ALERT MEMORANDUM

SDNY Holds Syndicated Loans Are Not Securities, Rejecting Challenge That Threatened To Disrupt $2 Trillion Market During COVID-19 Crisis

May 26, 2020

The syndicated loan market is a crucial component of capital formation in the United States, comprising a net volume of $2.4 trillion in 2019.[1] Under the current regulatory regime, loans are not treated as securities. In *Kirschner v. J.P. Morgan Chase, et al.*,[2] the plaintiff challenged these well-settled expectations by trying to bring state securities law claims based on the syndication of a rated term-loan facility. However, on May 22, 2020, the Southern District of New York rejected these claims and reaffirmed the widely held understanding that syndicated loans are not securities. Relying heavily on the Second Circuit's 1992 decision in *Banco Español de Crédito v. Security Pacific Nat'l Bank*, 973 F.2d 51 (2d Cir. 1992), which held that similar "loan participations" were not securities, the Court held that syndicated loans are just that—loans and not securities.

The *Kirschner* decision is particularly significant given its timing during the current COVID-19 crisis, which threatens to increase loan defaults and limit access to the capital markets. *Kirschner* is therefore doubly important, as it may head off meritless securities litigation concerning the performance of existing syndicated loans impacted by the COVID-19 crisis at a time when many potential borrowers have a heightened need for liquidity.[3]

If you have any questions concerning this memorandum, please reach out to your regular firm contact or the following authors.

NEW YORK

David C. Lopez
+1 212 225 2632
dlopez@cgsh.com

Carmine D. Boccuzzi Jr.
+1 212 225 2508
cboccuzzi@cgsh.com

Jeffrey D. Karpf
+1 212 225 2864
jkarpf@cgsh.com

Margaret (Meme) S. Peponis
+1 212 225 2822
mpeponis@cgsh.com

Duane McLaughlin
+1 212 225 2106
dmclaughlin@cgsh.com

Jared Gerber
+1 212 225 2507
jgerber@cgsh.com

Hugh C. Conroy Jr.
+1 212 225 2828
hconroy@cgsh.com

[1] Bloomberg, Global Syndicated Loans League Tables, FY 2019, at 6, https://data.bloomberglp.com/professional/sites/10/Bloomberg-Global-Syndicated-Loans-League-tables-FY-2019.pdf.

[2] *Kirschner v. J.P. Morgan Chase, et al.*, 17-cv-06334 (PGG) (S.D.N.Y. May 23, 2020).

[3] Cleary Gottlieb submitted an amicus brief on behalf of the Bank Policy Institute in support of the defendants in *Kirschner*.

clearygottlieb.com
© Cleary Gottlieb Steen & Hamilton LLP, 2020. All rights reserved.
This memorandum was prepared as a service to clients and other friends of Cleary Gottlieb to report on recent developments that may be of interest to them. The information in it is therefore general, and should not be considered or relied on as legal advice. Throughout this memorandum, "Cleary Gottlieb" and the "firm" refer to Cleary Gottlieb Steen & Hamilton LLP and its affiliated entities in certain jurisdictions, and the term "offices" includes offices of those affiliated entities.

Background

The dispute in *Kirschner* arose out of a $1.775 billion syndicated loan transaction that closed on April 16, 2014.[4] In that transaction, several banks assigned portions of a term loan made to Millennium Laboratories LLC ("Millennium") to about 70 institutional investor groups, including approximately 400 mutual funds, hedge funds and other institutions, evidenced by notes (the "Notes").[5] After Millennium filed for bankruptcy in November 2015, the investors' claims were contributed to the Millennium Lender Claim Trust ("Plaintiff"), which filed a complaint in August 2017 against the arranging banks asserting claims under several state securities laws and the common law.[6]

The complaint alleged that Millennium, a California-based private company that provided laboratory-based diagnostic testing of urine samples for physicians, violated various federal laws prior to the loan transaction. In particular, the complaint contended that the United States Department of Justice ("DOJ") began investigating Millennium for violations of federal healthcare law in March 2012, and that one of Millennium's competitors alleged that Millennium violated the Stark Law (42 U.S. Code § 1395nn) and the Anti-Kickback Statute (42 U.S.C. § 1320a-7(b)(b)) by providing various services and benefits to physician customers (including free supplies) contingent on referrals of certain amounts of urine tests to Millennium.[7] Subsequently, after the completion of the April 2014 syndicated loan transaction at issue, Millennium finalized a $256 million global settlement with the DOJ on October 16, 2015, which led to its defaulting on the loan and filing for bankruptcy protection.[8]

