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Are Leveraged Loans Subject To Securities Laws? It Depends…

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Leveraged loans continue to be a topic of interest in the current environment, particularly when they are pooled and securitized as collateralized loan obligations. A recent decision sheds light on whether and when leveraged loans and similar instruments may be classified as securities and, therefore, be subject to securities laws.

In the Millennium Laboratories LLC bankruptcy case*,* a trustee of a claim trust sued various financial institutions alleging, among other things, violations of securities laws. The claims were premised on a $1.775 billion syndicated loan transaction through which Millennium Laboratories LLC issued debt obligations; the financial institution defendants helped arrange the deal, and sold portions of the debt to the trust's beneficiaries (approximately 400 mutual funds, hedge funds and other institutional investors).

Nineteen months after the transaction closed, Millennium filed for bankruptcy, in part due to a government investigation and an unfavorable verdict in litigation with a competitor. The trustee argued, in part, that the defendants abandoned their obligations to perform due diligence concerning the troubles facing Millennium, and that the offering materials prepared by the defendants contained material misstatements and omissions. The defendants moved to dismiss, arguing that a syndicated bank loan is not a "security" and a loan syndication is not a "securities distribution," therefore securities laws do not apply to the transaction.

The Supreme Court has previously explained that, because the Securities Act defines "security" to include "any note," courts should begin with the presumption that every note is a security. However, that presumption may be rebutted if the note falls within, or resembles, one of the following categories: a note delivered in consumer financing, a note secured by a mortgage on a home, a short-term note secured by a lien on a small business or some of its assets, a note evidencing a "character" loan to a bank customer, short-term notes secured by an assignment of accounts receivable, and a note which simply formalizes an open-account debt incurred in the ordinary course of business. To determine if a note resembles one of the above categories, a four factor test is applied, and courts evaluate (1) the motivations that would prompt a reasonable seller and buyer to enter into the transaction; (2) the plan of distribution of the instrument; (3) the reasonable expectations of the investing public; and (4) the existence of another regulatory scheme to reduce the risk of the instrument.

In the *Millennium* decision, the District Court applied each of the above factors to the notes issued through the syndicated loan transaction, and ultimately concluded they were not securities. Under the first factor, the Court analyzed the parties' motivation in participating in the transaction. When the motivations of the parties are those of a buyer and seller for an investment, notes are more likely to be a security; when the motivations are instead more commercial or consumer driven, notes are more likely to not be a security. The Court found that, from the seller's perspective, the notes were not for investment purposes or for Millennium's general use, but rather for loan repayment and dividend distribution. From the buyer's perspective, however, the purpose of acquiring the notes was for investment. Because the motivations were mixed, the Court concluded that the first factor was not determinative.

Under the second factor, the Court considered whether the notes were subject to "common trading for speculation or investment." Because the notes were traded only among sophisticated investors, and not available to the general public, the Court found that the second factor weighed strongly in favor of finding that the notes were not securities.

Under the third factor, the Court found that the offering documents made clear to the investing public that this was a lending transaction, not a securities offering. The Court highlighted the fact that the offering documents were referred to as the "loan documents" and the words "loan" and "lender" were used throughout (rather than, e.g., "investor"). Accordingly, the Court held that the third factor favored a finding that the notes were not securities.

Finally, under the fourth factor, the Court noted that the parties disagreed as to whether federal banking regulations constituted an "alternate regulatory scheme." However, when distinguished with entirely unregulated scenarios that had concerned prior courts, the Court found that the banking regulations governing the sale of loan participations among sophisticated investors constituted an alternate regulatory scheme, and that the fourth factor favored a finding that the notes were not securities. Accordingly, because three of the four factors suggested the notes were not securities, the Court dismissed the trustee's claims associated with securities law violations (though the trustee was granted leave to amend its complaint).

As distress increases in the leveraged loan and collateralized loan obligation sectors, investors will explore all recovery avenues, including remedies for potential securities law violations.
This *Millennium* decision highlights the case-specific, fact-intensive analysis that is sometimes required to determine whether a financial instrument is subject to securities laws. One particularly relevant factor is the breadth of general public participation in the investment. As the *Millennium* Court repeatedly emphasized, the "limited number of highly sophisticated purchasers" involved in the Millennium transaction was a key component of its decision; courts are apt to be more protective if less sophisticated investors from the general public are involved.

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