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SDNY: Syndicated Loans Are Not Securities

Decision affirms long-standing market convention.

On May 22, 2020, Judge Gardephe of the US District Court for the Southern District of New York held that syndicated term loans do not constitute securities under various states' securities laws ("blue sky laws"), using an analysis developed under US federal law.[1] In so ruling, Judge Gardephe dismissed claims brought against arrangers of syndicated loans for alleged material misstatements and omissions contained in the marketing materials relating to the loans. In dismissing the claims, Judge Gardephe assumed the truth of the plaintiff's allegations and provided the plaintiff leave to amend its complaint to add claims for fraudulent misrepresentation, fraud, and conspiracy to defraud.

The ruling demonstrates that proper transaction planning is essential. Loan market participants should take care to continue to follow market practices designed to assure that syndicated loans are not mischaracterized as securities.

Background

In April 2014, a private laboratory services company completed a refinancing and dividend recapitalization while a government investigation and civil lawsuit were pending. The transaction was funded with US$1,825,000,000 in senior secured credit facilities, including US$1,775,000,000 in term loans marketed to institutional investors.[2] The defendants acted as arrangers for the syndicated credit facilities.

The company filed for bankruptcy protection in November 2015, after being held liable for damages in the civil lawsuit (in April 2014) and reaching a settlement with the federal government (in May 2015). A litigation trustee appointed by the bankruptcy court[3] brought claims against the defendants alleging, among other things, that the syndicated loans were securities under the blue sky laws of California, Massachusetts, Colorado, and Illinois, and that the defendants had violated such laws due to misstatements and omissions relating to the government investigation and the civil lawsuit in the marketing materials for the loans.[4]

Reves Analysis

In determining whether the syndicated loans constituted securities, Judge Gardephe applied the four-factor "family resemblance" test articulated by the US Supreme Court in 1990 in *Reves v. Ernst & Young* and concluded that the factual context of the syndicated loans overcame the legal presumption that notes are securities.[5] Judge Gardephe considered the four factors as follows:

1. ***Motivation of the seller and buyer of the debt instrument***.[6] Instruments resembling securities involve the seller using proceeds to finance investments and the buyer having a primary interest in the profits of those investments.[7] Judge Gardephe determined that the company ***did not*** have an investment-related motive in the loan transaction, because the proceeds were used to refinance debt and fund a dividend. He also determined that the lenders of the syndicated loans ***did*** have an interest in the profitability of the company.[8] As a result of the different motives of the parties, he did not give substantial weight to this factor.[9]

2. ***Plan of distribution of the debt instrument***. Judge Gardephe analyzed this factor using the methodology set out by the US Court of Appeals for the Second Circuit in 1992 in *Banco Espanol de Credito v. Security Pac. Nat'l Bank*.[10] *Banco Espanol* turned on whether an instrument was distributed to the "general public." While acknowledging that the company's syndicated loans were offered to hundreds of investment managers, Judge Gardephe concluded that this number was small relative to the general public. He also highlighted the following facts to support the conclusion that the plan of distribution was not to the general public: (i) consent would be required for further assignments to unaffiliated third parties, (ii) only institutional and corporate entities were solicited, (iii) transfers to natural persons were prohibited, and (iv) there was a "high absolute" US$1 million minimum investment amount.[11] The fact that there was an active secondary trading market for the loans did not alter Judge Gardephe's view that the distribution was not so broad as to constitute a public distribution because, as he noted, the transfer restrictions described above would still apply.[12]

3. ***Reasonable expectations of the investing public***.[13] In concluding that the investing public did not expect the syndicated loans to be securities, Judge Gardephe, again citing *Banco Espanol,* gave significant weight to the terminology used throughout the marketing materials and credit documentation for the syndicated loans, which consistently referred to "loans" and "lending" and "lenders" and not, conversely, to "securities" or "investors."[14] He rejected the litigation trustee's argument that market convention had shifted to such an extent that syndicated loans should be characterized as securities, noting that no other cases on record have come to that conclusion and that current market commentary is consistent in not endorsing that view.[15] Judge Gardephe also was not persuaded by the litigation trustee's argument that confidentiality provisions in the credit and marketing documents relating to the treatment of confidential information militated in favor of the loans being treated as securities. In his view, the fact that the lenders agreed to not use material non-public information for purposes other than their own credit analysis, or in connection with the administration of the loans, in no way suggested that US federal securities laws or state blue sky laws were implicated, or that the loans were intended to be treated as securities, noting that treatment of loans as securities and confidentiality restrictions are entirely separate concepts.[16]

