompass the infinite variety of devices that are alien to the climate of fair dealing.[127] The essence of rule 10b-5 is that it requires disclosure of material facts.[128] Misrepresentations, half-truths, omissions, and concealment of after-acquired information are proscribed.[129] Implied representations are also sufficient to establish liability.[130]

The second component inherent in the first element of proscribed conduct is materiality.[131] Thus, the misrepresentations or omissions in question must be material in the sense that there exists

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(5th Cir. 1976); Resort Car Rental System, Inc. v. Chuck Ruwart Chevrolet, Inc., 519 F.2d 317, 321 (10th Cir. 1975). Such deceptive or manipulative devices need not be precisely sufficient to sustain an action for common law fraud or deceit. Cady, Roberts & Co., 40 S.E.C. 905, 907 (1961). *See* Blackie v. Barrack, 524 F.2d 891 (9th Cir. 1975); Keene Corp. v. Weber, 394 F. Supp. 787 (S.D.N.Y. 1975); U.S. v. Koenig, 388 F. Supp. 670 (S.D.N.Y. 1974).

126. Courtland v. Walston & Co., 340 F. Supp. 1076, 1083 (S.D.N.Y. 1972), *citing* Superintendent of Insurance v. Bankers Life and Cas. Co., 404 U.S. 6 (1971), and Drachman v. Harvey, 453 F.2d 722 (2d Cir. 1972). *See* SEC v. Scott Gorman Municipals, Inc., 407 F. Supp. 1383 (S.D.N.Y. 1975); Wassel v. Eglowsky, 399 F. Supp. 1330 (D. Md. 1975).

127. SEC v. Capital Gains Research Bur., 375 U.S. 180, 201 (1963); *accord,* Dupuy v. Dupuy, 511 F.2d 641, 643 (5th Cir. 1975).

128. The only regulatory objective of rule 10b-5 is that access to material information be enjoyed equally, but this objective requires nothing more than the disclosure of basic facts so that outsiders may draw upon their own evaluative expertise in reaching their own investment decisions with knowledge equal to that of insiders. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848-49 (2d Cir. 1968), *cert. denied,* 394 U.S. 976 (1971); McGraw v. Matthaei, 388 F. Supp. 84, 91 (E.D. Mich. 1972). *See* A. BROMBERG, SECURITIES LAW: FRAUD—SEC RULE 10B-5 (1971); L. LOSS, SECURITIES REGULATIONS (2d ed. 1961); Hewitt, *Developing Concepts of Materiality and Disclosure,* 32 BUS. LAW. 887 (1977); Castruccio, *Developments in Securities Regulations,* 32 BUS. LAW. 1537 (1977); Anderson, *The Disclosure Process in Federal Securities Regulation: A Brief Review,* 25 HAST. L. REV. 1340 (1966); Cohen, *"Truth in Securities"—Revisited,* 79 HARV. L. REV. 1340 (1966).

129. SEC v. National Banker's Life Ins. Co., 324 F. Supp. 189, 195 (N.D. Tex.), *aff'd.,* 448 F.2d 652 (5th Cir. 1971). *See* Jacobs, *What is a Misleading Statement or Omission Under Rule 10b-5,* 42 FORD. L. REV. 243 (1973).

130. Sanders v. John Nuveen & Co., Inc., 524 F.2d 1064, 1069-70 (7th Cir. 1975). *See, e.g.,* Ahrens v. American-Canadian Beaver Co., 458 F.2d 607 (10th Cir. 1972).

131. Woodward v. Metro Bank of Dallas, 522 F.2d 84, 94 (5th Cir. 1975). *See* Smallwood v. Pearl Brewing Co., 489 F.2d 579 (5th Cir. 1974); Lehigh Valley Trust Co. v. Central National Bank of Jacksonville, 409 F.2d 989 (5th Cir. 1969); Heit v. Weitzen, 402 F.2d 909 (2d Cir. 1968); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied,* 394 U.S. 976 (1971).

The concept of materiality in an action under section 10(b) and SEC rule 10b-5 since materiality operates as a limit on the amount of information that must be disclosed under the Securities Acts. Hewitt, *supra* note 128, at 890. The "question of materiality, it is universally agreed, is an objective one, involving the significance of an omitted or misrepresented fact to a reasonable investor." T.S.C. Industries, Inc. v. Northway, Inc., 426 U.S. 438, 445 (1977).

a substantial likelihood that a reasonable investor *would* have considered them important in determining his choice of action in the transaction involved.[132] Where the material facts were misstated or misrepresented, some evidence of reliance on the part of the investor must be established.[133] Positive proof of reliance is not a prereq-

132. Sunstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033, 1048 (7th Cir. 1977). The concept of "materiality" has been said to suffer from a problem of definition; attempts at definition often end in circularity, for example, a material fact is a fact "which would materially affect the judgment of the other party to the transaction." Kardon v. National Gypsum Co., 73 F. Supp. 798, 800 (E.D. Pa. 1947). *See* Hewitt, *supra* note 128, at 888-909. As a result, variations in the formulation of a general test of materiality occur in the articulation of just how significant a fact must be or, put another way, how certain it must be that the fact would affect a reasonable investor's judgment. TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438 (1977). The widespread confusion over the proper standard of materiality has recently been resolved, however, by the Supreme Court's decision in TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438 (1977). In the context of a section 14(a), Securities Exchange Act action for violation of the proxy disclosure requirements, the *TSC* Court adopted the following standard of materiality:

> [A fact] is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. This standard . . . does not require proof of a substantial likelihood that disclosure of the omitted [or misrepresented] fact would have caused the reasonable investor to change his vote. What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure would have been viewed by the reasonable investor as having significantly altered the "total mix of information made available."

426 U.S. at 449. The courts have generally interpreted materiality in the same manner under all of the various provisions of the federal securities laws. *See, e.g.*, Mills v. Electric Auto Lite Co., 396 U.S. 375 (1970) (citing cases decided under rule 10b-5 and 14a-9); Gilbert v. Nixon, 429 F.2d 348, 355 (10th Cir. 1970) (standards of materiality under section 12(2) and rule 10b-5 considered the same). The *TSC* test of materiality was recently adapted to a rule 10b-5 context by the Seventh Circuit in Sunstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033, 1048 (7th Cir. 1977).

The test of materiality is the same whether the facts to be considered are omissions or misrepresentations. TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 447, n.9 (1977) (the test of materiality delineated in Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-54 (1972) is not the test to be used in cases of "omissions"). The issue of materiality of a nondisclosure or misrepresentation with respect to a security is one of the facts to be determined on the basis of all of the circumstances. Gelnan v. Westinghouse Elec. Corp., 73 F.R.D. 60, 68 (W.D. Pa. 1976); SEC v. Shapiro, 494 F.2d 1301, 1306 (2d Cir. 1974); Radiation Dynamics, Inc. v. Goldmuntz, 464 F.2d 876, 888 (2d Cir. 1972) (materiality "must be determined on a case-to-case basis according to the fact pattern of each specific transaction.")

133. Lehigh Valley Trust Co. v. Central National Bank of Jacksonville, 409 F.2d 989, 993 (5th Cir. 1969); Reeder v. Mastercraft Electronics Corp., 363 F. Supp. 574, 581 (S.D.N.Y. 1973). The test of justifiable reliance under section 10(b) and rule 10b-5 is a subjective test and not simply a reasonable man test. Myzel v. Fields, 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968). Plaintiff's sophistication, expertise, and business acumen in the financial community, his access to information and opportunity to detect the fraud are all relevant considerations to be made in determining a plaintiff's reliance. Clement A. Evans & Co. v. McAlpine, 434 F.2d 100 (5th Cir. 1970). Requiring reliance as a prerequisite to recovery serves to restrict the potentially limitless thrust of rule 10b-5 to those situations in which

uisite to recovery where the circumstances involve a material failure to disclose.[134]

Finally, as a result of the recent Supreme Court holding in *Ernst & Ernst v. Hochfelder*,[135] proscribed conduct requires that scienter necessarily be established on the part of the defendant.[136]

The alleged misrepresentations and nondisclosures on the part of EAB may come within the ambit of conduct if the plaintiffs' alle-

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there exists causation in fact between the act and the injury. Tucker v. Arthur Andersen & Co., 67 F.R.D. 468 (S.D.N.Y. 1975).

134. Affiliated Ute Citizens v. United States, 406 U.S. 128, 153 (1972). Although the Supreme Court's presumption of reliance in cases of omissions meets the conceptual difficulty of proof of reliance on a negative fact, that presumption is not held to be conclusive. As was stated by the court in Chelsea Assoc. v. Rapanos, 527 F.2d 1266 (6th Cir. 1975):

> We do not read [the] decision [in *Affiliated Ute Citizens*] to say that the question of reliance *vel non* may not be considered at all in non-disclosure cases, but only that proof of reliance is not required for recovery. If defendant is able to demonstrate that there was clearly no reliance, that is, that even if the material facts had been disclosed, plaintiff's decision as to the transaction would not have been different from what it was, then the non-disclosure cannot be said to have caused the subsequent loss, and under the ordinary principles of the law of fraud, recovery should be denied . . . . However, in light of the Supreme Court's holding in *Affiliated Ute*, the burden of proof rests squarely upon defendant to establish the 'non-reliance' of plaintiff. (citations omitted).

527 F.2d at 1271. *See* Note, *The Reliance Requirement in Private Actions Under SEC Rule 10b-5*, 88 HARV. L. REV. 584 (1975).

Thus, where the materiality of an omission to disclose material facts is established in a securities action, reliance is presumed, but nonreliance may be established as an affirmative defense. Sunstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033, 1048 (7th Cir. 1977); Chelsea Assoc. v. Rapanos, 527 F.2d 1266, 1271 (6th Cir. 1975); McLean v. Alexander, 420 F. Supp. 1057, 1077-79 (D. Del. 1976). *See* Wheeler, *Plaintiff's Duty of Due Care Under Rule 10b-5: An Implied Defense to an Implied Remedy*, 70 NW. U.L. REV. 561 (1975); Note, *Reliance Under Rule 10b-5: Is the "Reasonable Investor" Reasonable?*, 72 COLUM. L. REV. 562, 567 (1972).

135. 425 U.S. 185 (1976).

136. *Id.* at 193. The term "scienter" was interpreted to mean "a mental state embracing intent to deceive, manipulate or defraud." *Id.* at n.12.

