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2nd Circ. Ruling Is Good For Syndicated Lending Stability

By **Daniel Seale, Jane Summers and Alfred Xue** (September 1, 2023, 2:47 PM EDT)

On Aug. 24, the U.S. Court of Appeals for the Second Circuit issued its highly anticipated decision in the case of Kirschner v. J.P. Morgan Chase Bank NA.[1]


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The three-judge panel unanimously upheld the district court's decision, and affirmed the long-standing market convention and expectation that syndicated term loans are not securities.

This article discusses the Second Circuit's decision, and provides some key takeaways for loan market participants in light of the decision.


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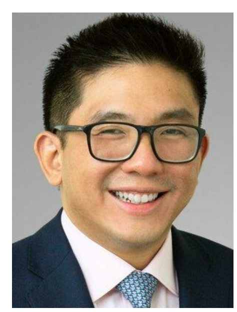
Above all, market participants should take care to continue to follow market practices designed to assure that syndicated loans are not mischaracterized as securities.

Background

In April 2014, Millennium Health LLC Inc., a private laboratory services company, completed a refinancing and dividend recapitalization while a government investigation and civil lawsuit were pending.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The transaction was funded with more than $1.8 billion in senior secured credit facilities, including over $1.7 billion 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 a related civil lawsuit in June 2014, and reaching a settlement with the government in May 2015.

Marc Kirschner, a litigation trustee appointed by the U.S. Bankruptcy Court for the District of Delaware,[3] brought claims against the defendants in the U.S. District Court for the Southern District of New York alleging, among other points, that the syndicated loans were securities under the securities laws of certain states — also known as blue sky laws — 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]

In 2020, the district court ruled that syndicated term loans were not securities under blue sky laws.[5]

Earlier this year, following a hearing, the Second Circuit entered an order asking the U.S. Securities and Exchange Commission to submit "any views [it] may wish to share" on whether the term loans referenced above are securities.

Notably, following the SEC's multiple motions for extensions of time, the SEC declined to submit a brief and weigh in on the subject, which the court took to suggest that the SEC did not see any need to revisit the court's 1992 holding in Banco Espanol de Credito v. Security Pacific National Bank,[6] in which the court had found that loan participations are not securities under federal law.

Discussion

The Second Circuit affirmed the Southern District of New York's decision to dismiss the plaintiff's state law securities claims, concluding that the district court properly dismissed claims brought against arrangers of syndicated loans for alleged material misstatements and omissions contained in the marketing materials for the loans, because the plaintiff failed to plead facts plausibly suggesting that syndicated loans are securities.[7][8]

Reves Analysis

In determining whether the district court erroneously dismissed the plaintiff's state law securities claims, the Second Circuit reviewed the case de novo and applied the four-factor "family resemblance" test articulated by the U.S. Supreme Court in 1990 in Reves v. Ernst & Young.[9]

The Second Circuit considered the four factors as follows.

1. Motivation of the Seller and Buyer of the Debt Instrument

While the parties' motivations were mixed, the court determined that the first Reves factor[10] weighed in favor of concluding the complaint plausibly alleged that the term loans were securities because the lenders unquestionably "expected to profit from their purchase of the [syndicated loans]" and "receive a 'valuable return' on their purchase of the [term loan]," both indicators of an investment motive.[11]

In its analysis, the court examined the transaction to assess whether the motivations of the seller and buyer were either investment — suggesting securities — or commercial, suggesting nonsecurities.[12]

On the one hand, the Second Circuit reasoned that the lenders expected to profit from the term loan because they "were entitled to receive quarterly interest payments over the course of seven years," indicating an investment motive.[13]

On the other hand, the Second Circuit determined that the company's motivations were not investment-focused, as it was not using the proceeds to grow the business and instead planned to repay its outstanding credit facility, pay a dividend to equity holders, pay bonuses to directors and officers, and retire other funded debt.

Ultimately, the Second Circuit concluded that, on balance, this factor weighed in favor of finding that the complaint plausibly alleged that the term loan was a security.[14]

2. Plan of Distribution of the Debt Instrument

The court determined that the second Reves factor weighed against concluding that the complaint plausibly suggested that the term loans were securities because they were offered in the primary syndication to a limited universe of potential lenders, and secondary market transfers were constrained by virtue of restrictions on assignment.[15]

The Second Circuit examined the plan of distribution of the term loans to determine whether they were instruments "'in which there is common trading for speculation or investment.'"