4. ***Whether there is another regulatory scheme that reduces the investment risks associated with the instrument, thereby making application of securities laws unnecessary***.[17] Judge Gardephe, again citing *Banco Espanol* (which in turn distinguished the entirely unregulated scenario in *Reves*) concluded that since the sellers were subject to the oversight of the various federal banking regulators, the final *Reves* factor weighed in favor of not treating the sale of syndicated loans to sophisticated purchasers as securities.[18]

Other Claims

In addition to the state securities laws claims, the litigation trustee also brought a common law claim for negligent misrepresentation.[19] Applying New York common law, Judge Gardephe based his analysis on whether a "special relationship" existed between the defendants and the lenders and concluded that no such relationship existed.[20] Citing *UniCredito Italiano SPA v. JPMorgan Chase Bank*,[21] he emphasized that even if the defendants had asymmetric information about the company from the lenders, there was no special relationship, because the parties had separately agreed that the lenders would be making their own credit decisions.[22] Judge Gardephe was not persuaded by the litigation trustee's arguments that the defendants' role in the rating agency process, syndication efforts, and diligence process implied a special relationship and instead noted that the litigation trustee failed to allege that the defendants actively interfered with any lender's ability to make a credit decision.[23]

The litigation trustee also brought claims against the defendant who served as administrative agent for the syndicated loans, alleging breach of fiduciary duty, breach of contract, and breach of the implied covenant of good faith and fair dealing.[24] Judge Gardephe did not find these claims convincing against the explicit disclaimers in the credit agreement that expressly addressed these points. As a consequence, he dismissed these additional claims as well.[25]

Key Implications

The decision supports and reaffirms long-held market practice and expectation that syndicated loans are not securities under state blue sky or US federal securities laws, and represents a positive development for the continued stability of the syndicated lending market. The decision also demonstrates the importance of continuing to structure and document term loans in a manner that is designed to assure that the marketing of syndicated term loans is not mischaracterized as a securities offering.

In light of Judge Gardephe's observations with respect to the third *Reves* factor regarding current market expectations, the practices outlined below are among those that will help market participants continue to assure that syndicated loans are not mischaracterized as securities:

- Use "borrower," "lender," and "loan" terminology throughout the credit documentation, and avoid using the terms "issuer," "investor," or "notes" when referring to the instrument and the parties to the financing transaction.
- Limit syndication to corporate and institutional entities and prohibit assignments to natural persons.
- Require agent or borrower consent to assignment to unaffiliated third parties as appropriate.
- Require minimum dollar amounts for assignments.

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Endnotes

1 *Kirschner v. J.P. Morgan Chase Bank, N.A., et al.*, No. 17-CV-6334 (PGG) (SLC).

2 The court noted that the institutional investors consisted of seventy-one funds with over two hundred sub-accounts. See *Id*. at 7. However the court did not consider these sub-accounts as separate investors but rather "merely reflects the fact that sophisticated investors have complex corporate structures through which they arrange their business and financial affairs." See *Id*. at 17.

[3] Pursuant to the company's reorganization plan the lenders of the syndicated loans conveyed their claims against the defendants to the trust overseen by the litigation trustee. See Complaint at 7, *Kirschner v. J.P. Morgan Chase Bank, N.A., et al.*, No. 17-CV-6334.

[4] The Litigation Trustee brought claims under the securities laws of California, Massachusetts, Colorado, and Illinois and initially filed the claims in the Supreme Court of New York. The case was later remanded to the SDNY by the defendants pursuant to the Edge Act, 12 U.S.C § 632. See *Kirschner,* No. 17-CV-6334 at 2.

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

[6] *Id*. at 66.

[7] *Id*.

[8] *Kirschner,* No. 17-CV-6334 at 16.

[9] *Id*.

[10] *Banco Espanol de Credito v. Sec. Pac. Nat'l Bank*, 973 F.2d 51 (2d Cir. 1992).

[11] *Kirschner,* No. 17-CV-6334 at 17-18.

[12] *Id*.

[13] *Reves*, 494 U.S. at 66.

[14] *Kirschner,* No. 17-CV-6334 at 19.

[15] *Id*. at 20.

[16] *Id*.

[17] *Reves*, 494 U.S. at 67.

[18] *Kirschner,* No. 17-CV-6334 at 21.

[19] *Id* at 22.

[20] *Id* at 25, 29.

[21] *UniCredito Italiano SPA v. JPMorgan Chase Bank,* 288 F. Supp. 2d 485 (S.D.N.Y. 2003).

[22] *Kirschner,* No. 17-CV-6334 at 28.

[23] *Id.* at 25, 26.

[24] *Id.* at 31-35.

[25] *Id.*