The narrow issue presented to the Supreme Court was whether scienter is a necessary element of an "aiding and abetting" violation of rule 10b-5. Nevertheless, the *Ernst* Court framed the issue to cover all private causes of action for damages under section 10(b) and rule 10b-5, thereby expanding the reach of the *Ernst* decision beyond the immediate facts. *Id.* at 193. Commentators and case authorities have concurred that this result was the necessary outgrowth of the Court's desire to find one standard applicable in all rule 10b-5 cases. *See* Rutgers, *Recklessness Under Section 10b: Weathering the Hochfelder Storm*, 8 CAMDEN L.J. 325 (1977); Note, *Rule 10b-5: Scienter Displaces the Flexible Duty Standard*, 56 NEB. L. REV. 382 (1977); Note, *Scienter's Scope and Application in Rule 10b-5 Actions: An Analysis in Light of Hochfelder*, 52 NOTRE DAME LAW. 925 (1977).

The *Ernst* Court did not address the issue of whether, in some instances, reckless behavior is sufficient for civil liability under section 10(b) and rule 10b-5. 425 U.S. at 193 n.12. However, recent lower court decisions have deemed extreme instances of recklessness sufficient to predicate liability. *See, e.g.*, Bailey v. Meister Brau, Inc. 535 F.2d 982, 993-94 (7th Cir. 1976); Rich v. Touche Ross & Co., [1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,514 (1976).

gations can be proven. Legislative intent and judicial interpretation indicate that such omissions and misrepresentations of fact made by a solicitor seeking to induce the purchase of securities are precisely the type of conduct the antifraud provisions of rule 10b-5 are designed to protect against.[137]

Facts relating to the financial condition of the borrower,[138] loan structure, and terms negotiated between EAB and the Coloco-

137. A fundamental purpose common to these securities regulation statutes is to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus achieve a high standard of business ethics in the securities industry. SEC v. Capital Gains Research Bureau, 375 U.S. 180, 186 (1963); City National Bank v. Vanderboom, 422 F.2d 221, 230 (8th Cir.), *cert. denied*, 399 U.S. 905 (1970); List v. Fashion Park, Inc., 340 F.2d 457, 463 (2d Cir. 1965); Lane v. Midwest Bancshares Corp., 337 F. Supp. 1200, 1209 (E.D. Ark. 1972).

However, since the aim of rule 10b-5 is to qualify, as between insiders and outsiders, the doctrine of *caveat emptor*, the courts have also recognized that the legislative enactment of section 10(b) and rule 10b-5 did not establish a scheme of investors insurance. Lane v. Midwest Bancshares Corp., 337 F. Supp. at 1209. Accordingly, the class of investors to be protected under rule 10b-5 is limited to conscientious buyers and sellers in good faith. City National Bank v. Vanderboom, 422 F.2d 221, 230 n.10 (8th Cir.), *cert. denied*, 399 U.S. 905 (1970); Lane v. Midwest Bancshares Corp., 337 F. Supp. 1200, 1209 (E.D. Ark. 1972). As a means of promoting this principal limitation on the scope of 10b-5 plaintiffs who have satisfied the *Birnbaum* requirement, *see* notes 121 and 122 *supra*, the courts consider independently whether the carelessness of a plaintiff should preclude recovery. Hence, the due diligence of the plaintiff is a separate element of a private cause of action for violation of rule 10b-5. Dupuy v. Dupuy, 551 F.2d 1005, 1014 (5th Cir. 1977); Straub v. Vaisman & Co., Inc., 540 F.2d 591, 597 (3d Cir. 1976). *See* Wheeler, *Plaintiff's Duty of Due Care Under Rule 10b-5: An Implied Defense to an Implied Remedy*, 70 NW. U.L. REV. 561 (1976); Note, *The Due Diligence Requirement for Plaintiffs Under Rule 10b-5*, 1975 DUKE L.J. 753 (1975).

The diligence of the plaintiff in a 10b-5 action is judged subjectively. Dupuy v. Dupuy, 551 F.2d 1005, 1016 (5th Cir. 1977); Straub v. Vaisman & Co., Inc., 540 F.2d 591, 598 (3d Cir. 1976). Thus, the duty of due diligence is imposed solely under the peculiar circumstances of each case, including existence of a fiduciary relationship, concealment of the fraud, opportunity to detect it, as well as plaintiff's sophistication, expertise, business acumen in the financial community, and knowledge of related proceedings. Dupuy v. Dupuy, 551 F.2d 1005, 1016 (5th Cir. 1977); Clement A. Evans & Co. v. McAlpine, 434 F.2d 100, 104 (5th Cir. 1970); Kohler v. Kohler, 319 F.2d 634, 641-42 (7th Cir. 1963). *See* Rogen v. Ilikon Corp., 361 F.2d 260 (1st Cir. 1966); Gerstle v. Gamble-Skogmo, Inc., 298 F. Supp. 66 (E.D.N.Y. 1969). The due diligence test, as applied by the courts, measures the plaintiff's conduct against that of a reasonable investor with the attributes of the plaintiff; it is, in effect, a negligence standard. Dupuy v. Dupuy, 551 F.2d 1005, 1017 (5th Cir. 1977).

In light of the Supreme Court's holding in Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), requiring proof of scienter on the part of the defendant as a prerequisite to recovery, the due diligence standard is presently undergoing re-evaluation and consequent reformulation by the courts. *See* note 124 *supra*. In a recent decision, the Third Circuit has responded to *Ernst* by reversing the burden of proof, thus making the question of due diligence an affirmative defense. Straub v. Vaisman & Co., Inc., 540 F.2d 591 (3d Cir. 1976). On the other hand, the Fifth Circuit has held that, in light of *Ernst*, a plaintiff should be barred from recovery under rule 10b-5 only if he has been reckless in not attempting to discover the alleged misrepresentations and omissions. Dupuy v. Dupuy, 551 F.2d 1005 (5th Cir. 1977).

138. *See, e.g.*, Lehigh Valley Trust Co. v. Central National Bank of Jacksonville, 409 F.2d 989 (5th Cir. 1969); IIT v. Vencap, Ltd., 411 F. Supp. 1094 (S.D.N.Y. 1975); Harriman

tronis companies,[139] as well as financial statements[140] and estimated projections of charter income,[141] constitute material facts.[142] The position of the plaintiffs dictates that they relied on EAB in its capacity both as entrepreneur and manager.[143] Perhaps the most troublesome requirement that the plaintiffs must establish is that of scienter. Though the requisite scienter may be shown circumstantially in EAB's failure to disclose known material facts,[144] it is questionable whether scienter can be established in regard to misrepresentations of fact.[145]

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v. E.I. DuPont de Nemours & Co., 411 F. Supp. 133 (D. Del. 1975); Green v. Jonhop, Inc., 358 F. Supp. 413 (D. Ore. 1973).

139. *See, e.g.*, Sanders v. John Nureen & Co., Inc., 463 F.2d 1075 (7th Cir.), *cert. denied*, 409 U.S. 1009 (1972); Lehigh Valley Trust Co. v. Central National Bank of Jacksonville, 409 F.2d 989 (5th Cir. 1969); *see* City National Bank v. Vanderboom, 422 F.2d 221 (8th Cir.), *cert. denied*, 399 U.S. 905 (1970).

140. *See, e.g.*, Gottlieb v. Sandia Am. Corp., 452 F.2d 510 (3d Cir.), *cert. denied*, 404 U.S. 938 (1971); Herzfeld v. Laventhol, Krekstein, Horwath & Horwath, 378 F. Supp. 112 (S.D.N.Y. 1974); Blakely v. Lisac, 357 F. Supp. 255 (D. Ore. 1972); Escott v. Bar Chris Constr. Corp., 283 F. Supp. 643 (S.D.N.Y. 1968) (financial statements containing inaccurate figures are misleading).

141. Estimates as to the present or the future status of an event and representations that an incident will occur are misleading statements of fact within the ambit of rule 10b-5 if they do not have a reasonable basis or are not believed by the speaker when made. Marx v. Computer Science Corp., 507 F.2d 485 (9th Cir. 1974); REA Express Inc. v. Interway Corp., 410 F. Supp. 192 (S.D.N.Y. 1976).

142. This conclusion assumes, however, that the plaintiffs can substantiate that the alleged material information was known to EAB at the time disclosure was to be made. *See* notes 123 and 124 *supra*.

143. Only EAB, a lead bank lender, had direct contact with the borrower and was responsible for structuring the loan and adequately securing collateral. *See* notes 7 and 8 *supra*, and text accompanying notes 32-40 *supra*.

However, where the materiality of the plaintiffs' alleged omissions can be established, reliance will be presumed. Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972). *But see* note 122 *supra*. However, *Affiliated Ute* should not be taken as a complete abolition of the reliance requirement. In "misrepresentation," as opposed to "omission" cases, positive proof of reliance on the misrepresented facts must still be shown by the plaintiff. Reeder v. Mastercraft Electronics Corp., 363 F. Supp. 574, 581 (S.D.N.Y. 1973). *See* note 121 *supra*. *But see* Tucker v. Arthur Andersen & Co., 67 F.R.D. 468 (S.D.N.Y. 1975) (holding that reliance may be inferred from the materiality of the misrepresentation); Herbst v. International Tel. & Tel. Corp., 495 F.2d 1308, 1316 (2d Cir. 1974) (reliance is inferred where materiality is established).

144. *See, e.g.*, Katz v. Realty Equities Corp., 406 F. Supp. 802 (S.D.N.Y. 1976); Spielman v. General Host Corp., 402 F. Supp. 190 (S.D.N.Y. 1975).

145. The accuracy of EAB's disclosure of material information is to be measured by the situation and the knowledge of the parties at the time they committed themselves, and not on the basis of subsequent events. Pittsburgh Coke & Chemical Co. v. Bollo, [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,130 (1977). Thus, the plaintiffs must show not only that EAB had knowledge of the alleged material misrepresentations and omissions at the time of the sale, but also that such misrepresentations and omissions were made with scien-

The second and third elements of 10b-5 liability are not in issue in the case. The plaintiffs purchased the securities, in the form of loan participations, in connection with the proscribed conduct.[146] Furthermore, a direct causal connection exists between EAB's conduct in soliciting the plaintiffs' participation and the resulting damages suffered.[147]

Assuming the plaintiffs prove the existence of the three required elements, EAB's disclaimers of contractual liability, made in the loan participation agreements,[148] will be ineffectual as a defense to a 10b-5 action because of the anti-waiver provision included in the Securities Exchange Act of 1934.[149]

Assuming, on the other hand, that plaintiffs fail to establish scienter or one of the other requirements, a rule 10b-5 action will not be viable. The mere potential of such an occurrence demands that an alternate avenue to recovery be considered. The most appropriate option taken by the plaintiffs for this purpose is an action under section 12(2) of the Securities Act of 1933.[150] The purpose of

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ter. *See* note 136 *supra*; Haimoff, *Holmes Looks at Hochfelder and 10b-5*, 32 BUS. LAW. 147 (1976).

