Alerts & Publications

In Fact-Specific Decision, New York Federal Court Affirms Long-Held Market Understanding That Syndicated Loans Are Not Securities

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KEY CONTACTS

Sung Pak
New York
D: +1-212-408-2456

Jennifer Taylor
San Francisco
D: +1-415-984-8922

Nidhi M. Geevarghese
New York
D: +1-212-326-2109

It has long been understood, or perhaps, assumed, that syndicated loans are not securities, and therefore, not subject to state or federal securities laws. Recently, however, the plaintiffs in *Kirschner v. J.P. Morgan Chase Bank, N.A.*,[1] challenged this notion by bringing state securities laws claims in New York state court (the case was later removed to federal court) against arrangers and underwriters in connection with a syndicated bank loan deal. Had the plaintiffs' position been adopted, the decision could have had far-reaching consequences for the availability and cost of syndicated loans. On May 22, 2020, based on the facts of the case, Judge Gardephe of the U.S. District Court for the Southern District of New York (the "Court") ruled that the syndicated loans at issue were not securities.

Background

In 2014, Millennium Laboratories LLC ("Millennium") entered into a US$1.775 billion syndicated term loan (evidenced by notes), which was arranged and underwritten by the defendant banks and broker-dealers (the "Defendants"). Eighteen months later, following an adverse jury verdict and a multimillion-dollar settlement with the U.S. Department of Justice, Millennium defaulted on the loan and filed for bankruptcy protection. Shortly thereafter, the trustee of a litigation trust formed in Millennium's bankruptcy, on behalf of mutual funds, pension funds, and other institutional investors who were part of the syndicate of lenders who purchased the loans, sued the Defendants. Among other things, the trustee claimed that the Defendants had violated state securities laws by including material misrepresentations and omissions in the confidential information memorandum used to market the loans. The Defendants moved to dismiss the state securities laws claims, arguing that a syndicated loan is not a security by pointing to the "family resemblance" test established by the U.S. Supreme Court in *Reves v. Ernst & Young*[2] and subsequently adopted by the Second Circuit in the context of loan participations in *Banco Espanol de Credito v. Security Pacific National Bank*.[3]

The Court's Analysis

In *Kirschner*, the Court applied the "family resemblance" test articulated in *Reves*, which begins with a presumption that every note is a security. *Reves* recognizes, however, that there are certain categories of instruments commonly in the form of notes that are definitively not securities, and that the foregoing presumption may be rebutted if the instrument bears a "strong family resemblance" to one of the enumerated categories of non-security instruments, including "notes evidencing loans by commercial banks for current operations." The Court applied the four factors of the family resemblance test to the syndicated loans at issue in *Kirschner* to determine if the loans are securities:

- *Motivations of a Reasonable Buyer and Seller*. Under the first factor, an instrument is likely to be a security if the buyer is primarily interested in profit and the motivation of the seller is primarily to "raise money" or "finance substantial investment." In *Kirschner*, the Court found that while the syndicated lenders had an investment-related motive, Millennium's motivation in issuing the loans was not investment, but to advance some other commercial purpose, namely refinancing existing debt and paying dividends. Since the motivations of the buyer and seller were mixed, the Court found that this factor did "not weigh heavily in either direction."
- *Plan of Distribution*. The second *Reves* factor looks at whether the plan of distribution for the instrument in question is subject to "common trading for speculation or investment." The Court cited *Banco Espanol*, where the restrictions on transfer prevented the loan participations "from being sold to the general public" and only allowed "institutional and corporate entities" to be solicited. Similarly, the Court in *Kirschner* found the plan of distribution for the syndicated loans was "relatively narrow," as it excluded natural persons and solicited only a few hundred investment managers, "a relatively small number compared to the general public," and therefore, was not typical of a plan of distribution for a security.
- *Reasonable Expectations of Investors*. The third factor articulated in *Reves* considers "the reasonable expectations of the investing public" as to whether an instrument is a security. The Court, again citing *Banco Espanol*, noted that the confidential information memorandum and the credit agreement consistently used terminology, such as "loan documents," "loans," and "lenders" and "potential lenders" rather than "investors," and therefore, a reasonable investor could not conclude that the loans were, in fact, securities. The Court also went on to reject the plaintiffs' claim, calling it "premature at best," that expectations in the market have shifted and that syndicated loans should be considered securities since they share features with high-yield bonds.
- *Existence of Another Regulatory Scheme*: The final factor of the family resemblance test looks at whether there is another regulatory scheme

> that reduces the risk of the instrument, such that oversight of securities laws is unnecessary. The Court in *Kirschner* found that federal banking regulators constitute "such a regulatory scheme" and therefore, the final factor weighed in favor of a finding that the loans were not securities.

The Court ultimately found that since three of the four factors weighed in favor of finding the notes comparable to one of the categories of non-security instruments enumerated in *Reves*—loans issued by banks for commercial purposes—the defendants overcame the presumption that every note is a security and dismissed the securities laws claims.

Practical Implications

A contrary decision in *Kirschner* would have had enormous implications on the nearly US$1.2 trillion syndicated term loan market. As the Loan Syndications and Trading Association noted in an amicus brief filed in support of the Defendants' motion to dismiss in the *Kirschner* case, if syndicated loans were treated as securities and the process of syndicating a loan needed to comply with securities laws, obtaining financing would become more costly, time-consuming, burdensome, and perhaps even impossible, for many borrowers. In addition, an alternative outcome could have upended the participation of CLOs, which currently hold nearly 60% of syndicated loans. CLOs depend heavily on bank investment, but banks are prohibited under the "Volcker Rule" from investing in CLOs that hold securities. Had banks been required to pull out from such investments, nearly $90 billion of funding available to CLOs would have been in jeopardy.

While the Court in *Kirschner* upheld the long-held expectation that loans are not securities and preserved the existing framework of the syndicated loan market, we note that this decision was fact specific. Participants in the syndicated loan market should continue to maintain common practices with respect to the issuance and distribution of syndicated loans, such as those described in the second and third *Reves* factors above, to reduce the risk of a court treating loans as securities.

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[1] *Kirschner v. J.P. Morgan Chase Bank, N.A.*, 2020 WL 2614765 (S.D.N.Y. May 22, 2020).

[2] *Reves v. Ernst & Young*, 494 U.S. 56 (1990).

[3] *Banco Espanol de Credito v. Security Pacific National Bank*, 973 F.2d 51, 56 (2d Cir. 1992).

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practice law in California, and Nidhi M. Geevarghese, an O'Melveny counsel licensed to practice law in New York, contributed to the content of this newsletter. The views expressed in this newsletter are the views of the authors except as otherwise noted.