Pratt's Journal of Bankruptcy Law

LEXISNEXIS® A.S. PRATT®

APRIL-MAY 2024

Pratt's Journal of Bankruptcy Law

VOLUME 20	NUMBER 3	April-May 2024

LexisNexis

QUESTIONS ABOUT THIS PUBLICATION?

For questions about the **Editorial Content** appearing in these volumes or reprint permission, please call or email:

Ryan D. Kearns, J.D., at 513.257.9021
Email: .... ryan.kearns@lexisnexis.com

For assistance with replacement pages, shipments, billing or other customer service matters, please call:

Customer Services Department at . . . . (800) 833-9844
Outside the United States and Canada, please call . . . . (518) 487-3385
Fax Number . . . . (800) 828-8341
Customer Service Website . . . . http://www.lexisnexis.com/custserv/

For information on other Matthew Bender publications, please call

Your account manager or . . . . (800) 223-1940
Outside the United States and Canada, please call . . . . (937) 247-0293

Library of Congress Card Number: 80-68780
ISBN: 978-0-7698-7846-1 (print)
ISBN: 978-0-7698-7988-8 (eBook)
ISSN: 1931-6992

Cite this publication as:

[author name], [*article title*], [vol. no.] PRATT'S JOURNAL OF BANKRUPTCY LAW [page number] ([year])

Example: Patrick E. Mears, *The Winds of Change Intensify over Europe: Recent European Union Actions Firmly Embrace the "Rescue and Recovery" Culture for Business Recovery*, 10 PRATT'S JOURNAL OF BANKRUPTCY LAW 349 (2014)

Editorial Office
230 Park Ave., 7th Floor, New York, NY 10169 (800) 543-6862
www.lexisnexis.com

MATTHEW BENDER

(2024–Pub.4789)

Editor-in-Chief, Editor & Board of Editors

POSTMASTER: Send address changes to *Pratt's Journal of Bankruptcy Law*, LexisNexis Matthew Bender, 230 Park Ave. 7th Floor, New York NY 10169.

U.S. Court of Appeals for the Second Circuit Confirms That Syndicated Loans Are Not Securities

By Ken Rothenberg, Russell Chiappetta, Jason Cygielman and Thomas Kelly*

In this article, the authors discuss a decision by a federal appellate court affirming that syndicated terms loans are not securities.

In last year's biggest court case involving the $1.5 trillion syndicated loan credit market, the U.S. Court of Appeals for the Second Circuit affirmed the U.S. District Court for the Southern District of New York's decision in *Kirschner v. JP Morgan Chase Bank N.A.* holding that a syndicated term loan is not a "security" under the Securities Exchange Act of 1934 and the Securities Act of 1933.

The highly anticipated ruling upheld the historical convention and understanding of borrowers and lenders alike that syndicated loans are not securities. After the U.S. Supreme Court denied Kirschner's writ of certiorari in February 2024, the issue is settled: syndicated term loans are not securities.

THE CASE

The *Kirschner* case stemmed from a 2014 refinancing transaction where Millennium Laboratories LLC secured a syndicated term loan from various institutional investors. Millennium was the subject of a Department of Justice (DOJ) investigation during the loan syndication process and, after the loan closed, Millennium agreed to a DOJ settlement of more than $250 million, which contributed to Millennium filing for bankruptcy in 2015. Marc S. Kirschner was appointed as litigation trustee, and he brought suit against the defendants (as the arrangers for that syndicated loan) in the bankruptcy case with claims that included federal and state securities laws violations for failure to disclose the 2014 DOJ investigation.

In 2020, the district court dismissed the case on account of Kirschner failing to plausibly suggest that the Millennium loans were securities when applying the four-factor "family resemblance" test outlined by the U.S. Supreme Court in 1990 in *Reves v. Ernst & Young*.

Kirschner appealed to the Second Circuit in 2021, but the Second Circuit also utilized the *Reves* test in upholding the district court decision in a direct

* The authors, attorneys with Alston & Bird LLP, may be contacted at ken.rothenberg@alston.com, russell.chiappetta@alston.com, jason.cygielman@alston.com and thomas.kelly@alston.com, respectively.

and concise opinion. Under *Reves*, there is a presumption that a note is a security, though this presumption can be rebutted if the note bears a strong "family resemblance" to notes that are not characterized as securities.

THE "FAMILY RESEMBLANCE" *REVES* TEST

There are four factors of the "family resemblance" test weighed by courts to determine whether a note was issued in an investment context (and would be considered a security) or in a consumer or commercial context (when it would not be considered a security).

Motivations That Would Prompt a Reasonable Seller and Buyer to Enter into the Transaction

A court must determine whether the motivations of the seller and buyer are investment or commercial/consumer. The Second Circuit stated that a buyer's motivation is investment if it expects a profit from its investment (specifically highlighting that profit may be through variable or fixed-rate interest), while a seller's motivation is investment if it intends to raise capital for general business enterprise use or to finance significant investments (specifically highlighting that the seller's motivation is commercial if the loan is exchanged for "the purchase and sale of a minor asset or consumer good, to correct for the seller's cash-flow difficulties, or to advance some other commercial or consumer purpose").