146. The phrase "in connection with the purchase or sale of any security" by a deceptive device within the meaning of rule 10b-5 and section 10(b) making such purchase or sale unlawful, means that the device employed, whatever it might be, be of a sort that would cause reasonable investors to rely thereon, and in connection therewith, so relying, cause them to purchase the securities. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1967), *cert. denied*, 394 U.S. 976 (1969); *In re* Equity Funding Corp. of America Securities Litigation, 416 F. Supp. 161, 180 (C.D. Cal. 1976); Kogan v. Nat'l Bank of North America, 402 F. Supp. 359, 361 (E.D.N.Y. 1975).

147. In order to recover in a civil action under rule 10b-5, the plaintiffs must show a causal connection between the alleged misrepresentations or omissions and their injury; hence, the plaintiff must establish that the loss claimed to have been suffered was a consequence of the defendant's fraud. *See, e.g.*, Tucker v. Arthur Andersen & Co., 67 F.R.D. 468 (S.D.N.Y. 1975); Polin v. Conductron Corp., 411 F. Supp. 698 (E.D. Mo. 1976). Since the plaintiffs decided to purchase the participations, and join the loan syndicate managed by EAB, on the basis of information supplied by EAB, causation is established where EAB can be shown to have made a fraudulent disclosure of the information supplied. For the measure of damages under rule 10b-5, *see* note 160 *infra*.

148. *See* note 22 *supra*.

149. 15 U.S.C. § 78cc (1976): "Any condition, stipulation or provision binding any person to waive compliance with any provision of this chapter or of any rule or regulation thereunder, or of any rule of an exchange required thereby shall be void." *See* 6 L. LOSS, SECURITIES REGULATION 1810-17 (2d ed. 1961, Supp. 1969).

150. *See* note 24 *supra*. Section 12(2) is said to provide "one of the most powerful but least appreciated weapons in the arsenal of a plaintiff in a securities fraud action." Kaminsky, *An Analysis of Securities Litigation Under Section 12(2) and How it Compares with Rule 10b-5*, 13 HOUS. L. REV. 231, 231 (1976). Unlike rule 10b-5, where a private right of action has been judicially implied, section 12(2) creates an express civil remedy. However, the class of plaintiffs that may recover under the statute is narrowly delineated, by its terms,

section 12(2) is to protect investors from misstatements or omissions of material fact which the seller either *knowingly* or *carelessly* communicates.[151]

Since the provisions of section 12(2) provide relief only to purchasers, the antifraud protections afforded therein relate primarily to statements made in the prospectus or oral communication by the seller made in connection with the sale of securities.[152] Although section 12(2) is identical to rule 10b-5 in many of its requirements, notable distinctions exist which afford the plaintiffs an easier burden of proof.[153] Primarily, scienter is not required by section 12(2).[154]

Furthermore, even though materiality must be established in regard to misrepresentations and omissions, proof of reliance is not required by section 12(2).[155] The same standard used to determine

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to purchasers of securities only; sellers are not covered. *See, e.g.*, Greater Iowa Corp. v. McLendon, 378 F.2d 783, 789 (8th Cir. 1967); E.L. Aaron & Co., Inc. v. Free, 55 F.R.D. 401, 402 (S.D.N.Y. 1972); Lynn v. Caraway, 252 F. Supp. 858, 865 (W.D. La. 1966), *aff'd*, 379 F.2d 943 (5th Cir. 1967), *cert. denied*, 393 U.S. 951 (1968). Under section 12(2) the plaintiff purchaser's remedy is limited to recission; that is, a refund to the purchaser of the consideration he paid for the security in exchange for the return of the security to the seller. Pfeffer v. Cressaty, 223 F. Supp. 756, 757 (S.D.N.Y. 1963). *See* Johns Hopkins Univ. v. Hutton, 297 F. Supp. 1165, 1226 (D. Md. 1968), *aff'd in part, rev'd in part on other grounds*, 422 F.2d 1124 (4th Cir. 1970).

Perhaps the most notable distinction possessed by section 12(2) in comparison to rule 10b-5 is that this provision does not require positive proof of scienter as a prerequiste to recovery; negligence will suffice. *See* Kaminsky, *supra* at 233-39, 253-80. *See also* text accompanying note 36 *supra*.

151. Ruszkowski v. Hugh Johnson & Co., 302 F. Supp. 1371, 1375 (W.D.N.Y. 1969). Although the statutory basis provided for liability is a negligence standard, section 12(2) is recognized as an "antifraud section within the meaning this term now has under the securities laws." Kaminsky, *supra* note 150, at 233. Both registered securities and those exempt from the registration requirements of the 1933 Act are within the purview of section 12(2). *See, e.g.*, Holloway v. Howerdd, 536 F.2d 690 (6th Cir. 1976); Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680 (5th Cir. 1971). As such, section 12(2) places the burden on the seller of *any* security to investigate carefully and disclose all material facts to the purchaser before selling to him; failure to properly do so will require that the seller make a refund, regardless of whether or not he intended to defraud the buyer. Kaminsky, *supra* note 150, at 239. *See* Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 690 (5th Cir. 1971); Gilbert v. Nixon, 429 F.2d 348, 357 (10th Cir. 1970); Johns Hopkins Univ. v. Hutton, 297 F. Supp. 1165, 1219 (D. Md. 1968), *aff'd in part, rev'd in part on other grounds*, 422 F.2d 1124 (4th Cir. 1970).

152. *See* note 24 *supra*.

153. *See* note 150 *supra*; *see generally* Kaminsky, *supra* note 150.

154. *See, e.g.*, Lewis v. Walston & Co., Inc., 487 F.2d 617 (5th Cir. 1973); Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680 (5th Cir. 1971); Odette v. Shearson Hammill & Co., Inc., 394 F. Supp. 946 (S.D.N.Y. 1975); Ferland v. Orange Groves of Florida, Inc., 377 F. Supp. 690 (M.D. Fla. 1974).

155. Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680, 695 (5th Cir.

materiality in rule 10b-5 actions is used as well.[156] In order to prevent liability under section 12(2), a defendant must show that he did not know of the falsity contained in the prospectus or oral communication, and that the exercise of reasonable care would not have revealed that a misrepresentation or omission was made.[157]

With the problem of scienter removed, and the procedural requirements satisfied, liability under section 12(2) can be established on the basis of the same argument made for the action in rule 10b-5.[158] Liability under section 12(2) allows the plaintiffs the remedy of rescission and holds the seller liable for damages equal to the consideration paid plus interest due.[159] Effectively, the measure of damages under section 12(2) or rule 10b-5 are the same.[160] The use

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1971); Gilbert v. Nixon, 429 F.2d 348, 356 (10th Cir. 1970); Johns Hopkins Univ. v. Hutton, 297 F. Supp. 1165, 1222 (D. Md. 1968), *aff'd in part, rev'd in part on other grounds*, 422 F.2d 1124 (4th Cir. 1970).

> The theory is that [section] 12(2) is designed to put the burden of responsibility upon those who would induce public reliance in the securities markets, namely the sellers of securities. To accomplish this policy, it is reasoned that the purchaser should be relieved of all proof of reliance, and consistent with this policy, the purchaser need not prove causation either.

Kaminsky, *supra* note 150, at 264-65. Despite the partial abolition of the reliance requirement in 10b-5 cases, *see* note 132 supra, section 12(2) still places a significantly lesser burden on a plaintiff than rule 10b-5, which requires a showing of causation-in-fact as a predicate to recovery. *Id.* at 266.

156. *See* note 132 *supra*. The standard of materiality under section 12(2) and rule 10b-5 is considered the same. Gilbert v. Nixon, 429 F.2d 348, 355 (10th Cir. 1970); De Marco v. Edens, 390 F.2d 836, 840 (2d Cir. 1968); Johns Hopkins Univ. v. Hutton, 297 F. Supp. 1165, 1218 (D. Md. 1968), *aff'd in part, rev'd in part on other grounds*, 422 F.2d 1124 (4th Cir. 1970); Hewitt, *supra* note 128, at 899. *See* Kaminsky, *supra* note 150, at 258-62.

157. Section 12(2) expressly requires that the seller prove not only that he had no knowledge of the untruths or omissions, but also that he could not have learned the truth by the exercise of reasonable diligence. *See* note 24 *supra*; Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680 (5th Cir. 1971); Gilbert v. Nixon, 429 F.2d 348, 357 (10th Cir. 1970); DeMarco v. Edens, 390 F.2d 836 (2d Cir. 1968). Courts will impute constructive knowledge to the defendant seller; thus, the defendant is deemed to know anything he could readily have learned. Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680, 696 (5th Cir. 1971); DeMarco v. Edens, 390 F.2d 836, 842-43 (2d Cir. 1968); Gould v. Tricon, Inc., 272 F. Supp. 385, 392-93 (S.D.N.Y. 1967). *See* Kaminsky, *supra* note 150, at 275-78. *See also* Peterson, *Recent Developments in Civil Liabilities Under Section 12(2) of the Securities Act of 1933*, 5 HOUS. L. REV. 274, 283, 291 (1967). The defenses of waiver and estoppel are also available to a defendant seller in a 12(2) action. Kaminsky, *supra* note 150, at 278-80.

158. The scope of misrepresentations and omissions is the same for section 12(2) as it is for rule 10b-5. Johns Hopkins Univ. v. Hutton, 422 F.2d 1124, 1129 (4th Cir. 1970). *See* Trussell v. United Underwriters, Ltd., 236 F. Supp. 801 (D. Colo. 1964).

159. Johns Hopkins Univ. v. Hutton, 422 F.2d 1124 (4th Cir. 1970); Pfeffer v. Cressaty, 223 F. Supp. 756 (D.C.N.Y. 1963). *See* note 150 *supra*.

