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Court Holds that Syndicated Bank Loan Is Not a "Security"

Federal and state securities laws generally apply only to instruments that qualify as "securities." The question of whether a particular instrument is a security, therefore, can have significant and far-reaching consequences. Nearly 30 years ago, in *Banco Espanol de Credito* v. *Security Pacific National Bank*, the Second Circuit Court of Appeals held that certain loan participations at issue in that case were not securities.[1]

Although the syndicated loan market has grown substantially since then, courts have only rarely had occasion to consider whether a syndicated loan qualifies as a security (and thus falls within the scope of federal and state securities laws). That question was squarely presented in *Kirschner* v. *JPMorgan Chase Bank, N.A. et al*, a case pending in the Southern District of New York, and on May 22, 2020, U.S. District Judge Paul Gardephe held that syndicated bank loans were not securities.[2] Judge Gardephe noted in his decision that he had not identified any decisions from other courts concluding that a syndicated bank loan was a security, and he rejected the plaintiffs' argument that changes in the syndicated loan market compelled a different conclusion.

Kirschner arose out of a $1.775 billion syndicated loan transaction in which several banks served as lenders to Millennium Laboratories LLC ("Millennium"), a private company, and then syndicated the loan to a group of approximately 70 institutional investors. Shortly after the transaction was completed, Millennium lost a significant litigation involving alleged kickbacks and entered into a settlement with the U.S. Department of Justice to resolve alleged violations of the False Claims Act. Millennium thereafter filed for bankruptcy, and the bankruptcy trustee filed a lawsuit against the banks, claiming they had, among other things, violated state securities laws (so-called "blue sky" laws) by making misrepresentations to investors, including falsely assuring investors that Millennium had no exposure to material litigation.

The defendants moved to dismiss the complaint for failure to state a claim, arguing that a syndicated bank loan is not a "security" under the state securities laws and that a loan syndication is not a "securities distribution." In response, the plaintiffs argued that syndicated loans are "markedly different" from the loan participations at issue in *Banco Espanol*.[3] According to the plaintiffs, *Banco Espanol* "anticipated that evolving ways of marketing bank loans to downstream investors . . . would create instruments constituting

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1 *Banco Espanol de Credito* v. *Security Pacific National Bank*, 973 F.2d 51, 56 (2d Cir. 1992).

2 *Kirschner* v. *JPMorgan Chase Bank, N.A.*, No. 17 Civ. 6334 (PGG), 2020 WL 2614765 (S.D.N.Y. May 22, 2020).

3 Pl. Memo. of Law in Op. to Defs.' Mot. to Dismiss, *Kirschner*, No. 17-Civ.-06334 (PGG), 2020 WL 2614765, at 23.

securities under [the U.S. Supreme Court's decision in *Reves* v. *Ernst & Young*]."[4] The plaintiffs argued that the market had in fact evolved such that the syndicated bank loans at issue in *Kirschner* had essentially transformed into high-yield bonds, which are firmly recognized as securities and therefore subject to federal and state securities laws.[5]

The Loan Syndications and Trading Association ("LSTA") and the Bank Policy Institute ("BPI") filed an amicus brief arguing that syndicated bank loans are not securities under federal or state securities laws. They warned of upending a market where participants have long operated with the understanding that loans are not securities, and cautioned the court against "jeopardiz[ing] a trillion-dollar-plus market that is vital to the economy" by holding that syndicated bank loans are securities.[6]

On May 22, 2020, Judge Gardephe granted the defendants' motion to dismiss, holding that the syndicated bank loan at issue was not a security.[7] The Court applied the "family resemblance" test established by the United States Supreme Court in *Reves* to determine whether a debt obligation is a security. In *Reves*, the Supreme Court instructed that courts begin with a presumption that every note is a security, because the Securities Act definition of a security includes "any note."[8] The Court also adopted, however, the Second Circuit's "list of instruments commonly denominated 'notes' that nonetheless fall without the 'security' category," including, among others: the note delivered in consumer financing, the note secured by a mortgage on a house, the short-term note secured by a lien on a small business, and notes evidencing loans by commercial banks for current operations.[9] The presumption that a note is a security may be overcome if the note at issue bears a strong family resemblance to one of the enumerated categories of instruments excluded from the definition of a security.[10]

The four factors of the family resemblance test are: (1) The motivations that would prompt a reasonable seller and buyer to enter in the transaction (i.e., the commercial purpose for seeking lending by the borrower, and the nature of the return expectations of the lender); (2) the breadth of the plan of distribution

4 *Id*. at 2.

5 *Id*. at 17.

6 Br. of Amici Curiae the Loan Syndications and Trading Assoc. and the Bank Policy Inst., *Kirschner*, No. 17-Civ.-06334 (PGG), 2020 WL 2614765, at 17.

7 Although the complaint alleged state securities law claims under California, Colorado, Illinois, and Massachusetts law, the Court deemed *Reves* applicable to the plaintiffs' claims.

8 *Reves* v. *Ernst & Young*, 494 U.S. 56, 63 (1990).

9 *Id*. at 65.

10 *Id*. at 63—64.

of the instrument; (3) the reasonable expectations of the investing public; and (4) the existence of another regulatory scheme to reduce the risk of the instrument.

Applying those factors to the facts at issue in *Kirshner*, Judge Gardephe found each of them either mixed or weighing against the conclusion that the syndicated loans at issue in the case are securities. As to the first, the Court held that the motivations of the buyers and sellers were mixed, so that factor did not weigh significantly in either direction. As to the second, the Court found that the relatively narrow plan of distribution caused this factor to weigh heavily in favor of a finding that the syndicated loans were not securities. Citing *Banco Espanol,* the Court observed that a note is not a security where the plan of distribution prevented the loan participations from being sold to the general public, and in this case, as noted, there was a relatively narrow plan of distribution.

As to the third factor, the Court agreed with the defendant banks that the credit agreement would lead a reasonable investor to believe that the notes constituted loans, not securities. The agreement repeatedly referred to the underlying transaction documents as "loan documents" and repeatedly referenced "lenders and potential lenders" rather than "investors." The Court also noted that it was unable to find any other decision holding that a syndicated term loan was a security. According to the Court, the plaintiffs' claim of a shift in market expectations as to the treatment of syndicated loans was "premature."

Finally, the Court found that the existence of an alternative regulatory scheme for syndicated loans caused the fourth *Reves* factor also to weigh in favor of a finding that the notes were not securities. Judge Gardepehe concluded that interagency guidance and other measures taken by the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Federal Reserve Board constituted a sufficient "regulatory scheme."

In recent years, due to the growth and evolution of the syndicated loan market, including the increased prevalence of secondary-market transactions, some have questioned whether the longstanding view that syndicated bank loans are not securities should be revisited. The *Kirschner* decision, however, reaffirms the common market understanding that loan participations are generally not considered securities. While this decision may signal a general unwillingness to classify such instruments as securities, the ruling is highly fact-specific. The Court applied the traditional *Reves* framework for evaluating whether a debt instrument is a security, which turns in part on the reasonable expectations of the investing public. As such, any shift in investors' expectations could affect future court decisions.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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