Loans Are Not Securities — Widely Accepted Premise Underpinning the Syndicated Loan Market Reconfirmed

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The Second Circuit Court of Appeals recently issued an eagerly awaited decision in *Kirschner v. JP Morgan Chase Bank, N.A.,*[1] which reconfirmed the widely accepted view that loans are not securities under federal or state securities laws. A decision to the contrary would have had a substantial negative impact on the approximately $2.4 trillion syndicated loan market and altered the way loans are arranged, underwritten, syndicated, and traded.

Background

The *Kirschner* case arose out of a $1.775 billion term loan made to Millennium Health LLC in 2014, while a government investigation and civil lawsuit with a competitor were pending against Millennium. Millennium used the term loan primarily to refinance an existing credit facility and complete a dividend recapitalization.

Millennium filed for bankruptcy relief in 2015 after losing the civil lawsuit and agreeing to a settlement with the government. In the bankruptcy case, the litigation trustee appointed by the bankruptcy court brought claims against various defendants who had acted as agents and arrangers for the 2014 financing. The litigation trustee alleged, among other things, that the term loans constituted securities under various state "blue sky" securities laws and that the defendants had violated such laws by failing to provide adequate information about the government investigation.

In May 2020, the United States District Court for the Southern District of New York ruled that the term loans were not securities and dismissed the plaintiff's case. The appeal to the Second Circuit Court of Appeals followed, and on August 24, 2023, the Second Circuit issued a decision affirming the District Court's dismissal of the plaintiff's securities law claims.

Second Circuit Decision

All of the parties in the case agreed that the proper test for determining whether the term loans were securities was the four-part test enunciated by the Supreme Court in 1990 in *Reves v. Ernst & Young*.[2] The test begins with the presumption that every note is a security but then directs the courts to look at the following four factors to determine whether the note is in fact a security:

(1) **the motivation of the parties** – examination of whether the transaction was motivated by investment (*i.e.,* did the buyer expect to profit, suggesting a security) or commercial purposes (*i.e.,* did the transaction advance some commercial purpose, suggesting a loan);

(2) **plan of distribution** – whether the notes were offered and sold to a broad segment of the general public or to a limited universe of sophisticated institutional entities;

(3) **reasonable expectation of investors** – whether the participants in the market understood the instrument to be a security or a loan; and

(4) **existence of other risk-reducing factors that render the application of securities laws unnecessary** – such as the existence of other regulatory schemes or collateral securing the instrument.

The Second Circuit found that three of the four *Reves* factors led to the conclusion that the term loan was not a security, with only the first factor (motivation of the parties) indicating that the loans could be securities because the buyer and seller had mixed motivations for entering into the transaction.

Possible Disruption Avoided

If the term loan in the *Kirschner* case had been recharacterized as a security, it would have resulted in significant uncertainty and disruption of the current practices and conduct in the active syndicated loan market. Among other things that could be called into question include whether:

- arrangement and syndication of loans would be subject to registration requirements or assurances that the issuance of the loan was exempt from registration;
- syndications, distributions, and trading of loans would have to be conducted through broker-dealers;
- the standard of liability and burden of proof applicable to securities for misrepresentations or material omissions would apply to loans (currently, liability for material representations with respect to loans are governed by common law standards of fraud);
- lenders with access to syndicate-level information, which may contain material non-public information, would not be able to trade loans based on "big-boy" letters, as is the current practice;
- expanded borrower information that lenders receive as compared to bond holders would likely be reduced;
- secondary loan trades would be subject to mandated reporting, margin, net capital, settlement period, and other regulatory requirements for settling securities trades; and
- non-bank participants in the syndicated loan market may have to register as brokers or dealers with the Securities and Exchange Commission.

The Second Circuit's *Kirschner* decision, however, reaffirms the fundamental view and expectation that loans are not securities, a premise which has underpinned the operations of the active syndicated loan market.

For More Information

We are available at any time to answer questions, discuss scenarios, and provide guidance. Please do not hesitate to reach out to us with any questions or concerns.

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1 *Kirschner v. JP Morgan Chase Bank, N.A. et al.*, No. 21-2726 (2d Cir. Aug. 24, 2023); 2023 WL 5439495.

2 *Reves v. Ernst & Young*, 494 U.S. 56, 110 S. Ct. 945, 108 L. Ed. 2d 47 (1990).

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