160. Under rule 10b-5, the measure of damages is usually stated to be the difference between the amount paid for the security and the true value of the security at the time of the purchase. *See, e.g.*, Blackie v. Barrack, 524 F.2d 891 (9th Cir. 1975); Estate Counseling Serv-

of remedies supplied by section 12(2) and rule 10b-5 are cumulative and not mutually exclusive.[161]

In summation, the plaintiffs arguably may be able to establish violations of rule 10b-5. In the event that scienter proves an insurmountable obstacle in establishing EAB's liability under rule 10b-5, a strong alternative action exists under section 12(2).

IV. THE IMPACT OF LEAD BANK LIABILITY UPON THE INTERNATIONAL LENDING MARKET

Before concluding that lead bank liability under rule 10b-5 or section 12(2) should be imposed whenever domestic branches of United States banks are involved in participation lending, consideration must be given to the impact such a policy would have on the dynamics of the international banking market.

In order to fully appreciate the impact that such a policy would have, it is essential to discuss the present status of international banking. Once the dynamics of this system are established, the effect of lead bank liability can be determined. Predictions concerning the ultimate effect of this policy can subsequently be made on the basis of changing trends in international lending.

A. An Overview of International Lending

The spectacular growth of the international lending market within the past decade has followed from the expansion of its counterpart, international trade.[162] Increased efforts by United States firms in manufacturing, resource extraction, and commerce to exploit their advantages in foreign markets precipitated the expansion

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ice, Inc. v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 303 F.2d 527, 533 (10th Cir. 1962); Tucker v. Arthur Andersen & Co., [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,107 (1975). *But cf.* Wolf v. Frank, 477 F.2d 467 (5th Cir.), *cert. denied*, 414 U.S. 975 (1973); Levine v. Seilon, Inc., 439 F.2d 328 (2d Cir. 1971); Lewis v. Bogin, 337 F. Supp. 331 (S.D.N.Y. 1972). Exceptions to this rule sometimes exist where the security was bought for investment and would not have been bought at all but for the fraud. *See, e.g.*, Chasins v. Smith, Barney & Co., 438 F.2d 1167, 1173 (2d Cir. 1970); Baumel v. Rosen, 412 F.2d 571 (4th Cir. 1969), *cert. denied*, 396 U.S. 1037 (1970); Samet, *Damages Under Rule 10b-5: The Out of Pocket Measure Is Out of Order*, 9 BEV. HILLS B.J. 35, 43 (1975). Although rule 10b-5 contains no express provision regarding interest, the courts have allowed an award of prejudgment interest as a matter of judicial discretion. Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 384 F. Supp. 507, 528 (S.D.N.Y. 1974), *aff'd in part, rev'd in part on other grounds*, 516 F.2d 172 (2d Cir. 1975).

161. *See, e.g.*, Johns Hopkins Univ. v. Hutton, 297 F. Supp. 1165 (D. Md. 1968), *aff'd in part, rev'd in part on other grounds*, 422 F.2d 1124 (4th Cir. 1970).

162. *See* note 1 *supra*, and accompanying text.

of United States banks abroad in the mid-1960's.[163]

Initially, integration into foreign markets was a means for United States banks to serve multinational corporations abroad.[164] Subsequently, expansion overseas signified a means for United States banks to circumvent domestic exchange controls—the Interest Equalization Tax of 1963 and the Balance of Payment Programs of 1965 and 1968.[165] Domestic banks discovered that international banking—particularly international lending—was a means to rapidly increase market shares.[166]

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163. *See* Aliber, *supra* note 1, at 9-10; *Like Topsy, they just grow'd*, THE ECONOMIST, Jan. 22, 1977, at 9 [hereinafter cited as *Like Topsy*].

164. Lees, *supra* note 5, at 40-41; Thomas & Segall, *Moneyweight Contenders*, THE ECONOMIST, Jan. 22, 1977, at 5-6. The United States banks which have taken the lead in international banking activities have relied heavily on overseas affiliates of United States industrial corporations to build foreign loan servicing operations. Lees, *supra* note 5, at 41. Major American banks needed to go abroad to service the overseas operation of their corporate customers or risk losing the business to foreign banks. *Like Topsy, supra* note 163, at 9. Also, bank expansion abroad was furthered by the regulatory straight jackets put on banks by both federal and state banking authorities which prevents interstate branch banking. Once a bank reaches a certain size, further penetration into an existing market becomes exceedingly difficult. *Id.*

165. Aliber, *supra* note 1, at 10; Lees, *supra* note 5, at 41; *see* Carson, *Government Policies and the Eurodollar Market*, 10 COLUM. J. WORLD BUS. 58 (no. 4, 1975). The need for American banks to expand overseas became essential after the introduction of strict balance-of-payment controls in the United States during the Kennedy and Johnson Administrations, restricting the ability of American banks to use local funds to finance overseas customers and for non-American companies to raise money in American capital markets. In order to meet the financial needs of American customers with overseas subsidiaries, American banks began setting up branches abroad capable of gathering and relending expatriate dollar funds, or Eurodollars. Once some banks had established overseas operations their competitors were obliged to follow, for unless they did so they risked losing even domestic business to those banks better able to provide an international service. *Like Topsy, supra* note 163, at 9-10. *See* Thomas & Segall, *supra* note 164, at 5-9.

166. The international earnings of the 13 American banks with the largest overseas operations for the period 1970-1975 reflects the remarkable success enjoyed as a result of expansion abroad.

> The international earnings of these banks went up from 177 million dollars to 836 million dollars in 1975, a compound growth of 36.4 per cent a year. Over the same years domestic earnings trod water—918 million dollars in 1975, against 884 million dollars in 1970, or a mere compound rate of growth of 0.7 per cent . . . . Put another way it sounds even more startling: the rise in international earnings accounted for ninety-five per cent of the total growth in earnings.

Thomas & Segall, *supra* note 164, at 9.

International business also allowed American commercial banks the freedom for uninhibited expansion into merchant banking, a freedom withheld from them in the United States by the Glass-Steagall Act. In 1969-1974, the 30 largest American banks spent 839 million dollars on acquiring merchant banks overseas. *Like Topsy, supra* note 163, at 10. During the international trade boom of 1970-1975, American banks took advantage of their close links with American multinational corporations; they also expanded their Eurodollar business with non-American multinationals, and became more active in local currency mar-

Foreign banks recognized the same promise for growth and freedom from restrictions in the early 1970's.[167] In part, the greatly increased activities of European and Japanese banks in the American financial market followed the surge of foreign investment in the United States after the two devaluations of the dollar.[168] The unique opportunities in the world financial system allowed for by the United States market and its currency, provided an impetus for rapid acceleration in the strength and number of foreign banks in the United States.[169] Foreign banks now compete actively with domestic banks for local and international business.[170]

Perhaps one of the greatest advantages international lending offers banks, as compared with domestic lending, is the variety of opportunities for diversification and spreading of risk.[171] This po-

kets. This was the period when the American banks became truly multinationals. *Id. See also* note 164 *supra*, and note 192 *infra*.

167. Aliber, *supra* note 1, at 10; Edwards, *supra* note 1, at 7-8. Several advantages are available to foreign banks operating in the United States which are not available to domestic banks. Presently, foreign banks are subject only to the laws of the state in which they are licensed; they do not have to adhere to the Federal Reserve requirements or other regulations; they are not subject to the Bank Holding Company Act of 1956, 12 U.S.C. §§ 1841-1850 (1976), or the Glass-Steagall Act. Perkins, *The Regulation of Foreign Banks in the United States*, 10 COLUM. J. WORLD BUS. 115, 116-17 (no. 4, 1975).

168. Aliber, *supra* note 1, at 10. Although the motives for entry into the United States market are complex and varied, several impelling reasons can be identified: 1) Initially, foreign banks expanded abroad to provide financial services to United States subsidiaries of foreign corporations, a goal similar to that pursued by American banks expanding overseas. *See* note 154 *supra*, and accompanying text; 2) Since the dollar remains the world's major transactions and reserve currency, foreign "parent" banks found United States offices convenient service centers for their customers' dollar operations; 3) Foreign banks could establish investment banks to engage in underwriting and selling domestic securities, a practice from which United States banks are barred by the Glass-Steagall Act of 1933, 48 Stat. 162 (1933), and the Bank Holding Company Act of 1956, 12 U.S.C. §§ 1841-1850 (1976), as amended (BHCA); 4) Foreign branches were a means to provide services to American corporations that had existing business relationships with the head office of the foreign bank; 5) The dismantling of capital restraint programs in the United States in January 1974, contributed to the attractiveness of New York and other United States financial markets as an unfettered source of funds for international financing, thereby increasing the flow of funds through American financial markets. Klopstock, *Foreign Banks in the United States: Scope and Growth of Operations*, MONTHLY REVIEW OF THE FEDERAL RESERVE BANK OF NEW YORK, June 1973, at 140; Terrell & Leimone, *The U.S. Activities of Foreign-Owned Banking Organizations*, 10 COLUM. J. WORLD BUS. 87 (no. 4, 1975); *See* Perkins, *supra* note 167, at 116-17; *See also* Lichtenstein, *Foreign Participation in United States Banking: Regulatory Myths and Realities*, 15 B.C. INDUS. & COM. L. REV. 879 (1974).

169. Perkins, *supra* note 167, at 117.

170. *Id.* During 1974, foreign banks made 9.0% of all commercial and industrial loans made in the United States. *Id.*

171. This is due to the possibilities of achieving regional diversification, minimizing country risk and undertaking a wider variety of types of credits. Lees, *supra* note 5, at 43-47. *See generally* Ganoe, *Controlling the Foreign Banks in the U.S.*, EUROMONEY, June 1975, at

tential was realized with the advent of a new type of banking subsidiary in the international banking market.[172] As part of a strategy employed by large international banks, designed to achieve broad diversification and access to capital, special loan and credit making affiliates were established, providing new structural credit forms and syndication loans.[173]

Of the various kinds of international affiliates developed during the early 1970's, the medium-term consortium[174] bank stands out in importance. Many of these banks were established in the 1970's by groups of internationally oriented banks for the purpose of providing and syndicating medium-term loans in the Eurocurrency market.[175] These banks have enjoyed strong connections through their parent institutions and have experienced rapid growth in their Eurocurrency operations.[176] EAB is one such medium-term consortium.[177]

The introduction of medium-term syndication loans and the subsequent establishment of medium-term consortium banks were signs of the changing trends in international lending during the early 1970's.[178] Prior to this time, commercial banks active in the

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75-76; Ruckdeschel, *Risk in Foreign and Domestic Lending Activities of U.S. Banks*, 10 COLUM. J. WORLD BUS. 50 (no. 4, 1975); Terrel & Leimone, *The U.S. Activities of Foreign-Owned Banking Organizations*, 10 COLUM. J. WORLD BUS. 87 (no. 4, 1975); Thoman, *International Banking Can Be Profitable for U.S. Regional Banks*, 10 COLUM. J. WORLD BUS. 23 (no. 4, 1975).

