Articles + Publications | October 9, 2023

Locke Lord QuickStudy: Are Term Loan Notes Securities? Court ?Confirms Longstanding Market View ?They Are Not

Locke Lord LLP

WRITTEN BY

Andrew K. Truong | Jason Ulezalka | Jonathan W. Young

Introduction

On August 24, 2023, the United States Circuit Court of Appeals for the Second Circuit (the "Second Circuit") decided *Kirschner v. JP Morgan Chase Bank, N.A.*,[1] addressing the issue of whether notes issued as part of a syndicated loan transaction are "securities" under state securities laws. This case represented a challenge to the longstanding market view that loans are not securities. Had the court not upheld this understanding, this case would have had broad implications on the syndicated loan market, subjecting sales of loans to SEC regulation and registration requirements and forcing market participants to rework their approach to loan diligence, syndication, and trading. Ultimately, however, the Second Circuit affirmed the district court's holding that loans are not securities, avoiding confusion and disruption in the syndicated loan market, and affirming the reasonable market expectations of term loan participants.

Case Overview

The *Kirschner* case stemmed from a $1.8 billion syndicated term loan facility entered into in 2014 (the "Transaction") by Millennium Health LLC, Inc., a California-based drug testing company ("Millennium"). In November 2015, Millennium filed for Chapter 11 bankruptcy. In August 2017, the appointed trustee for the Millennium Lender Claim Trust[2] filed suit in the New York Supreme Court for New York County. The suit alleged in part that the notes syndicated in connection with the Transaction (the "Notes") were securities and, as such, that the defendants violated various state securities laws due to misrepresentations and omissions in the marketing materials for the Transaction relating to a prior government investigation into and a prior civil lawsuit against Millennium. In May 2020, the District Court for the Southern District of New York dismissed the plaintiff's claims, ruling that the Notes were not securities under state securities laws. The plaintiff then appealed the district court's decision to the Second Circuit on October 28, 2021. Notably, though the Second Circuit asked the U.S. Securities and Exchange Commission to submit its views as to whether the Notes were securities, the commission declined to do so, leaving the Second Circuit to determine the classification of the Notes as a *de novo* question of law.

***Reves* Four-Factor Test**

Prior caselaw has addressed the question of whether loans are securities, including the 1990 Supreme Court case *Reves v. Ernst & Young*[3] and the 1992 Second Circuit case *Banco Espanol de Credito v. Security Pacific National*

Bank.[4] In *Kirschner*, the Second Circuit stated that the four-part "family resemblance test" established in *Reves* and adopted in *Banco Espanol* remained the appropriate standard to determine whether the Notes were securities. The four factors of this test are:

1. "[T]he motivations that would prompt a reasonable seller and buyer to enter into the transaction;
2. [T]he plan and distribution of the instrument;
3. [T]he reasonable expectations of the investing public; and
4. [W]hether some factor such as the existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering application of the Securities Acts unnecessary."[5]

In applying these factors in *Kirschner*, the Second Circuit reached the conclusion that the syndicated term loan notes were *not* securities. The Second Circuit's analysis of these factors is well reasoned and informative, and offers practical guidance for as to how transactions in the syndicated loan market can avoid the implication that they amount to an offering of securities.

1. <u>Motivations of the Seller and Buyer</u>. The court must examine the transaction at issue, and determine whether the motivations of the seller and buyer are "investment" (suggesting a security) or "commercial" (suggesting not a security). A buyer's motivation is "investment" if they expect to profit from the transaction, including through earning interest. A seller has an "investment" motivation if the purpose of the transaction is to raise money for the general use of a business enterprise or to finance substantial investments. The Second Circuit cited *Reves* in providing examples of a "commercial" motivation for a buyer, including if "the note is exchanged to facilitate 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." Here, the Second Circuit found mixed motivations: Millennium's intended use of the Notes (including repaying outstanding debt and making shareholder distributions) suggested a commercial purpose, whereas the lenders' motivations (i.e., the expectation of earning a profit from their purchase of the Notes) suggested an investment purpose. The Second Circuit ultimately decided this factor weighed in favor of finding the Notes to be securities.
2. <u>The Plan of Distribution</u>. An instrument is considered a security if "offered and sold to a broad segment of the public," but not if there are limitations preventing it from being sold to the general public.[6] Here, the Second Circuit found this factor militated against the Notes being considered securities. Millennium only offered the Notes to sophisticated institutional entities. Also, while a secondary trading market for the Notes existed, the Notes carried several assignment restrictions that precluded their sale to the general public: assignments were subject to both Millennium and the administrative agent's prior written consent, a $1 million minimum assignment amount threshold, and a prohibition on assignments to natural persons. The Second Circuit also noted these assignment restrictions were similar to those used in *Banco Espanol*, where it was held that resales of loan participations without the express written consent of the issuer prevented the participations from being sold to the general public.
3. <u>The Investing Public's Reasonable Perceptions</u>. If buyers are given "ample notice that the instruments were…loans and not investments" then this suggests they are not securities.[7] Here, the Second Circuit found that the participating lenders did have sufficient notice the Notes were in fact loans and thus not securities. The Millennium loan documents almost exclusively referred to the note purchasers as "lenders" aside from certain isolated references to "investors." Further, the lenders also certified they were "sophisticated and experienced in extending credit to entities"[8] similar to Millennium and that they made their own independent appraisal and investigation of Millennium. The Second Circuit also noted this certification was "substantively identical" to the