On this basis, the complaint alleged that the defendant banks ("Defendants") involved in the loan made misstatements and omissions actionable under state securities laws because the offering materials failed to disclose Millennium's underlying wrongdoing.[9] The complaint also alleged claims for common law negligent misrepresentation, breach of fiduciary duty, breach of contract, breach of post-closing contractual duties and breach of the implied covenant of good faith and fair dealing.[10]

On June 28, 2019, Defendants moved to dismiss the complaint, contending in part that the loan was not a security subject to state securities laws. Plaintiff opposed that motion, arguing that the loan was a security or that the determination of whether it was "is a fact intensive question and generally not appropriately resolved on a motion to dismiss."[11] Cleary Gottlieb submitted an amicus brief on behalf of the Bank Policy Institute in support of Defendants.

Motion to Dismiss Decision

On May 22, 2020, the District Court granted Defendants' motion to dismiss in its entirety, including holding that Defendants had "overcome" the "presumption that the Notes are securities . . . under the facts of this case."[12]

In reaching this ruling that the syndicated loan at issue was not a security, the Court applied the "family resemblance" test in *Reves v. Ernst & Young*, 494 U.S. 56 (1990).[13] In *Reves*, the Supreme Court held that "because the Securities Acts define 'security' to include 'any note,'" courts "begin with a presumption

[4] "A syndicated loan is a commercial credit provided by a group of lenders," and is "structured, arranged, and administered by one or several commercial or investment banks, known as arrangers." S&P Global Market Intelligence, *Syndicated Loans: The Market and the Mechanics* 1 (2017), https://www.lcdcomps.com/d/pdf/LCD%20Loan%20Primer.pdf.

[5] *Kirschner* at 2.

[6] *Id.* at 2, 9.

[7] *Id*. at 3-4.

[8] *Id.* at 9.

[9] *Id.* at 9-11.

[10] *Id.*

[11] *Id.* at 14.

[12] *Id.* at 22.

[13] For purposes of resolving Defendants' motion to dismiss, the Court accepted Plaintiff's assertion that *Reves* applied to Plaintiff's state law securities claims. *Kirschner* at 13.

that every note is a security."[14] However, *Reves* recognized that many specifically identified "instruments commonly denominated 'notes' . . . nonetheless fall without the 'security' category," including "notes evidencing loans by commercial banks for current operations," among others.[15] *Reves* therefore held that the presumption that a note is a security "may be rebutted . . . by a showing that the note bears a strong [family] resemblance . . . to one of the enumerated categories."[16]

The four factors of this "family resemblance" test are:

1. the motivations that would prompt a reasonable seller and buyer to enter into [the transaction];
2. the plan of distribution 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, rendering application of the Securities Acts unnecessary.[17]

The Court in *Kirschner* concluded that three of the four "family resemblance" factors weighed strongly in favor of the Notes not qualifying as securities, and that the fourth factor did not weigh determinatively in either direction.

Motivations of the Seller and Buyer. The Court found that this factor did not weigh heavily in either direction, because the seller and buyer's motivations were mixed. In particular, the Court stated that under *Reves*, where "the seller's purpose is to raise money for the general use of a business enterprise or to finance substantial investments . . . the instrument is likely to be a 'security,'" but where "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 … the note is less sensibly described as a 'security.'"[18] From Millennium's perspective, the purpose of the Notes was to advance "some other commercial purpose": repayment of other outstanding loans and payment of a dividend.[19] However, from the buyer's perspective, the Court concluded that buyers appeared to have investment intent.

Plan of Distribution. The Court found that this factor weighed strongly in favor of the Notes not being securities, relying on the Second Circuit's holding in *Banco Español* that a loan participation was not a security where the "plan of distribution . . . worked to prevent the loan participations from being sold to the general public."[20] The District Court likewise found that the assignment restrictions in the loan "worked to prevent the loan participations from being sold to the general public," and that the solicitation of investment managers, solely from institutional and corporate entities, constituted a relatively small number compared to the general public.[21] The Court also found that Plaintiff had not successfully pleaded that the fact that the loan assignments subsequently traded in a secondary market significantly broadened the distribution of the loan.[22]

Reasonable Expectations of the Investing Public. The Court similarly found that this factor weighed in favor of the Notes not being securities under *Banco Español* because the governing documents distributed to potential investors made clear to the parties that they were participating in a lending transaction, not investing in securities.[23]

[14] *Reves*, 494 U.S. at 65.