172. Lees, *supra* note 5, at 46; Thomas & Segall, *supra* note 164, at 5. *See* Curran, *supra* note 7, at 55-65; *Banks Under Attack, supra* note 28, at 110.

173. Lees, *supra* note 5, at 46; *Like Topsy, supra* note 163, at 10-13; *Banks Under Attack, supra* note 28, at 110; Curran, *supra* note 7, at 55-61.

174. A medium-term consortium bank is an affiliate formed by a group of internationally orientated banks for the purpose of providing medium-term loans. *See* Lees, *supra* note 5, at 46.

175. Lees, *supra* note 5, at 46; Curran, *supra* note 7, at 63-65. Typically, a large percentage of these loans have been made to foreign governments or other official bodies. *Like Topsy, supra* note 163, at 9. It is estimated that the amount banks lent in syndicated Eurocurrency credits increased from 6.9 billion dollars in 1972 to 29.3 billion dollars in 1974. *Id.* at 13. Lending to poor countries became *avant garde* for international bankers, and in 1972 banks lent these countries 2.5 billion dollars in syndicated credits. In 1973 and 1974, another 14 billion dollars was lent. So fierce was the competition for this business that at one stage margins sunk to a ludicrous five-eights of 1.0%. *Id. See* Curran, *supra* note 7, at 57.

176. Lees, *supra* note 5, at 46; *Banks Under Attack, supra* note 28, at 110; *See The 75 Most Active Lead Managers in the Euromarkets*, EUROMONEY, Sept. 1976, at 24-25. The medium-term consortium bank can function either as a lead syndicating the loan itself or as a participant pruchasing a participation in a syndicate arranged and organized by one of its parent institutions. Lees, *supra* note 5, at 46. In late 1973, the consortium banks accounted for 8.0% of the Eurocurrency claims held by London based institutions. *Id.*

177. *Banks Under Attack, supra* note 28, at 110. *See* note 31 *supra*.

178. The medium-term syndication loan was initially an outgrowth of the *term loan*

international market made only short-term loans.[179] Medium-term syndication loans met with favorable acceptance and widespread use. In 1976, a year of relative stagnation for the Euromarkets as a whole, syndicated Euroloans continued to expand rapidly.[180]

Perhaps the most revealing indicator of the success enjoyed by the medium-term syndication loan in international finance is seen in its rapid acceptance and growing use in the Euromarkets.[181] The widespread acceptance and use of loan syndications may well result from the unique flexibility in structuring provided for under a syndicate arrangement. The medium-term syndicated Eurocurrency credit market differs from the foreign and Eurobond markets in that it is designed to accomodate two very different types of borrowers.[182] This fact becomes particularly well pronounced now, at a

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developed by commercial international banks to finance corporate investment projects. The basic concept underlying the new international *term loan* was that the amortization of the loan was adjusted to meet the project's cash flow; this required greater expertise for credit analysis and for complex cash flow projections. Banks eventually were able to undertake loans to foreign governments and to finance other project-related investments abroad. Subsequently, commercial banks took the lead and began to arrange syndicated term loans for multinational corporations and government agencies. Curran, *supra* note 7, at 57. These international lenders remain reluctant to finance long-term debts or imbalances in the current account of foreign governments. Neither of these uses is related to the cash flow of a specific project; therefore, loans made are not by definition *term loans. Id. See Like Topsy, supra* note 163, at 10-13.

179. Until a few years ago, commercial banks usually lent to their best customers for a maximum term of one year; companies needing longer-term funds went to the bond and equity markets. Curran, *supra* note 7, at 58.

180. A faltering world recovery from a deep recession left the largest single element in the Euromarkets—the short-term self-liquidating commercial Eurocurrency credits extended directly by international banks—moving sluggishly. The growth of syndicated Euroloans over the past year reflects the fact that determinants of their growth are essentially different from those underlying the Euromarket as a whole. The slower-than-anticipated world recovery was offset, so far as the Euromarkets are concerned, by a substantially increased level of syndicate credit lending. *Euromarkets: Relative Stagnation in 1976*, THE BANKER, Jan. 1977, at 27. *See* note 175 *supra*. "The volume of new medium term Eurocurrency syndicated bank credits has been running at an annual 25 billion dollars since mid-1975." Mendelsohn, *supra* note 3, at 903.

181. Mendelsohn, *supra* note 3, at 903; *See Euromarkets: Relative Stagnation in 1976*, THE BANKER, Jan. 1977, at 27. "This market makes finance available to borrowers with names which are not sufficiently saleable in the more select Eurobond market, while also providing finance in far larger amounts than is possible through the issue of Eurobonds, irrespective of the borrower's credit rating." *Banks as Borrowers*, THE BANKER, Jan. 1977, at 61. *See* note 182 *infra*, and accompanying text.

182. At one extreme, the top names in international lending are raising balance of payments financing in sums too big for the international bond markets, like the European Economic Community's borrowing for Italy in March, 1976. At the other extreme are borrowers not quite strong enough for the international bond markets, notably the members of Comecon and the relative handful of oil-importing developing countries with access to private capital markets. Mendelsohn, *supra* note 3, at 905.

time in the world's economy when the requests from such borrowers are numerous and running high.[183] A borrower who seeks a medium-term syndicate loan will pay handsomely for the lending arrangements he seeks; to leads and participants this means easy money to be made.[184]

As a matter of course, the organizational and managerial format taken on by the syndicate will depend in large part on the amount sought by the borrower.[185] With the increasing use of medium-term syndication loans in international lending, and the integration of foreign medium-term consortium banks in American financial markets, large and small domestic banks alike have become increasingly active in syndicate lending.[186]

Yet, underlying the statistics is the cold reality that much of the financing made during an intensely competitive world borrowers market of 1972 and 1973 involved too many risks.[187] Liberal lending activities which financed the world tanker surplus, as well as large scale real estate investments in Britain and the United States, have left banking institutions throughout the world feeling

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183. The combination of a sluggish world economy and a higher oil price is likely to increase [lesser developing countries'] demand for Eurocredits quite substantially. The danger is that this will lead to a 'crowding out' situation, with the OECD (Organization for Economic Cooperation and Development) countries and other industrialized borrowers (such as South Africa) denying access to some of the poorer nations.

> As it is, the syndicated credits market already tends to concentrate its lending on the more prosperous of the [lesser developing countries], virtually to the exclusion of the middle and low income countries . . . . So long as domestic loan demand remains depressed in the United States and other major industrial economies, the international banks may well be able to meet the requirements of both the OECD and lesser developing country oil importers. But mere ability to do so does not imply willingness as well.

Reasons for Discrimination, Not Alarm, THE BANKER, Jan. 1977, at 51. *See* Mendelsohn, *supra* note 3, at 905-07; *Euromarkets: Relative Stagnation in 1976*, THE BANKER, Jan. 1977, at 27.

184. Mendelsohn, supra note 3, at 903-07. *See* Sandeman, *The Legal Tangle*, THE BANKER, Jan. 1978, at 75, 77; *Reasons for Discrimination, Not Alarm*, THE BANKER, Jan. 1977, at 51-52. *See generally* Curran, *supra* note 7, at 55-65. *But see Harder Times*, THE ECONOMIST, Jan. 22, 1977, at 21.

185. Curran, *supra* note 7, at 61, 63.

186. In 1976, eight of the ten leading managers of medium-term syndication credits were American. Fogarty, *The City's Staying Power*, THE BANKER, Feb. 1978, at 67. *See The 75 Most Active Lead Managers in the Euromarkets*, EUROMONEY, Sept. 1976, at 24. As to the activity of smaller American banks in syndicate lending, *see* note 15 *supra*. Despite the international activities of the smaller banks in the United States, the major American banks prevail as dominant in the field of global financing, as well as lead syndicate lenders. *See* note 166 *supra* and note 218 *infra*; Curran, *supra* note 7, at 63.

187. *Banks Under Attack, supra* note 28, at 109-10; *Obstacle Course*, THE ECONOMIST, Jan. 22, 1977, at 22-25.

expensive repercussions.[188] Large banks have sufficient collateral and capital to survive impending defaults without serious repercussions.[189] Smaller banks, however, are the most seriously threatened by the current difficulties.[190]

> Unfortunately bankers have only themselves to blame for at least part of what . . . [has] recently been described as a 'massive erosion of confidence.' The strong accentuation of the world business cycle in the past four years helps to explain but has by no means been the sole cause of foreign exchange losses in Europe, property losses in Britain and America, the over-extension of banks in the world tanker market and the increase in bad and doubtful assets nearly everywhere. What has become clear in the past 2 years is that although most bankers kept their heads, many took more risks than they should have . . . .[191]

In light of it all, there are those who clearly insist that at least part of the problem stems from the general absence of rules and regulations in international lending.[192] They contend that complexity and magnitude are factors in the current market which preclude the

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188. Aliber, *supra* note 1, at 9; *Banks Under Attack, supra* note 28, at 110; Faith, *supra* note 30, at 14-16. *See generally Harder Times*, THE ECONOMIST, Jan. 22, 1977, at 21.

As to the risks taken by syndicates in Euromarket credits, it has been observed that during the rapid growth of international lending in 1973-1974 "[m]any Euromarket credits were arranged very quickly—often considerably faster than domestic syndicated credits could be put together. As Mr. Johannes Witteveen, managing director of IMF, said in 1976, 'credits were sometimes granted in a market climate that wasn't very conducive to the maintenance of adequate (credit appraisal) standards.' " *A Cash-Flow Approach to Sovereign Risk Analysis*, THE BANKER, Jan. 1977, at 55.

189. Barron's, June 2, 1975, at 33.

190. *Id. See The Smaller They Are The Harder They Fall*, THE ECONOMIST, Jan. 22, 1977, at 13-17. Perhaps the real reason that the repurcussions have been felt primarily by smaller banks is to be found in an observation made by commentators in the field:

> The real test of a bank's success or failure is not the loans that go bad. Rather, it is the ability of the banks to generate enough earnings to finance growth even after the subtraction of loan loss provisions, so long, of course, as these earnings are not made doubtful by a lending portfolio that includes an excess of high risk loans.

