Articles + Publications | March 14, 2023

Second Circuit Hears Oral Argument RE Whether Syndicated Loans Are Securities

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The U. S. Court of Appeals for the Second Circuit heard oral arguments on March 9 in Kirschner. A reversal of the lower court's holding — that syndicated loans as an asset class are not securities for purposes of securities law — could dramatically alter the landscape for commercial lenders and borrowers participating in the $2.5 trillion syndicated loan market.

The appeal revisits the 2020 U. S. District Court for the Southern District of New York decision that the syndicated loans in question are not securities and are not subject to the more stringent disclosure rules under so-called "blue-sky" state securities laws. The Second Circuit is expected to issue an opinion soon after oral argument concludes.

Background

In analyzing the question of whether debt obligations are securities, the lower court in *Kirschner* applied the four-factor "family resemblance" test first articulated by the Supreme Court in *Reves v. Ernst & Young*.[1] The test presumes that every note is a security other than certain enumerated categories of notes and notes bearing a strong family resemblance to one of those categories.

Using the four factors in *Kirschner*, the lower court held that the debt obligations in that case did not constitute securities. The lower court granted the defendant's motion to dismiss all claims in May 2020. In October 2021, the plaintiff, a trust representing the investors (trustee), filed an appeal with the Second Circuit to have the lower court decision overturned.

Oral Argument Key Takeaways

The three-judge panel on the Second Circuit noted that the SEC and federal regulators did not appear in the case, inferring the SEC's and federal regulators' implicit support of the status quo. The panel questioned why the SEC had not interjected if the SEC believed that the lower court had decided incorrectly. One judge stated that "if the SEC thought as a matter of law that this [interpretation] was unsettling the markets in a way that was inconsistent with their understanding of the term "security" vs. "loan," you would think they would have weighed in." He continued that the SEC could have filed an amicus brief or been "right where [the trustee was] standing" if the SEC thought securities laws were improperly interpreted.

The panel emphasized that over the last 30 years, neither the SEC nor other federal regulators, such as the Office of the Comptroller of Currency, the Federal Deposit Insurance Commission, or the Federal Bank, have passed

restrictions on activities in the syndicated loan market.

The panel acknowledged the existence of regulatory guidance and the sophistication of investors, inferring that Securities Act protections are unnecessary. In 2020, the lower court decided that 2013 federal interagency banking guidance constituted a regulatory scheme governing the investment. Although the trustee argued that the interagency guidance was inapplicable, the panel did not seem persuaded. One judge went as far as to ask and answer the question: "[I]s this regulated by some government entity and I think the answer to that is, yes."

The defense argued that loan participants were "institutional entities that buy and trade loans all the time, every day, in large quantities," which did not need the same Securities Act protections as "John and Sally Q. Public." The investors were capable of, and the record showed that they performed, diligence to decide whether to make the investment. The panel returned to this argument and asked the defense to walk them through the evidence a second time.

A through line in the panel's questioning was the need for efficiency. The trustee argued that discovery was necessary for the defendants to rebut the presumption that the notes are a security, and therefore, the lower court should not have dismissed the case without allowing discovery. The panel did not appear convinced. One judge recited the facts in the pleadings, concluding that the facts sufficiently established that the notes are not a security, and the court had a right to dispose of the issue without discovery. The panel also reminded the trustee that one of the *Reves* factors is an objective test. As such, the court is not expected in every case to allow discovery to determine the motivations of the parties involved.

In another example, one judge questioned whether investors spend resources under the assumption that their investments are not coming under securities law. While acknowledging that the significant size of the syndicated loan market may lead to instability due to a lack of regulation, the judge considered that the market's size may indicate that market participants knowingly make investment decisions based on regulators' laissez faire approach. She noted that the market's size may argue for less waste than would arise in a regulatory environment.

Conclusions

Regulations, like those applicable to high-yield bonds, entail extra risk. Regulations also carry administrative burdens and costs arising from compliance issues. If loans were securities, investors would pass on these risks and costs to borrowers in the form of higher pricing, stricter terms, and narrower access to capital. These changes would upset the reasonable, settled expectation of market participants that loans as an asset class are not regulated securities, and would lead to inefficiencies in the market.

The Second Circuit panel seemed resistant to interfere with the syndicated loan market where the SEC and federal regulators had to date been unwilling to do so. Although the panel questioned whether the size of the market called for greater scrutiny, the panel implied that regulators could step in if they wanted to do so, and in their absence, sophisticated investors have participated in the market on the basis of this lack of regulation, without the need for Securities Act protections.

[1] 494 U.S. 56 (1990).

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