Good News for the Loan Market: Court Distinguishes Syndicated Loans from Securities

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The U.S. District Court for the Southern District of New York has dismissed a complaint that included state securities law claims based on allegations that interests in a syndicated term loan to a corporate borrower constitute securities. This article analyzes the test used in deciding the case and explores the extent to which this ruling provides guidance to market participants.

In *Kirschner v. JP Morgan Chase Bank, N.A.*,[1] Judge Gardephe of the U.S. District Court for the Southern District of New York dismissed a complaint that included state securities law claims based on allegations that interests in a syndicated term loan to a corporate borrower constitute securities. In dismissing the complaint, Judge Gardephe applied a four-factor test adopted by the U.S. Supreme Court in *Reves v. Ernst & Young*[2] (the "*Reves* test") to determine that interests in a syndicated term loan did not constitute securities.[3] This article discusses the analysis of the *Reves* factors in the *Kirschner* case and explores the extent to which this ruling provides guidance to market participants.

Why This Dismissal Matters

A finding that the syndicated loan notes at issue in *Kirschner* were recharacterized as securities would subject the loan to securities laws and liability and thus, dramatically affect underwriting, syndication and the secondary market for syndicated loans. Typically, arrangers rely on standard disclaimers of reliance in loan agreements to protect themselves from claims brought by individual syndicate lenders (and those to whom they have assigned or transferred their interests via the secondary market) over flaws in the syndication process or in the loan documentation.

However, if an arranger of a syndicated loan could be held liable to current and future syndicate members under the securities laws for misstatements and omissions made in the loan documentation provided to the syndicate, arrangers would be exposed to substantially greater liability than they currently are subject to. To avoid such liability to syndicate members for misstatements made in loan documenta-

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tion, loan arrangers would have the same responsibilities as an underwriter in a securities offering to conduct adequate investigation of the borrower and all aspects of its business in order to establish a "due diligence" defense as required by the securities laws, which the arranger would be unable to disclaim through contract. This would require increased disclosures and due diligence, causing the syndication process and borrowers' access to financing to be far slower and more expensive.

Furthermore, material non-public information is commonly provided to syndicate members to assist them in conducting their own evaluations of the borrower's creditworthiness, but this would raise thorny problems under the securities laws. Secondary loan trading and the settlement process would also be severely impacted as the rules and regulations that apply to securities would equally apply to secondary trading of loans such as trade reporting, trade clearance, charges against net capital and margin regulations. As a result, were syndicated loan notes to be deemed securities, the underwriting, syndication, and secondary loan trade settlement processes would all face significant disruption.

Related areas of finance, such as collateralized loan obligations ("CLOs"), would also have been affected. As the owners of approximately 60 percent of all syndicated loans, CLOs[4] supply much of the funding for the syndicated loan market.[5] In turn, banks are one of the largest groups of buyers of the highest-rated debt issued by CLOs, accounting for 25 percent of CLOs' AAA-rated notes,[6] making banks a critical funding source for the CLO market. Yet banks are subject to the Volcker Rule's[7] prohibition on investments in "covered funds." Many CLOs rely on the "loan securitization exemption" (the "LSE") to avoid "covered fund" status. However, this exemption would not be available if the loans held by a possible covered fund constituted securities.[8] For purposes of the Volcker Rule, the term "security" references the definition contained in the Securities Exchange Act of 1934 (the "Exchange Act"),[9] which could include any "note" - subject to interpretation in accordance with the *Reves* test.

If the syndicated loan notes at issue in *Kirschner* had been found to constitute securities after application of the *Reves* test, many CLOs would have lost their ability to rely on the LSE, making them "covered funds" under the Volcker Rule. As a result, banks would have found themselves suddenly restricted from holding debt issued by those CLOs,[10] forcing them to divest existing CLO debt and preventing them from purchasing new CLO debt. This would have disrupted key sources of capital for CLOs and the syndicated loan market.

By confirming that the leveraged loan syndication at issue in the *Kirschner* case did not constitute an offering of securities, the dismissal in this case offers welcome clarity for the syndicated loan market and CLOs. In addition, it eliminates a source of regulatory uncertainty for banks that purchase debt issued by CLOs. Had this issue in *Kirschner* been decided differently, both markets could have experienced significant disruption, potentially hindering corporate borrowers' access to credit. The court's analysis of the *Reves* factors in the *Kirschner* case accordingly provides much-needed guidance to a diverse spectrum of participants in both the syndicated loan and CLO markets.

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Facts of the *Kirschner* Case

The *Kirschner* case had its genesis in a $1.775 billion syndicated loan extended by a group of banks to a private lab testing company, Millennium Laboratories LLC (the "borrower"), which closed in April 2014, with the proceeds used to pay off existing debt and pay dividends. With the banks' broker-dealer affiliates serving as arrangers, the loan was subsequently syndicated to approximately 70 groups of institutional investors, such as mutual funds, hedge funds, and CLOs. While the syndicated loan was being negotiated, the borrower was under investigation by the U.S. Department of Justice ("DOJ") as well as the defendant in a lawsuit brought by a competitor over unlawful business practices.