Thomas & Segall, *supra* note 164, at 6. The strength of the major American banks in international lending well indicates their ability to generate earnings above and beyond any loss experienced by bad loans. *See* note 166 *supra*.

191. *Banks Under Attack, supra* note 28, at 110.

192. Sandeman, *The Legal Tangle*, THE BANKER, Jan. 1978, at 75. As international lending emerged as a global economic community of itself, perhaps the greatest obstacle to any concomitant designation of clear-cut rules of order was the multinational character of its members:

> Bank regulatory systems in most countries, including the United States, have evolved primarily in response to domestic banking development, and are oriented largely to the regulation of the domestic activities of domestic banks.
>
> The response of bank regulators to the rapid emergence of multinational banking activities has been almost hesitant, sporadic and almost exclusively national . . . . [T]he goals and means of bank regulation in this country and other countries have not been designed with multinational banking in mind.

present informal procedures from continuing usage; clear-cut procedures and regulations, they say, are at long last an essential need.[193] Others protest the call for regulation and reform, asserting that Euromarket bankers are the best and most efficient policemen in the world's only truly international capital market.[194] The controversy continues.

In the medium-term syndication market competition has been particularly fierce.[195] And it suffices well to say that there are banks playing in this ball park who will make what could be considered questionable concessions to a prospective borrower in order to win the business.[196] The Colocotronis case, however, has become an illustrative *caveat* to syndicate lenders, and the emphasis appears now to be shifting to a strong preoccupation with safer banking.[197] In light of this trend of precaution, the impact of making lead banks legally vulnerable would predictably be seen in two phases: an initial reaction and a subsequent adjustment.

Thomas & Segall, *supra* note 164, at 6 (quoting remarks made by the Senate Banking Committee).

193. Sandeman, *supra* note 192, at 75, 77. *See Banks Under Attack, supra* note 28, at 109-10. As for the need for uniform disclosure procedures in syndicate lending as expressed by some international lenders, *see In and Out of Court, supra* note 16, at 35.

194. Sandeman, *supra* note 192, at 75. *See In and Out of Court, supra* note 16, at 35.

195. *Like Topsy, supra* note 163, at 13; Sandeman, *supra* note 192, at 75. The experience and access to capital resources of the major American lead banks appear to provide a selective advantage to these banks in the competition for borrowers. "Needless to say, a reputation for having successfully arranged a number of difficult credits in the past is advantageous . . ." to lead lenders seeking new borrowers. "It is essential to have the confidence of the company or government with whom one is dealing. No one can run the risk of having a syndication fail because it was badly structured or priced; governments are especially sensitive to this." Curran, *supra* note 7, at 58.

Although most banks would prefer to manage their own syndication, the factors of reputation and experience noted above also exert an influence over the activities of lesser qualified banks wishing to participate in the international market. "[M]ost banks would prefer to participate in a well-structured syndication managed by a bank experienced in the negotiation and syndication of large credits, rather than attempt to manage a syndication of their own with the many risks that this entails." *Id.* at 63.

196. Colombia, for example, has managed to insist on writing loan agreements under its own law, a concession which many regard as inexcusable. Yugoslavia has won a battle to keep out clauses triggering a repayment if lending to them becomes illegal. Sandeman, *supra* note 192, at 75.

197. *Banks Under Attack, supra* note 28, at 109-10; Sandeman, *supra* note 192, at 75-77. *See In and Out of Court, supra* note 16, at 35.

> A year or so ago participating banks in a syndicate looked to the lead managers for assurances on the credit-worthiness of the obligor and were satisfied to receive an offering memorandum setting out a country's political, economic and financial statistics. This is not so prevalent today, as participating banks, quite rightly, feel the necessity to justify such a participation through their own analysis of credit risk.

Curran, *supra* note 7, at 58.

B. The Impact of Lead Bank Liability

The initial reaction of international lenders is prophesied in the assessments of European and American bankers monitoring the European-American suits.[198] The vulnerability of lead banks to rule 10b-5 damages would force drastic and costly changes in their method of marketing participation loans in the United States.[199] Offering circulars sent to proposed participants would become documents of legal significance in America, and consequently would require the lead to give proper disclosure.[200] As well, lead banks would be effectively prevented from deferring to the desires of borrowers to keep sensitive information confidential and out of the placement memorandum.[201] Contrary to prior lead bank procedures, potential liability would make standard practice of a borrower approving and, in fact, certifying that all information is true, accurate, and complete.[202] The long-standing tradition in international financial centers of "reliance on 'name' in lending or investment operations"[203] would be tarnished, if not entirely deflated, by the necessity of such protection being granted to participants.[204]

However, it appears that a part of the initial reaction by international lead lenders will be to circumvent such liability. By excluding small United States banks from participatory roles, lead lenders may choose to deal only in true multibank syndicates where

198. Mathews, *supra* note 4, at 1, col. 6; Fleming & Wyles, *supra* note 16, at 6; *In and Out of Court, supra* note 16, at 35.

199. Mathews, *supra* note 4, at 1, col. 6; *But see In and Out of Court, supra* note 16, at 35.

200. If offering circulars could possibly expose a lead bank to liability, this would inevitably mean a bigger role for legal talent; banks would be compelled "to have a lawyer check every word" on the offering circular before participants were solicited. Mathews, *supra* note 4, at 18, col. 2. Other bankers disagree and claim that court decisions are necessary to clarify procedures in international financial markets. *In and Out of Court, supra* note 16, at 35.

201. At the present time this is said to be a common practice in the lead-borrower relationship. Mathews, *supra* note 4, at 18, col. 2. *But see* Sandeman, *supra* note 192, at 75 (on the changing trends prompted by the EAB suits).

202. Some bankers suggest that the EAB suits have already prompted banks to follow this procedure. "Without such a guarantee," says Bankers Trust's Mr. Shirano, "Many banks won't make an offering circular available to other banks." Mathews, *supra* note 4, at 18, col. 2. *See Banks Under Attack, supra* note 28, at 110; Sandeman, *supra* note 192, at 75-77.

203. Fleming & Wyles, *supra* note 16, at 6. Bankers regard themselves as a "community" and prefer to settle their differences in private. Until now international business has usually been done on an informal basis, with banks relying on an unwritten code of ethics. *In and Out of Court, supra* note 16, at 35. *See* Sandeman, *supra* note 192, at 75.

204. Fleming & Wyles, *supra* note 16, at 6. However, the contrasting opinion has been expressed that the present magnitude of international lending precludes the continuance of informal "clubby" procedures and that definite and clear-cut practices must be established now. *In and Out of Court, supra* note 16, at 35.

larger international lenders participate in the active role of co-managers.[205]

Perhaps the greatest fear expressed by bankers monitoring the EAB suits is that lead "liability" will inevitably subject loan syndications to an expensive registration process with the SEC.[206] In the words of C.P. Brauch, president of Chase Manhattan Bank's Chase Asia Ltd., "[t]his would kill the international syndication industry. It would certainly drive out the American banks."[207] Registration is expensive and makes public, activities that many banks prefer to keep secret.

Under the 1933 Act, bank securities are exempt from registration. It is questionable whether such a result would occur from establishing "lead" bank liability.[208] Certain factors exist, however, to suggest that these reactions may well be, in part, initial changes in lending patterns that will inevitably give way to a subsequent acceptance of a full disclosure policy for lead lenders marketing participations which qualify as securities. The current trend in international lending toward safer banking policies reveals a concerted internal effort among major lead lenders to establish full disclosure policies when offering participations.[209] Other international lenders call for more action; they contend that definite and clear-cut practices must be established in order to maintain the current magnitude of international lending.[210]

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205. Mathews, *supra* note 4, at 1, col. 6. Banks have already become cautious and seek to protect themselves against legal liability. Participation agreements are said to run to greater length than ever before; as well, some lead banks have already turned their backs on smaller banks in choosing potential syndicate partners. *In and Out of Court, supra* note 16, at 35; *see Banks Under Attack, supra* note 28, at 110; Sandeman, *supra* note 192, at 75. *See* note 202 *supra*, and accompanying text.

206. Mathews, *supra* note 4, at 1, col. 6. *But see* Hennessy, *Rating and Other Factors in Approaching the U.S. Capital Markets—II*, EUROMONEY, Mar. 1976, at 28.

207. Mathews, *supra* note 4, at 1, col. 6.

208. If loan participations are found to be securities, they may be exempt under § 3(a)(2) of the 1933 Act. 15 U.S.C. § 77c(a)(2) (1976) exempts from registration and prospectus requirements "[a]ny security issued or guaranteed by any national bank or banking institution organized under the laws of any State . . . the business of which is substantially confined to banking . . . ." Even if the exemptive provisions apply so that registration with the SEC or some state securities commission is not required, distribution and trading remains subject to several antifraud and anti-half-truth provisions, in particular rule 10b-5 and section 12(2). Simpson, *Investors Civil Remedies Under the Federal Securities Laws*, 12 DEPAUL L. REV. 71 (1961).

209. *Banks Under Attack, supra* note 28, at 110; *In and Out of Court, supra* note 16, at 35. *See* Curran, *supra* note 7, at 58. *See* note 202 *supra*.

210. *In and Out of Court, supra* note 16, at 35. It has further been observed that smaller banks participating in international lending do not have the resources to deal in such an

At the present time, the international nature of the market makes it hard to decide how *adequate* loan documentation and disclosure, in fact, are; loan documents are generally tailored to national law.[211] The imposition of federal disclosure requirements on American involvement in the offer, as well as the sale and purchase of loan participations, would provide a uniform standard of full disclosure of all material facts wherever such a transaction could be reached by United States jurisdiction.

The collective and individual strengths of the American banks can not be questioned.[212] And some indication exists that the international lending activities of United States banks, in particular syndicate lending, may substantially increase in the future.[213]

Although the smaller American banks are not unimportant, the "big twelve," the so-called twelve major banks in the United

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informal way with international business; this is an additional reason for formulating rules. *Id. See also* note 36 *supra*.

