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UPDATE: Second Circuit May Answer Loans Securities Question in Kirschner Appeal

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A 2020 case that held that syndicated loans as an asset class are not securities for purposes of the securities laws is making a return to the spotlight as an appeal threatens to upend the decision.

In *Kirschner v. JPMorgan Chase Bank, N.A.*[1], the lower court held that the loans in question were not securities and thus were not subject to state and federal securities laws. While the decision offered relief within the commercial lending industry, in October 2021, the plaintiff filed an appeal to the Second Circuit to have the decision overturned. With oral argument set to begin in fall 2022, the result of the appeal could have serious implications for commercial lenders and borrowers.

Background

In *Kirschner*, around 70 institutional investors purchased $1.775 billion in debt obligations of Millennium Laboratories LLC from the defendant lenders in 2014. Millennium filed for bankruptcy in 2015. As part of Millennium's bankruptcy plan, investors' claims against the defendants were assigned to a trust.

Among various other claims, the bankruptcy trustee alleged that the debt obligations constituted securities, and thus were subject to the more stringent disclosure rules under the so-called "blue sky" state securities laws. The defendants moved to dismiss the securities laws claims on the grounds that a syndicated bank loan is not a security, and a loan syndication is not a securities distribution.

In analyzing the question of whether the debt obligations were securities, the lower court applied the "family resemblance" test first articulated by the Supreme Court in *Reves v. Ernst & Young*.[2] The Supreme Court in *Reves* provided that any analysis into whether a note is a security must begin with the presumption that every note is a security apart from certain enumerated categories of notes, as well as notes bearing a strong family resemblance to one of those categories.

According to *Reves*, the family resemblance test consists of four factors: (1) the motivations of the parties to enter the transaction, (2) the plan of distribution of the instrument in question, (3) the reasonable expectations of the investing public with respect to the instrument in question, and (4) the existence of another regulatory scheme to reduce the risk of the investment, thus making the Securities Act protections unnecessary.

After finding that three of the four factors in the family resemblance test weighed in favor of rebutting the presumption that the debt obligations were securities, the lower court held that the debt obligations did not constitute securities and granted the defendant's motion to dismiss all claims in May 2020.

Update

In October 2021, the trustee filed an appeal with the Second Circuit to have the lower court decision in the motion to dismiss overturned. The Loan Syndications and Trading Association (LSTA), Bank Policy Institute, U.S. Chamber Litigation Center, and the Securities Industry and Financial Markets Association together filed an amici curiae brief in connection with the appeal, supporting the argument that syndicated loans as an asset class are not securities, and therefore, should not be subject to state and federal securities laws. The Second Circuit is expected to issue an opinion soon after oral argument concludes this fall.

Potential Impact

The outcome of the appeal could have a profound effect on the syndicated loan market. With over $1 trillion in syndicated loans currently circulating in the U.S., the consequences could impact not just the commercial loan industry, but also the global economy.

Borrowers and lenders would be required to comply with state and federal securities laws and the rules and regulations of securities industry organizations, such as FINRA, if syndicated loans were securities. Secondary market trading activity would need to involve a registered broker-dealer who is also subject to securities regulations. Parties receiving compensation from a loan transaction would need to determine whether they needed to register as broker-dealers. The additional securities regulations compliance would entail extra risk, as well as administrative burdens and costs.

Compliance costs would likely be passed on to borrowers because lenders have little incentive to absorb them. Lenders may also be more hesitant to fund loans to borrowers because of the added compliance risk, thereby making it more difficult for borrowers to access debt financing and to negotiate flexible terms. Approved deals would slow to a pace more suitable for the comprehensive due diligence and disclosures required in a hyper-regulated environment where added liability becomes another issue.

Moreover, loans are originated and traded in the syndicated loan market based on confidential information or material nonpublic information shared with lenders by borrowers. Lenders can choose whether to opt out of receiving such information, so they can continue to trade in the borrower's securities. When a lender that opts out trades with a lender that has material nonpublic information about the borrower, the former acknowledges such informational disparity and that it is relying on its own due diligence in entering the transaction. Securities regulators frown on these savings provisions because the provisions are seen as a way to skirt the disclosure requirements of securities laws.

If syndicated loans are deemed securities, lenders may opt out of such confidential disclosures, and borrowers would not be able to provide lenders with private financial and corporate information. Lenders will find due diligence more difficult, and borrowers will be hamstrung in their ability to find capital.

The decision could also influence the collateralized loan obligation (CLO) market. CLOs are single securities backed by a pool of debt. The asset portfolios of many CLOs are limited by the number of securities permitted to be held as part of the portfolio. As a result, many CLOs hold mostly syndicated loans based on the premise that syndicated loans are loans and not securities. If loans are considered securities, then CLOs would reach their limits earlier, which could negatively impact the CLO market.

Takeaways

The decision in *Kirschner* validated the reasonable, settled expectations of market participants that loans as an asset class are not securities. Market participants should pay close attention to the outcome of the *Kirschner* appeal. The analysis under *Reves* and *Kirschner* is fact-based, and a case bearing different facts could produce a different result, and individual loans may still be classed as a security under the *Reves* test. Furthermore, this opinion is not binding authority in other jurisdictions.

Parties should not take for granted that court decisions will always confirm the expectations of market participants and observers. Parties hoping to avoid any potential fallout from additional regulation of their transactions should remain vigilant in structuring and documenting loan transactions to fall safely within the confines of the *Reves* test, even if the Second Circuit affirms.

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[1] 2020 WL 2614765 (S.D.N.Y. 2020).

[2] 494 U.S. 56 (1990).

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