After the loan closed, the borrower suffered an adverse jury verdict in the competitor's lawsuit, received notification from the Centers for Medicare & Medicaid Services that its Medicare billing privileges could be revoked, and was forced to settle litigation brought by the DOJ by agreeing to pay $256 million. Shortly after finalizing the DOJ settlement, the borrower defaulted on the syndicated loan and filed for bankruptcy.

On behalf of the institutional investors, the bankruptcy trustee filed the complaint in the *Kirschner* case against the banks involved in the syndicated loan transaction and their broker-dealer affiliates. They asserted state securities law claims, focused on alleged misstatements and/or omissions resulting in a purported failure to fairly characterize and accurately disclose the full extent of the legal and regulatory risks facing the borrower. In addition, the complaint alleged common law claims of misrepresentation and breaches of contract, fiduciary duty, and the implied covenant of fair dealing.

The *Reves* Analysis of the *Kirschner* Case

The U.S. Court of Appeals for the Second Circuit had used the *Reves* four-factor test in *Banco Espanol de Credito v. Security Pacific National Bank*[11] in 1992 to determine that loan participations are not securities. In the three decades since *Banco Espanol*, despite significant growth in the size of the syndicated loan market and related developments, courts have had few opportunities to consider whether - and under what circumstances - a syndicated loan might be a security under the *Reves* test.

The *Reves* test starts with the presumption that every note is a security (even notes that evidence syndicated term loans), because federal securities law defines the term "security" to include "any note." However, that presumption may be rebutted by a showing that the note in question bears a "family resemblance" to an enumerated list of notes which courts have determined are not securities, including, among others, notes evidencing loans by commercial banks for current operations.[12] The *Reves* test examines four factors:

- The motivations of the seller and buyer;
- The plan of distribution;
- The reasonable expectations of the investing public; and
- The existence of another risk-reducing regulatory scheme.

For the first factor, under *Reves*, if the seller's motivation is to raise money for the gen-

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eral use of a business enterprise or to finance substantial investments, a security is present; on the other hand, if the seller's motive is to facilitate the purchase of a minor asset or consumer good, correct cash-flow difficulties, or advance "some other commercial or consumer purpose,"[13] the note is not a security. If the buyer is interested primarily in the profit the note will generate, security status is likely; but *Banco Espanol* held that if the note buyers seek "a short-term return on excess cash" it is not a security.[14]

In analyzing the first factor, Judge Gardephe found that the borrower did not issue the notes for the purpose of investment or general use, but instead did so for "some other commercial purpose" - repaying its existing debt and paying a dividend to shareholders. However, the note buyers - the institutional investors - were interested primarily in the notes' expected profits; many were pension and retirement funds who purchased the notes for their investment portfolios. Because the note seller displayed commercial intent while the note buyer evidenced investment intent, Judge Gardephe ruled that the first factor was inconclusive as to security status and did not "weigh heavily in either direction."[15]

The second factor looks at the plan of distribution for the notes, including whether it is subject to "common trading for speculation or investment."[16] Relying heavily on *Banco Espanol*, the court concluded that the plan of distribution was "relatively narrow," which "strongly" weighed against the notes being securities.[17] Although hundreds of investment managers were offered the notes, Judge Gardephe found that:

- The general public as a whole was not solicited;
- All offerees were institutional or corporate entities, not natural persons;
- The transfer restrictions did not permit the notes to be freely assigned to unaffiliated third parties without consent;[18] and
- The $1 million minimum investment amount ensured that only sophisticated investors were able to participate.

The fact that the $1 million minimum amount was a gross allocation that could be sub-allocated by an investment manager to affiliated funds did not have the effect of allowing unsophisticated investors to acquire the notes. Finally, the existence of a secondary market on which the notes could be traded did not materially broaden the limited scope of the plan of distribution, given that such trading took place in accordance with the above transfer restrictions. Accordingly, the analysis of this second factor weighed against a finding that the notes in question were securities.

The third *Reves* factor considers the reasonable expectations of the investing public. Judge Gardephe accepted the arrangers' argument that the transaction documents, including the credit agreement and confidential information memorandum, clearly put note purchasers on notice that they were participating in a commercial loan transaction, not investing in securities. The loan documents employed terminology consistent with commercial lending, not a securities investment. While the plaintiff argued that a shift in market expectations had occurred in recent years, leading investors to view syndicated loan notes similarly to high-yield bonds (which are

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securities), the court rejected this proposition as "premature at best."[19] As a result, the third factor weighed against a finding that the notes in question were securities.

The fourth and final *Reves* factor assesses whether an alternative regulatory scheme reduces risks from the notes. The arrangers argued that interagency guidance on leveraged lending issued by the Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, and Federal Reserve Board, in addition to other measures taken by federal banking regulators, were sufficient to constitute an alternative risk-reducing regulatory scheme. Judge Gardephe accepted this argument, finding that the fourth factor also weighed against a finding that the notes in question were securities.