The court noted that this factor would weigh in favor of determining that the term loans were securities if they were offered and sold to a broad segment of the public.[16]

The court highlighted the following facts to support the conclusion that the plan of distribution was not a plan to distribute to the general public:

- There were robust trading restrictions in the secondary market, including a prohibition on the term loans being held by natural persons;
- Assignments to any nonlender required the consent of both the company and the administrative agent; and
- The minimum assignment amount was generally $1 million.[17]

The fact that there was an active secondary trading market for the loans did not alter the Second Circuit's view that the distribution was not so broad as to constitute a public distribution because, as the court noted, the collective impact of the transfer restrictions described above would prevent the term loans from being sold to the general public.[18]

3. Reasonable Expectations of the Investing Public

The Second Circuit found that the third Reves factor[19] weighed against concluding that the complaint plausibly suggested that the term loans were "securities because the lenders were sophisticated and experienced institutional entities with ample notice that the [term loans] were not securities."[20]

In examining the reasonable expectations of the investing public, the court gave significant weight to the sophisticated nature of the lenders, reasoning that since the lenders were required to certify that they were experienced in extending credit to entities like the company, and that they had conducted their own diligence, the lenders could not have reasonably perceived the loans to be securities.[21]

The court was not persuaded by the argument that the fact that the loan documents at times referred to the buyers as "investors" weighed in favor of the loans being treated as securities.[22]

In the court's view, "isolated references to 'investors' ... could not have plausibly created the reasonable expectation that the buyers were investing in securities."[23]

4. Presence of Another Regulatory Scheme That Reduces the Investment Risks

The court reasoned that the fourth and final Reves factor — whether there is another regulatory scheme that reduces the investment risks associated with the instrument, thereby making application of securities laws unnecessary[24] — weighed against concluding that the complaint plausibly suggested that the term loans were securities because both (1) "they were secured by collateral," and (2) "federal [banking] regulators have issued specific policy guidance addressing syndicated loans."[25]

First, the court reasoned that since the term loans were secured by first-priority liens on most of the company's assets, the risk associated with purchasing the term loans was reduced.

Second, the court emphasized that all of the principal federal banking regulators — i.e., the Office of the Comptroller of the Currency, the Federal Reserve System and the Federal Deposit Insurance Corp. — have issued policy guidelines for syndicated loans that those regulators have made clear are designed not only to assure safety and soundness in the banking system, but also to protect consumers.

Key Implications

The Second Circuit's decision supports and reaffirms long-held market practice and expectation that syndicated loans are not securities under state blue sky or U.S. 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 the Second Circuit'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.

- Continue to adopt clearly defined plans of syndication and distribution that focus on a limited universe of lenders and not the broader investing public. Limit syndication to corporate and institutional entities and prohibit assignments to natural persons.

- Continue to require agent or borrower consent to assignment to unaffiliated third parties as appropriate.

- Require minimum dollar amounts for assignments.

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

[2] The court noted that the institutional investors consisted of 71 funds with over 200 sub-accounts. See Kirschner, No. 17-CV-6334 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." SeeId. 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] Kirschner v. JP Morgan Chase Bank, N.A., et al., No. 17-CV-6334 (PGG) (SLC).

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

[7] Id.

[8] The Second Circuit made the following passing observation, "The parties agree that to determine whether the Notes [sic] are 'securities,' we should apply the test enunciated by the US Supreme Court in Reves."[8] The court then explained that Reves is used to determine whether syndicated loans are securities under federal securities laws, and noted without comment that plaintiff did not bring any claims under the federal statutes, and accepted plaintiff's assertion that Reves applies to the state law claims.

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

[10] Id. at 66.

[11] Kirschner, No 21-2726, at 28-29.

[12] Id. at 26

[13] Id. at 28.

[14] Id. at 28-29.

[15] Kirschner, No 21-2726, at 38.

[16] Reves, 494 U.S. at 66 (internal quotation marks and citations omitted).

[17] Kirschner, No 21-2726, at 29-30.

[18] Id. at 31.

[19] Reves, 494 U.S. at 66.

[20] Kirschner, No 21-2726, at 38.

[21] Id at 33.

[22] Id.

[23] Id. at 34.

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

[25] Kirschner, No. 21-2726 at 39.