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# Federal Appeals Court Reaffirms That Syndicated Loans Are Not Securities

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The $1.4-trillion leveraged loan market[1] yet again breathed an immense sigh of relief on August 24, 2023, with the United States Court of Appeals for the Second Circuit's unanimous affirmation[2] of the Southern District of New York's 2020 *Kirschner v. JPMorgan Chase Bank, N.A.*[3] *("Kirschner")* decision. The latest decision affirmed the prevailing market view that notes representing syndicated loans do not constitute "securities."[4] The leveraged loan market had operated for decades under the assumption that syndicated loans are not securities, but without firm judicial or regulatory certainty as to such assumption. Although the Second Circuit's latest decision is not necessarily the final word (or binding law throughout the country), it provides strong legal guidance to the industry that loans are not securities.

The historical lack of certainty stemmed in part from the fact that "notes" and "evidences of indebtedness" are enumerated types of securities in the federal securities laws' "security" definition, leading to a plausible assumption that such instruments are, in fact, securities. Furthermore, under the seminal *Howey* test,[5] an instrument is deemed to be a security if it involves an investment of money in a common enterprise with an expectation of profits from others' efforts. The *Howey* test could certainly be interpreted to consider a note or syndicated loan to be an investment contract, with the act of syndication itself causing the noteholders to be reliant on the efforts of others and thus an SEC-regulated "security". Many loan-related products (e.g., letters of credit) exist that are known not to be securities. In recognition of this, in the seminal *Reves*[6] case, the U.S. Supreme Court first acknowledged that notes are not necessarily securities, even though they are specifically included in the Securities Act's "security" definition. In 1992, in *Banco Espanol de Credito v. Security Pacific National Bank*[7]*,* the Second Circuit Court of Appeals expanded *Reves*' ruling in holding that loan participations are not securities. The U.S. Supreme Court refused to address the *Banco Espanol* ruling on appeal, allowing it to become the law (at least in the Second Circuit) for the past three decades. While *Banco Espanol* and *Reves* led to the accepted market practice that syndicated loans are not securities, uncertainty has remained. Some of this uncertainty relates to the fact that in the intervening decades, the syndicated loan market has grown exponentially (particularly in volume of secondary market transactions), leading some to question whether *Banco Espanol* would still be upheld in light of the resemblance in some ways of the current syndicated loan market to a securities marketplace. Further, *Banco Espanol* did not expressly address more current types of loan transactions, which are syndicated and involve a purchase and immediate resale to investors.

## The Case

As discussed in our July 2020 advisory[8], *Kirschner* involved a $1.775 billion syndicated loan transaction in which Millennium Laboratories LLC syndicated a term loan to investors. The *Kirschner* defendants[9] had served as arrangers and underwriters in the transaction. Two months after the loan facility closed, Millennium was found liable for violating the Physician Self-Referral (Stark) law and anti-kickback statutes. Millennium also was the target of other proceedings, including a Department of Justice investigation in connection with False Claims Act violations, all of which impacted Millennium's valuation. In light of such actions and other issues, Millennium filed for bankruptcy protection in New York. After Millennium's bankruptcy filing, Marc Kirshner, the bankruptcy trustee of the Millennium Lender Claim Trust, filed suit in the United States District Court for the Southern District of New York, alleging securities and other violations. The case considered whether the origination and distribution of a syndicated bank loan were subject to state securities ("blue sky") laws in California, Colorado, Illinois and Massachusetts. The District Court granted the defendants' motion to dismiss on the ground that a syndicated bank loan is not a "security." Sidestepping the *Howey* test completely, the District Court applied the "family resemblance" test outlined in *Reves* to determine whether the Millennium notes were securities.

Under *Reves* and its progeny, a note is presumed to be a security unless it bears a strong family resemblance to instruments that are denominated as notes but nonetheless not legally categorized as securities. Mortgage loans, consumer financing loans, accounts receivable factoring agreements, notes evidencing debt incurred in the ordinary course of business (particularly if collateralized) and notes evidencing loans by commercial banks for current operations fall within such category. The four factors of the *Reves* "family resemblance" test are:

1. motivations that would prompt a reasonable seller and buyer to enter into the transaction;
2. the instrument's plan of distribution;
3. the investing public's reasonable expectations; and
4. whether some factors, including the existence of another regulatory scheme, significantly reduce the instrument's risk, thereby rendering Securities Act application unnecessary[10].