211. Sandeman, *supra* note 192, at 77. *See generally* note 192 *supra*.

212. American banks are now ahead of their foreign competitors' international currency lending. Approximately 140 United States banks have an international presence of some kind. The smaller American banks have approximately 200 branches abroad, with aggregate assets of 40 billion dollars. These smaller banks are not unimportant, but the "big twelve" remain dominant; these twelve include: Bank of America, Citibank, Chase Manhattan, Manufacturers Hanover, Morgan Guaranty, Chemical Bank, Bankers Trust Company, Continental Illinois, First National Bank of Chicago, Wells Fargo, Marine Midland of New York, and First National Bank of Boston. In 1974, this group collectively represented 75% of total American overseas branches. *The Smaller They Are The Harder They Fall*, THE ECONOMIST, Jan. 22, 1977, at 13. *See* notes 164 and 166 *supra*.

213. As to the competition posed by American financial markets to London's continuing status as the center of the medium-term eurocurrency syndications loans:

> In December 1976 the dollar accounted for more than 70 per cent of the Eurocurrency market. London's share of the Eurodollar market has always been signficantly higher than has its share of the other Eurocurrencies; and any developments affecting the dollar sector have a sharp impact in London. There are a number of possible developments in the dollar arena that will bear watching:.
>
> (1) It is being proposed, not for the first time, that New York City should establish a 'Montetary Free Trade Zone'. Under this arrangement, banks would be allowed to establish branches which would deal specifically in international transactions; they could accept non-US deposits free of the burden of non-earning reserves and at rates unrestricted by Regulation Q and they could make loans to foreign borrowers without city or state taxation on the related earnings. In effect, this would enable the American banks to move to New York a large amount of the identical business which they presently undertake in offshore centres.
>
> While this idea is in its infancy, the potential advantages to New York City are manifest, and if—and it's a very big 'if'—the necessary legislation were to be passed, one could argue the prospect of a major shift in the centre of the syndicated loan market for the following reasons:
>
> According to *Eurostudy*, in 1976 eight of the 10 leading managers of medium-term syndicated credits were American.
>
> Many of the credit and sovereign risk decisions are already taken in the United States. The New York legal and financial infra-structure is more than adequate.

Fogarty, *The City's Staying Power*, THE BANKER, Feb. 1978, at 71.

States, remain dominant over international activities.[214] That the top lead lenders in the Euromarket number among the big twelve seems to indicate that a mandatory requirement of full disclosure imposed upon them would, in turn, influence disclosure requirements throughout the market.

The question remains, however, whether some bankers would not find the disclosure requirements of section 12(2) and rule 10b-5 a bit too sticky.[215] Borrowers possessing confidential information of a sensitive sort may prefer to acquire financing outside the reach of United States securities regulation rather than make public *all* material facts.[216] Furthermore, what economic ramifications would follow from making such sensitive information public?

In light of the possibilities, leading American syndicate managers may find the problems posed by section 12(2) and rule 10b-5 regulation too imposing; so much so that at least some of these banks could be expected to utilize tactics designed to preclude *any* control by the securities acts over the disclosure of information.[217] One such tactic would be for a lead bank not to sell participations that could constitute securities. Effectively, this would mean that the syndicate arrangement will not pass muster under the *Howey* test to qualify as a security.[218] Without the offer, sale, and purchase of a "security," the disclosure requirements of section 12(2) and rule 10b-5 will not apply.[219]

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214. *See* notes 166 and 212 *supra*.

215. For observations made by commentators in the field as to potential problems in the disclosure of information, *see* Sandeman, *supra* note 192; Hennessy, *Ratings and Other Factors in Approaching the U.S. Capital Markets—II*, EUROMONEY, Mar. 1976, at 28 (particularly discussing problems of full disclosure under the United States securities regulations).

216. *See* Mathews, *supra* note 4, at 18, col. 2; Sandeman, *supra* note 192, at 75.

217. *See* Mathews, *supra* note 4, at 1, col. 6; *In and Out of Court, supra* note 16, at 35. As was observed by one commentator in regard to the changes in procedure that have already been generated by the pending EAB suits:

> [B]anks started to call what had been the placement memorandum an information memorandum, and to supply only what information they had been given by the borrower. Information memoranda now start out with an emphatic disclaimer by the banks concerned, and the document is usually signed by the borrower, who asks the lead manager in a special letter to distribute it to potential customers. This ought to wash the banks' hands of any responsibility if anything can, but quite a few Euro-bankers take the view that the information memorandum will always remain a selling document: it would be hard to argue in court that the lead managers were involved in an arcane form of journalism, or just thought the other banks might like to know what was going on.

Sandeman, *supra* note 192, at 75, 77.

218. For a discussion of the qualification of a loan participation as a security under the Federal Securities Acts, *see* text accompanying notes 53-119 *supra*.

219. *See* notes 25 and 26 *supra*, and accompanying text.

A means that could be used to accomplish this result would be for lead lenders to engage in true multibank loan syndications, rather than syndications similar to those used by EAB[220] and now involved in the pending suits. The distinction that exists in such an arrangement is that each of the participants in a true multibank syndicate also attains the status of co-manager.[221] In the EAB loan participation syndications, only EAB, as the lead bank, acquired a managerial position.[222] The difference between the two appears sufficient to qualify the agreement between the co-lending banks of a true multibank syndicate as a joint venture instead of a security.[223]

Without anticipating the European-American Banking suits, this approach to loan syndications appears to be the recent trend in London, *the* financial center for medium-term syndicates.[224] Instead of the originating bank single-handedly managing the entire loan, management groups are formed exclusively of banks in the area.[225] In the event that lead lenders follow this trend to circumvent United States legal liability, two effects will occur.

First, United States financial markets will avoid syndications which require extensive marketing of participations in order to keep the international medium-term loans under the exclusive preserve of large international lenders in the United States.[226] Smaller banks that wish to actively continue participation in the international market would have no alternative but to expand overseas, taking the risk involved upon their own shoulders.[227]

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220. *See* note 7 *supra.*

221. *See* note 11 *supra*; Curran, *supra* note 7, at 61, 63.

222. *See* note 80 *supra*, and accompanying text. *See also* note 83 *supra.*

223. The distinction between a securities investment and a joint venture is that in the former the investor's profit must come from the entrepreneurial or managerial efforts of others, whereas in the latter each member of the co-venture shares in a mutual right of control. *See* note 111 *supra.*

224. Curran, *supra* note 7, at 60. *See* Fogarty, *The City's Staying Power*, THE BANKER, Feb. 1978, at 67.

225. This means that the loan agreement is made under the law of the management group's situs and all changes and negotiations pertaining to documentation occur there also. Curran, *supra* note 7, at 61.

226. "According to a Eurostudy in 1976, eight of the ten leading managers of medium-term syndicated credits were American [banks]." Fogarty, *The City's Staying Power*, THE BANKER, Feb. 1978, at 67. *See generally* note 212 *supra.* The major United States banks, by virtue of their strength in the medium-term Eurocredit syndication market appear capable of excluding smaller banks from participation. This appears particularly true in light of the fact that smaller banks presently feel more competent as participants than lead lenders. *See* note 195 *supra.*

227. Another possibility is that smaller American banking institutions will form consor-

Secondly, each party in the management group will get a slice of the front-end commitment fee.[228] If such syndications were to limit the number of participants in the syndicate to the members of the managerial group, United States securities regulation and potential liability would be entirely circumvented,[229] or so it appears.[230]

However, the use of true multibank loan syndicates over the use of participation loans will deprive lead lenders of certain advantages acquired by virtue of their position. The lead bank in a loan participation syndicate not only acquires a tremendous power in being able to direct the allocation of such substantial sums,[231] but it also profits from both ends of the syndicate arrangement in terms of managerial fees paid by participants[232] and commitment fees paid initially by borrowers.[233] If the active participation of many banks in loan participation syndications translates into a greater ability for lead lenders to provide more syndications to more borrowers, the benefits attained by virtue of a lead bank position are truly enhanced.

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tium banks as a means of entering the highly competitive Eurocurrency market. Lees, *supra* note 5, at 46. *But see* notes 186 and 195 *supra*, and accompanying text.

228. *See* Curran, *supra* note 7, at 64. Front end fees and commission comprise the lucrative part of international business; competition is keen between international lenders for lead and co-managerial positions. *The Leopards Change Their Spots*, THE ECONOMIST, Jan. 22, 1977, at 17, 18-21.

229. *See* notes 220-223 *supra*, and accompanying text. In London, the majority of syndicates arranged limit the number of participants to the number of managing banks. Curran, *supra* note 7, at 61. Hence, this strongly suggests a trend in lending patterns which American lead lenders may well choose to follow. However, if loan participations were also sold to banks outside the management group, that group as a whole could well be held responsible for full disclosure under the Securities Acts if American participation therein could be used to establish jurisdiction.

230. Although a true multibank syndicate appears to take on the characteristics of a joint venture, *see* note 111 *supra*, the context over text method of defining a security requires the examination of substance rather than form. Hence, the inquiry must go beyond the basic contractual outlines of the transaction and into actual business practices. *See* United Housing Foundation Inc. v. Forman, 421 U.S. 837, 851-52 (1975). The distinction between a joint venture and a security is perhaps in some instances a fine line, *see* note 223 *supra*. It would seem that where a participating bank took only a small interest in a true multibank syndicate, the right of joint control it attains as co-manager may be nominal only. This result may be dictated not only by business realities, but also by geographical barriers. If the involvement of a co-managing bank in a true multibank syndicate were purely ministerial with little impact upon the ultimate success of the venture, the argument could be made that the agreement should be considered a security. *See generally* text accompanying notes 53-119 *supra*.

231. *See, e.g., The Leopards Change Their Spots*, THE ECONOMIST, Jan. 22, 1977, at 18.

232. *See* Curran, *supra* note 7, at 61, 63.

233. *See* note 15 *supra*; Curran, *supra* note 7, at 61, 63.

The threatened exclusion by lead lenders of smaller banks from participation in lending syndicates has already begun to materialize in the American financial market.[234] Yet, whether this change in lending patterns will continue with any fervor for any length of time remains to be determined in light of the loss felt by lead lenders in sharing the managerial position as well as the continuing demands made for future financing.

The international banking system is said to be a lender's market.[235] Its growth in recent years has been propelled by increasing demands for financing from all levels of the world's economy.[236] By meeting these demands, international lenders are ultimately left to determine which areas of the world economy will receive funds and under what terms such funds will flow.[237] At the present time, the level of competition among lenders for international borrowers is fierce.[238] Although the need for funding clearly exists in numerous sectors throughout the world, banks are predicted to give careful consideration to the risk involved before providing such loans.[239]

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234. *In and Out of Court, supra* note 16, at 35.