[15] *Kirschner* at 13-14 (quoting *Reves,* 494 U.S. at 65, 67).

[16] *Id*. at 14 (quoting *Reves*, 494 U.S. at 67).

[17] *Reves*, 494 U.S. at 66-67.

[18] *Kirschner* at 16 (quoting *Reves*, 494 U.S. at 66).

[19] *Id.*

[20] *Id.* at 16-18 (citing *Banco Español*, 973 F.2d at 55).

[21] *Kirschner* at 17.

[22] *Id.* at 18.

[23] *Id.* at 19 (citing *Banco Español*, 973 F.2d at 55, in which notes were not classified as securities because borrowers "were given ample notice that the instruments were participations in loans and not investments in a business enterprise").

Existence of Another Regulatory Scheme. Again relying on *Banco Español*, the Court agreed that the specific policy guidelines addressing the sale of loans issued by the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation and the Federal Reserve Board were sufficient to constitute another regulatory scheme, precluding the need for the securities law to apply to the transaction.[24]

Conclusion. In weighing these factors, the Court also stressed that "Plaintiff has cited no case in which a court has held that a syndicated term loan is a 'security,' and this Court has found no such case in its review of *Reves* and its progeny. Given these circumstances, Plaintiff's claim of a shift in the market are [*sic*] premature at best."[25]

In sum, the Court concluded that "the limited number of highly sophisticated purchasers of the Notes would not reasonably consider the Notes 'securities' subject to the attendant regulations and protections of Federal and state securities law."[26] Instead, the Court stated "it would have been reasonable for these sophisticated institutional buyers to believe that they were lending money, with all of the risks that may entail, and without the disclosure and other protections associated with the issuance of securities."[27] Accordingly, the Court held that Defendants had overcome the presumption that the Notes evidencing the loan were securities and granted their motion to dismiss the state securities law claims on that basis.

Implications

While not unexpected in light of the Second Circuit's prior *Banco Español* decision, *Kirschner* is a significant ruling in that it reaffirmed nearly three decades of settled market expectations that syndicated loans are not securities and rejected a challenge that threatened to disrupt the trillion-dollar market for syndicated loans. A contrary holding subjecting syndicated loans to the securities laws could have fundamentally altered this market, by making it more expensive and time-consuming for companies to borrow and reducing the flexibility that both borrowers and arrangers have in quickly accessing the loan market as a source of capital. Even a more modest ruling declining to consider the issue at the motion to dismiss stage could have been hugely disruptive, by subjecting market participants to costly and burdensome discovery in securities litigation before confirming that the loans at issue were not securities.

Although the Court in *Kirschner* also granted Plaintiff leave to amend its complaint, noting the possibility that some of the defects identified in its decision could be cured, it appears unlikely that any amendment could change the bases on which the Court concluded that the syndicated loan at issue was not a security. Moreover, the features of the Millennium loan that led the Court to conclude it was not a security are common across the syndicated loan market. Thus, even though the Court limited its ruling to "the facts of this case," the decision should serve as important precedent and reaffirmation for other syndicated loan transactions.

Finally, *Kirschner*'s refusal to classify syndicated loans as securities is particularly important in the context of the current COVID-19 crisis. A decision subjecting such loans to securities regulation could have chilled that market at a time when many potential borrowers have a heightened need for liquidity. Similarly, a ruling permitting securities claims to proceed concerning syndicated loans could have led to a flood of costly and meritless litigation in an attempt to recover losses caused by the current crisis, rather than any underlying fraud.

…

CLEARY GOTTLIEB

[24] *Id.* at 21 (citing *Banco Español*, 973 F.2d at 55-56).

[25] *Id.* at 20.

[26] *Id*. at 22.

[27] *Id.*

* New York associate Ye Eun Charlotte Chun contributed to the preparation of this Alert Memorandum.