Ultimately, the District Court concluded (and the Second Circuit court ultimately agreed) that the second, third and fourth *Reves* test factors weighed in favor of finding that the notes were "analogous to the enumerated category of loans issued by banks for commercial purposes" and, as such, not securities[11]. Given the determination that the notes at issue in the *Kirschner* case satisfied three out of the four *Reves* test prongs, the District Court dismissed the action in May 2020, granting summary judgment to the defendants. For more details as to how the District Court analyzed these factors, please see our 2020 advisory.

The *Kirschner* plaintiff appealed to New York's Second Circuit, arguing (among other things) that the District Court should disregard the *Reves* test's presumption that the loan was a security. Prior to making its decision, the Second Circuit issued an order to "solicit any views that the [SEC] may wish to share" regarding the status of the syndicated term loan notes as securities under *Reves*. Interestingly, even given the current SEC's activism, and despite the court's prodding, the SEC declined to weigh in with its own arguments in the case after indicating a prior intention to file an amicus brief (and procuring extensions on the filing deadline[12]), leading to speculation that the SEC was unable to muster internal policy consensus to submit an amicus brief that the loans were (or were not) securities (especially given the gravity of a possible policy change). This is in contrast with the *Banco Espanol* case, in which the SEC filed a short amicus brief asking the court to rule that the notes were purchased in investment transactions and, therefore, were securities[13].

Notwithstanding (or maybe due to) the SEC's lack of amicus guidance in the case, the Second Circuit affirmed the *Kirschner's* lower court ruling that the notes at issue were not securities. In particular, the Second Circuit observed that the third prong had been satisfied since the lenders purchasing the notes had to certify that they (a) were sophisticated and experienced in extending credit to entities similar to Millennium, (b) had independently (and without reliance upon any agent or lender, and based on documents and information that they deemed appropriate) made their own appraisal of (and investigation into) Millennium's business, operations, property, financial and other condition and creditworthiness and (c) made their own decisions to make loans thereunder. The Second Circuit again noted a parallel with *Banco Espanol*, under which a substantively identical certification was central to the court's determination that the buyers could not have reasonably perceived the loan participations to be securities.

## Takeaways From The August 2023 Ruling

It is hard to overestimate the profound effect that would come about should syndicated loans be re-classified as securities. Indeed, the market as we know it would cease to exist. The transaction at issue involved a loan facility that was similar to other syndicated loan facilities. If the Second Circuit had deemed such loan a security, it would have been difficult to differentiate it from most other syndicated loans – which could have brought the entire loan market's operations under SEC scrutiny (thus disrupting the loan markets and likely changing their economics). It also is likely that the structure of the collateralized loan obligation (CLO) market (which currently purchases about 70% of all U.S. syndicated loans issued[14]) would not transition well to a regulatory environment where loans are deemed securities. Another unintended consequence of classifying notes as securities is the possibility that more borrowers would seek financing from less desirable sources, such as entirely unregulated private lenders.

The *Kirschner* opinions (together with the prior case law) suggest that a transaction's facts and circumstances will largely determine whether a note will be deemed a "security," with the application of the *Reves* family resemblance test to a transaction being analyzed on a case-by-case basis. To minimize the risk of a particular loan becoming considered a security, leveraged loan products should be structured in a manner that is consistent with general principles in the Loan Syndications and Trading Association (LSTA) Code of Conduct and the *Reves* family resemblance test[15]. One reason why the leveraged loan market has been able to thrive thus far without being regulated as a security is that loan syndications have steered clear of the retail market and have done a good job of policing themselves.