Key Takeaways

The analysis of whether a given note is a security under the *Reves* test is inherently fact-intensive and depends heavily on the particular characteristics of the notes before the court. Nonetheless, the court's decision in the *Kirschner* case suggests certain actions participants in syndicated loan transactions can consider taking which may help contribute to avoiding recharacterization of the loan interests as securities, for instance:

- Avoiding solicitation of the general public;
- Instituting effective transfer restrictions and other procedures designed to prevent purchases by unsophisticated investors;
- Consistently using of loan-specific terminology ("loan," "lender," "credit agreement"), rather than terminology common in securities offerings ("investor," "investments," "prospectus") in the documentation for syndicated term loans, and expressly stating that the securities laws do not apply to the transaction;
- Requiring lenders and transferees to represent that they (i) have had sufficient access to information to make their own credit analysis and decision; (ii) have made their own credit analysis and lending decision; and (iii) have not relied on the arrangers to evaluate the loans or enhance their value; and
- Involving original lenders that are subject to bank regulatory supervision.

NOTES:

[1] *Kirschner as Trustee of Millennium Lender Claim Trust v. JPMorgan Chase Bank, N.A.*, Blue Sky L. Rep. (CCH) P 75291, 2020 WL 2614765 (S.D. N.Y. 2020).

[2] *Reves v. Ernst & Young*, 494 U.S. 56, 110 S. Ct. 945, 108 L. Ed. 2d 47, Blue Sky L. Rep. (CCH) P 73213, Fed. Sec. L. Rep. (CCH) P 94939 (1990).

[3] *Kirschner*, at *6 ("[T]his Court accepts Plaintiff's assertion that *Reves* applies to Plaintiff's claims under California, Colorado, Illinois, and Massachusetts law").

[4] CLOs are special purpose vehicles that purchase syndicated loans from banks, pool them into tranches with differing credit risks, and then issue their own debt securities backed by the cash flows from each tranche.

[5] Amicus Brief, Loan Syndications and Trading Ass'n and Bank Policy Inst., *Kirschner v. J.P. Morgan Chase Bank, N.A.*, 2020 WL 230183 (S.D. N.Y. 2020) ("LSTA Brief"), at 4 ("the most important lenders in the syndicated term loan market [are] collateralized loan obligations ("CLOs"), which provide about 60% of the capital for such loans").

[6] LSTA Brief, at 18.

[7] The "Volcker Rule" is codified as Section 13 of the U.S. Bank Holding Company Act of 1956, as amended. The Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, and the Securities and Exchange Commission have adopted regulations to implement the Volcker Rule. *See Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds; Final Rule*, 79 F.R. 5536 (Jan. 31, 2014).

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[8]12 C.F.R. 248.2(s) ("*Loan* means any loan, lease, extension of credit, or secured or unsecured receivable that is not a security or derivative.").

[9]12 C.F.R. 248.2(y).

[10]For purposes of the Volcker Rule, "ownership interest" in a covered fund includes debt securities which confer the right to select and remove the covered fund's investment manager. In CLOs, typically the holders of the most senior "controlling class" of CLO debt have the right to remove the CLO's investment manager for cause and to select the successor manager. Banks typically hold the most senior class of CLO debt, which means that - if the CLO is a covered fund under the Volcker Rule - the bank could be deemed to hold an "ownership interest" in a covered fund.

[11]*Banco Espanol de Credito v. Security Pacific Nat. Bank*, 973 F.2d 51, Fed. Sec. L. Rep. (CCH) P 96,819 (2d Cir. 1992).

[12]*Reves v. Ernst & Young*, 494 U.S. 56, 65, 110 S. Ct. 945, 108 L. Ed. 2d 47, Blue Sky L. Rep. (CCH) P 73213, Fed. Sec. L. Rep. (CCH) P 94939 (1990).

[13]*Reves v. Ernst & Young*, 494 U.S. 56, 66, 110 S. Ct. 945, 108 L. Ed. 2d 47, Blue Sky L. Rep. (CCH) P 73213, Fed. Sec. L.Rep. (CCH) P 94939 (1990).

[14]*Banco Espanol de Credito v. Security Pacific Nat. Bank*, 973 F.2d 51, 55, Fed. Sec. L. Rep. (CCH) P 96,819 (2d Cir. 1992).

[15]*Kirschner*, at *8. While the borrower in *Kirschner* used the proceeds of the loan to repay debt and pay a dividend, certain other uses of proceeds should also be capable of constituting a "commercial purpose."

[16]*Reves v. Ernst & Young*, 494 U.S. 56, 66, 110 S. Ct. 945, 108 L. Ed. 2d 47, Blue Sky L. Rep. (CCH) P 73213, Fed. Sec. L. Rep. (CCH) P 94939 (1990).

[17]*Kirschner*, at *8.

[18]The transfer restrictions are included in the Credit Agreement, *Kirschner v. J.P. Morgan Chase Bank, N.A.*, 2020 WL 230183 (S.D. N.Y. 2020), Exh. A.

[19]*Kirschner*, at *10.

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