purchasers' certification in *Banco Espanol*, where such lender certification was central to the court's determination of the loan participations as not being securities.

4. Whether Other Risk Reducing Factors Render the Application of Securities Laws Unnecessary. The fact that an instrument is secured by collateral and governed by specific policy guidelines issued by federal banking regulators indicated that securities laws are not necessary to govern the instrument in question. Here, the Second Circuit found that both these factors were present, further supporting the conclusion that the Notes are not securities. The Notes were secured by a perfected first priority security interest in Millennium's assets. Further, the Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, and Federal Deposit Insurance Corporation issued specific policy guidelines addressing syndicated term loans. The Second Circuit noted that, while these guidelines aim to minimize risks to banks, they also protect customers.

Practical Implications for Market Participants

Ultimately, in affirming the longstanding view that syndicated term loans are not securities, this case offers practical insight into how to avoid the issue for borrowers and lenders alike. Below are some guidelines to help market participants ensure loans avoid classification as securities.

1. *Assignment restrictions.* The Second Circuit found the assignment restrictions on the Notes crucial to its decision finding that these instruments were not securities. Examples of such restrictions that market participants can utilize include (i) limiting assignments to institutional entities (i.e., prohibiting assignments to natural persons); (ii) requiring prior written consent of the borrower and the administrative agent for an assignment; and (iii) establishing a minimum dollar threshold for assignments, all of which are consistent with current prevailing practice in the syndicated loan market.
2. *Lender certifications.* Lenders should certify that they are sophisticated entities that have conducted their own independent diligence surrounding the relevant loans. A best practice to avoid ambiguity is to include an acknowledgment in loan documentation that (i) the loans are not securities and that securities laws do not apply to them and (ii) the loans serve a commercial, rather than investment, purpose.
3. *Collateral.* Establishing a security interest over collateral for a syndicated loan is an indication that securities laws may be inapplicable to such a loan. Accordingly, unsecured loans may be at greater risk as being classified as securities under the *Reves* analysis.
4. *Intentional and consistent terminology.* Market participants should use terms like "borrower, "lender", and "loan" in loan documentation consistently, rather than terms like "issuer", "investor", and "investment".

A syndicated loan transaction following these best practices may well be able to claim safe harbor from securities regulation under the authority of the *Kirschner* decision—particularly in the Second Circuit jurisdictions of New York, Connecticut and Vermont. And even where *Kirschner* is not binding authority, the decision's precise delineation of the *Reves* factors offers a clear road map for how to avoid syndicated term loan notes being recharacterized as securities.

—

[1] *Kirschner v. JP Morgan Chase Bank, N.A. et al*., No 21-2726, 2023 WL 5437811 (2d Cir. Aug. 24, 2023)

[2] This trust was established for the benefit of lenders who purchased term loan notes and hold claims in the Millennium bankruptcy proceeding. *See Kirschner* at *16.

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

[4] *Banco Espanol de Credito v. Sec. Pac. Nat'l Bank*, 972 F.2d 51 (2d Cir. 1992).

[5] *Kirschner*, at *8.

[6] *Reves*, 494 U.S. at 68.

[7] *Banco Espanol*, 973 F.2d at 55.

[8] *Kirschner*, at *11.

RELATED INDUSTRIES + PRACTICES

- Corporate
- Financial Services
- Financial Services Litigation
- Private Equity
- Real Estate Finance