While the Second Circuit's *Kirschner* decision was favorable to the loan market, it does not constitute binding precedent for other districts and, therefore, does not create certainty. Accordingly, the characteristics of syndicated loans will continue be analyzed on a case-by-case basis, even in light of the recent decision. That said, the Court's application of the *Reves* test rather than the *Howey* test solidifies the legal consensus that debt instruments should be analyzed using the *Reves* test. Other industries (in particular “network” or “utility” digital assets) have looked at syndicated loans and the *Kirschner* ruling with a bit of envy, wondering if digital assets could be structured to similarly avoid SEC scrutiny[16]. The loan market could be seen as evidencing a historical anomaly, partly based on its resemblance to instruments that are not securities and cannot be compared with other financial instruments. It would be prudent for any industry or asset class that wants to avoid SEC scrutiny to follow the lead of syndicated loans - with a relatively strict code of conduct, few failed transactions and possibly limited retail involvement.

The Kirschner reassurance that syndicated loans do not constitute securities could erode as other courts weigh in on this issue and/or other and new financial instruments are tested in court. For instance, advancement to create efficiencies in the loan market (such as continued automation of the loan trading process, potentially through the use of a blockchain) may require further analysis. It also will need to be clarified whether an instrument with identical characteristics to a syndicated loan would be considered a security simply because the debt is tokenized rather than represented by a note.

[1] As of June 30, 2023, according to the Loan Syndications and Trading Association. See, e.g., https://www.lsta.org/news-resources/2q23-the-dog-days-of-summer/#:~:text=In%20light%20of%20this%2C%20it,2023%20and%202022%20highs%2C%20respectively.

[2]*Kirschner v. JP Morgan Chase Bank, N.A.*, No. 21-2726, 2023 WL 5437811 (2d Cir. Aug. 24, 2023).

[3]*Kirschner v. JP Morgan Chase Bank, N.A.*, 2020 U.S. Dist. LEXIS 90797 (S.D.N.Y., May 22, 2020).

[4] The Second Circuit first analyzed and agreed with the District Court with respect to the lower Court’s jurisdiction over the case pursuant to the Edge Act (§12 U.S.C. 632) based on the engagement by JPMorgan Chase Bank, N.A., in international or foreign banking in connection with the transaction.

[5] *SEC v. W.J. Howey Co*., 328 U.S. 293 (1946).

[6] *Reves v. Ernst & Young*, 110 S. Ct. 945 (1990) (“*Reves*”).

[7] *Banco Espanol de Credito v. Security Pacific National Bank,* 973 F.2d 51 (2nd Cir. 1992).

[8] Court Provides Additional Guidance On When Notes Are Not Securities- The Kirschner Case (July 13, 2020. https://www.polsinelli.com/publications/court-provides-additional-guidance-on-when-notes-are-not-securities-the-kirschner-case.

[9] The defendants were JPMorgan Chase Bank, N.A., JPMorgan Securities LLC, Citigroup Global Markets Inc., Citibank, N.A. and BMO Capital Markets Corp.

[10] Reves, 494 U.S. at 67.

[11] *Banco Espanol,* 973 F. 2d 51, 56 (1992).

[12] See, e.g., https://www.lsta.org/app/uploads/2023/08/AFR-letter-re-SEC-Punt.pdf.

[13] See https://casetext.com/case/banco-espanol-de-credito-v-sec-pac-nat-bank. The *Banco Espanol* dissent noted that the SEC had submitted a brief amicus curiae advocating the use of the *Howey* test rather than the *Reves* test.

[14] As of March 2023, according to Pitchbook.

[15] Factors in the Kirschner transaction that could help weigh against classification of the transaction as a "loan" and not a "security," including the following: (1) the transaction documents language should use the explicit language of loan transactions; e.g., references to "loan" and "lender" throughout the governing documents weighed against classification as a security in *Kirschner*; (2) the composition of purchasers and potential purchasers that are solicited should be sophisticated, and ideally qualified institutional buyers; (3) parties should consider the minimum hold requirements that preclude retail investors; (4) transfer/assignment restrictions should be at least as stringent as were found in the Kirschner and Banco Espanol loans; and (5) the administrative agent and/or the borrower should have control of who becomes a lender.

[16] Certain tokenized loan products have been drafted so as to comply with *Reves* and its progeny.



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