235. *See* note 3 *supra.*

236. The increasing number of requests for financing coming from Third World and developing countries (LDC) illustrates one example where much of the capital resources available have already been committed. Curran, *supra* note 7, at 63, 65. *See* Hauge, *The Challenges That International Banking Now Faces*, EUROMONEY, Oct. 1976, at 43; *Reasons for Discrimination, Not Alarm*, THE BANKER, Jan. 1977, at 51; *Like Topsy, supra* note 163, at 9; *Third World Risks*, THE ECONOMIST, Jan. 22, 1977, at 25. The pressures to provide the financing that translates the promises for a better life political leaders make to their people continue to increase.

> This continuing and rising tide of expectations is found in every quandrant of the globe, developed or developing, OPEC or non-OPEC. Given the drama of a United Nations General Assembly or Nairobi UNCTAD meeting, they are mirrored concretely in the demand for nuclear energy projects, metropolitan subways, drilling platforms, and for schools, hospitals and housing everywhere. They all carry high price tags.

Hauge, *supra*, at 43.

237. *See Reasons for Discrimination, Not Alarm, supra* note 236; *A Cash-Flow Approach to Sovereign Risk Analysis*, THE BANKER, Jan. 1977, at 55.

> Banks that want to survive must be present in New York, London, Tokyo, Frankfurt, and Zurich simultaneously. These and other centers spread all over the world are the ones—and this will become even more apparent in the future—in which the most momentous financial operations, perhaps even the outcome of world economy and finance, will be decided.

Sindona, *Multinational Banking*, THE BANKERS MAGAZINE, Spring 1974, at 56.

238. *See* note 195 *supra*, and accompanying text; *Third World Risks, supra* note 236, at 26.

239. *Reason for Discrimination, Not Alarm, supra* note 236, at 51-52; *A Cash-Flow Approach to Sovereign Risk Analysis, supra* note 237, at 55-59; *Third World Risks, supra* note 236, at 25-26.

Due to the unique nature of syndicate lending, many borrowers that would not be able to secure financing in other areas of the market can be accomodated under a syndicate arrangement.[240] The utilization of syndications provides for the spreading of risk among participants.[241] The obvious factor remains that the risk decreases as the number of banks participating increases. The use of largely marketed participation syndicates also allows smaller banks to diversify their risk by participating in a number of different syndications. The use of medium-term syndications of the nature utilized by EAB are, in this sense, well suited to meet the present demands being made for financing.[242] Should lead banks choose to meet these demands, smaller American banks and others appear to be a willing group of participants.[243]

Under the requirements of section 12(2) and rule 10b-5, a lead bank can only be held responsible for the disclosure of material information, and not for the success or failure of the loan itself.[244] By allowing for these protections, participants will be guaranteed a full and accurate disclosure of material information upon which an informed decision can be made.[245]

This policy of full disclosure would favor sound lending practices by requiring lead lenders to thoroughly evaluate the proposed loan syndication.[246] At a time in the international lending market when too many loans already made are labeled "risky," the disclosure requirements of section 12(2) and rule 10b-5 would replace the sense of *caveat emptor* that now exists in the marketplace with a

240. *See* notes 181 and 182 *supra*, and text accompanying note 182 *supra*.

241. *See* note 9 *supra*, and accompanying text.

242. This stems from the fact that many of the borrowers seeking financing are of the type that would not qualify for loans in other areas of the market. *See* notes 181 and 182 *supra*, and text accompanying note 182 *supra*; *Reasons for Discrimination, Not Alarm, supra* note 236, at 51-55.

243. *See Like Topsy*, *supra* note 163, at 9-10, 13; *The Smaller They Are The Harder They Fall*, THE ECONOMIST, Jan. 22, 1977, at 21; *The Leopards Change Their Spots, supra* note 231, at 17-21.

244. A lead bank would be held, at the threat of potential liability under section 12(2) and rule 10b-5, to provide participants with a full disclosure of material facts reasonably known to it at the time of the offer and sale. *See generally* text accompanying notes 120-159 *supra*.

245. *See* note 128 *supra*.

246. The real impact on the responsibility of a lead bank for the disclosure of information in offering a loan participation will be the terms in which a court decision in favor of the plaintiffs in the EAB suits were actually couched. However, if lead lenders can be held liable under section 12(2) and rule 10b-5, it only follows from the potential for liability that more care will be given to evaluating the loan than has been given in the past. *See* note 188 *supra*.

practice of fair dealing and honesty.[247] If the leading American banks would be willing to accept the Federal Securities Acts' standard for disclosure, their collective strength in the international market would exert influence on the quality of disclosure in syndicate lending as a whole. The nature of the market, and the possibilities that a borrower may have sensitive information in his background which best remains confidential, suggests that the future use of loan participations which could qualify as securities will be limited to those discriminatory circumstances where full disclosure can be given. With lead lenders being required to provide all material information in such instances, a proposed participant is guaranteed the opportunity of making an informed decision.[248] This guarantee seems to imply that the quality of loan syndications made, and the risks taken, would correspondingly improve.

V. CONCLUSION

It appears likely that the loan participations purchased by the plaintiffs in the pending European-American Banking suits do possess the necessary features as dictated by the *Howey* test to bring them into the definition of securities.[249] Once a loan participation is determined to constitute a security, an affirmative duty to disclose may be imposed by rule 10b-5[250] or section 12(2) of the Securities Act of 1933.[251]

Whether the plaintiffs will be able to establish liability under rule 10b-5 will depend upon successfully establishing the requisite elements of a 10b-5 action.[252] The most difficult obstacle that the plaintiffs will be required to overcome appears to be the element of scienter.[253]

In the event that liability under rule 10b-5 cannot be established, a viable alternative exists under section 12(2) of the Securities Act of 1933.[254] The plaintiffs have an easier burden of proof

247. The fundamental purpose of rule 10b-5 and section 12(2) was to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and to protect persons who engage in buying and selling securities. *See* Herpich v. Wallace, 430 F.2d 792 (5th Cir. 1970); Shuman v. Serman, 356 F. Supp. 911 (D. Md. 1973); Ruszkowski v. Hugh Johnson & Co., 302 F. Supp. 1371 (W.D.N.Y. 1969).

248. *See* notes 123, 128, 131 & 132 *supra*.

249. *See* text accompanying notes 27-119 *supra*.

250. *See* notes 25, 123 & 124 *supra*.

251. *See* notes 24, 150 & 151 *supra*.

252. *See* text accompanying notes 120 & 149 *supra*.

253. *See* notes 135 & 136, 144 & 145 *supra*, and accompanying text.

254. *See* note 24 *supra*.

under section 12(2),[255] which encompasses both negligent and intentional material misrepresentations[256] and does not require that the element of scienter be proven to establish liability.[257] If the plaintiffs are unable to establish their case under rule 10b-5, there is a strong possibility that liability under section 12(2) can be established.[258]

The ultimate outcome of placing liability on the lead bank appears to be reasonable and well justified, particularly when it is considered that the plaintiffs and others like them would have no course for redress adequate to compensate for the damages suffered. It is believed that the impact of holding a lead bank liable will seriously effect the international lending market.[259] Undoubtedly, many lead lenders will move away from the use of participation loans,[260] such as the ones present in the pending European-American suit, and will form true syndicate loans[261] which clearly do not carry the characteristics of a security, but rather retain the qualities of commercial lending.[262] In light of the fact that EAB was only one of many international lenders that helped "finance" the world tanker glut,[263] it appears that this additional vulnerability will, as described by one New York banker, "put a real fender-bender on the international loan market."[264] Lead bank liability will undoubtedly initially drive out some of the lead banks in the United States, and attempts will be made to exclude smaller banks from participation in international loans.[265]

However, it appears that this predicted reaction on the part of the American financial market is an initial reaction which may well give rise to a subsequent adjustment and acceptance of the full disclosure policy embodied in the United States securities regulations. The trend in international lending is currently toward safer banking policies and fuller disclosure.[266] Moreover, the need for clear-cut rules and practices in the international banking market has

255. *See* note 153 *supra*, and accompanying text.
256. *See* notes 150 and 151 *supra*, and accompanying text.
257. *See* note 154 *supra*, and accompanying text.
258. *See* text accompanying notes 150 & 161 *supra*.
259. *See* text accompanying notes 198-208 *supra*.
260. *See* text accompanying notes 5-15, 178 & 186 *supra*.
261. *See* note 7 and 11 *supra*, and text accompanying notes 217-225 *supra*.
262. *See* notes 111, 220-223 *supra*; *but see* note 230 *supra*.
263. *See* notes 30 and 32 *supra*.
264. Mathews, *supra* note 4, at 1, col. 6.
265. *See* text accompanying note 205 *supra*.
266. *See* text accompanying note 209 *supra*.

been expressed from various sectors.[267] International bankers have become all too aware of substantial risks taken in large loans already made;[268] and if the international banking arena is left to regulate itself, as others in international lending insist is the only proper avenue to regulation,[269] then what assurance is there that voluntary disclosure policies, self-imposed by lenders, will provide adequate protection?

Under the requirements of section 12(2) and rule 10b-5, a lead bank can only be held liable for the full disclosure of all material facts in the offer or sale and purchase of a loan participation which qualifies as a security, and not for the ultimate success or failure of the loan. Such a requirement would favor sound lending practices as well as provide protection to participating banks. Although it is said that the potential for lead bank liability under section 12(2) and rule 10b-5 would drive the major American lead lenders out of the syndication market, in light of their current position of strength, can this be said to be likely? Most assuredly, if the major American lead banks chose to continue in the business of loan participation, thus accepting the regulation of full disclosure under the Securities Acts, the impact would effect lending practices and disclosure policies throughout the world.

The use of participations is well suited to meet many of the current needs that exist for financing. Yet, if the problems of full disclosure are too great, such as for loan documentation containing sensitive information, an alternative means for financing will need to be found. However, where full disclosure can be made, the continued use of widely marked loan participations is likely.

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267. *See* text accompanying notes 192, 193 & 210 *supra*.

268. *See* text accompanying notes 187, 188 & 191 *supra*.

269. *See* text accompanying note 194 *supra*.

* As this article proceeded to the final stage of publication, a settlement was reached between the parties to the European-American Banking suits. However, as the context in which these cases arose is highly reflective of international loan participation arrangements, the legal issues raised remain relevant and of interest and concern to lenders in the international marketplace.