While the Second Circuit reasoned that Millennium had commercial motivation due to its intent to use the syndicated loan to pay off a then-existing credit facility, the court also noted that the lenders' motivation was investment-driven due to the scheduled interest payments under the syndicated loan. Because of the mixed motivations of the parties, the Second Circuit intimated that, at the early stage of the *Kirschner* case, the first factor leaned in favor of the Millenium loans resembling securities.

Plan of Distribution of the Instrument

The court must look to the distribution plan of the instrument to determine whether it was offered and sold to a broad segment of the public. The Second Circuit highlighted that the lead arrangers offered the Millennium loan solely to institutional investors who would receive an allocation of the loan only after submitting a legally binding offer. The Second Circuit found that the loan syndication process was not a broad, unrestricted sale to the general public.

The Second Circuit also found unpersuasive Kirschner's argument that the existence of a secondary market for the Millennium loan demonstrated an offering to the general public. In particular, the court referenced credit agreement transfer restrictions, such as minimum transfer requirements, agent and borrower consent, and restricting transfer of the loans only to current lenders or affiliates of lenders. It further noted that such assignment restrictions were similar to those in the 1992 Second Circuit case *Banco Espanol de Credito v. Security Pacific National BankKirschner*, which concluded that loan participations were not securities because of the restrictions preventing participations from being sold to the general public.

The Second Circuit held these transfer restrictions coupled with the syndication procedure for Millenium "rendered [the loans] unavailable to the general public." Therefore, the second factor weighed in favor of the Millennium loans not being securities.

Reasonable Expectations of the Investing Public

This factor requires a court to examine the public's expectations for the notes. If the public was given sufficient notice that the notes were loans and not an investment in a business, then the loans are not securities. The Second Circuit highlighted that before purchasing the Millennium loan, the lenders certified that they were sophisticated and experienced in credit matters similar to the Millennium transaction and that they independently and without reliance on any agent or lender made their own determination whether to extend its portion of the Millennium loan. That certification was substantively identical to the certification made by the *Banco Espanol* participation purchasers, which was central to determining whether those buyers would have perceived the participations as securities.

Additionally, the Second Circuit rejected Kirschner's argument that the use of the term "investors" sporadically throughout the Millennium loan documents fostered a reasonable expectation among the lenders that they were investing in securities. Consequently, the Second Circuit found that the pleaded facts did not support the argument that the lenders reasonably believed the Millennium loans were securities.

Whether Some Factors Significantly Decrease the Instrument's Risk Rendering the Application of the Securities Act Unnecessary

The final factor requires the court to evaluate whether there is another regulatory scheme that substantially reduces the risk that the sale of the instrument will cause harm to the public, rendering application of the Securities Act unnecessary. Here, the Second Circuit found that there were other sufficient risk-reducing factors weighing against the loans qualifying as securities.

More precisely, the court pointed to the fact that the loans in *Kirshner* were secured by perfected security interests in all the borrower's tangible and intangible assets, reducing the risks associated with the notes.

Furthermore, the Second Circuit stated that the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation issued specific policy guidelines addressing syndicated term loans. The Second Circuit recognized that these guidelines were meant to reduce the risk to banks and, in doing so, also sought to reduce risk to consumers and investors. Taking into account the reduction of risk by way of the security interest and the regulatory guidelines, the court found the application of the Securities Acts unnecessary. Therefore, the pleaded facts did not support the claim that the Millennium loans were securities.

KEY TAKEAWAYS

Despite the Second Circuit ruling that the first factor weighed in favor of Kirschner, the remaining three factors were held to be in favor of the defendants and, consequently, the *Kirshner* decision was affirmed by the Second Circuit. That decision has been lauded as a major win for leveraged loan market participants because it validates the long-standing approach that syndicated loans are not securities. One item of note is that although the Second Circuit requested the position of the Securities and Exchange Commission, the SEC declined to submit a brief on the *Kirshner* question.

Had the *Kirshner* decision gone the other way, requiring market participants to comply with cumbersome securities laws requirements would have caused a monumental shift in loan issuance and trading. Characterizing loans as securities would severely impact secondary trading liquidity due to the enhanced transfer restrictions necessitated by securities laws, in addition to trading potentially requiring the use of registered broker-dealers. It is not uncommon for syndicated lenders to receive nonpublic information about a borrower, though if loans were deemed securities, then lenders may run into issues with remaining "public" in order to potentially still trade in that borrower's securities.

Additionally, applying securities laws to loans would require substantially more extensive due diligence on borrowers due to heightened disclosure requirements under securities laws. For borrowers, securities registration requirements would result in considerable additional time and costs and diminish the borrowers' control over the composition of the lender group and to whom material nonpublic must be disclosed.

Kirshner also highlighted the importance in properly drafting loan documentation to avoid loans potentially being characterized as securities. When issuing a syndicated loan, market participants should consider:

- Limiting the potential lender universe to sophisticated investors;
- Including clearly defined assignment provisions and consent requirements in loan documents, such as minimum transfer requirements and a definition of an eligible assignee;
- Adding language to the issuance documents reflecting the understanding that the notes being issued are loans and not investments in a business, while making it clear that the issuance is not considered a securities offering;
- Ensuring the loans are secured by collateral whenever possible; and
- Continuing to request bank regulators to issue and update guidance aimed at protecting consumers in the syndicated loan market.