ALERT MEMORANDUM

Second Circuit Affirms Syndicated Loans Are Not Securities, Avoiding Market Disruption

September 21, 2023

On August 24, 2023, the Second Circuit affirmed the dismissal of state-law securities claims in *Kirschner v. JP Morgan Chase*,[1] concluding that the plaintiff failed to adequately plead that the syndicated term loans at issue were securities. This decision avoids large-scale disruption across a number of aspects of the $2.5 trillion syndicated loan market[2], including the daily functioning of bank lenders, the secondary loan trading market, the creation of loan participations and the markets for related investments such as loan funds and collateralized loan obligations.

Prior to this ruling, the Second Circuit had sought guidance from the SEC on the issue, but the SEC declined to provide an opinion on the matter.[3]

The case has been closely watched because a pronouncement by the SEC that syndicated loans were securities or a decision to that effect by the Court could have led to significant uncertainty and market disruption in the syndicated loan market, and could have encouraged similar suits against other arrangers. While the Court's decision avoids these negative outcomes, it will likely cause arrangers of leveraged loans and perhaps borrowers to pay additional attention to the syndication process and the disclosures provided to potential assignees of leveraged loans. It remains to be seen whether the decision will have any effect on the overall convergence of terms between high yield bonds and widely syndicated leveraged loans that has been in process for more than a decade, or if there will be any effect on loans to investment grade borrowers.

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

Sabrina Singer
+1 212 225 2792
ssinger@cgsh.com

Anirudh Sivaram
+1 212 225 2389
asivaram@cgsh.com

Allison Caramico
+1 212 225 2459
acaramico@cgsh.com

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

[2] Reuters, *SEC Punts on Whether Syndicated Loans are Securities, in Closely Watched Appeal* (2023), https://www.reuters.com/legal/transactional/column-sec-punts-whether-syndicated-loans-are-securities-closely-watched-appeal-2023-07-19/.

[3] *Id.*

clearygottlieb.com
© Cleary Gottlieb Steen & Hamilton LLP, 2023. 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] The loan at issue in this matter is generally referred to as "Term Loan B"—a relatively widely syndicated term loan with terms similar to those of high yield bonds. Several banks assigned portions of the term loan made to Millennium Laboratories LLC ("Millennium") to institutional investor groups, including mutual funds, hedge funds and other institutions. The loans were evidenced by notes (the "Notes").[5] After Millennium filed for bankruptcy in November 2015, the Millennium Lender Claim Trust ("Plaintiff") filed a complaint in August 2017 on behalf of the Note investors against the arranging banks asserting claims under several state securities laws and the common law.[6]

After the completion of the April 2014 syndication, Millennium finalized a $256 million global settlement regarding various allegations of federal healthcare and anti-kickback violations with the Department of Justice on October 16, 2015, which led to its filing for bankruptcy protection.[7] On this basis, the complaint alleged that the defendant arranging banks ("Defendants") made misstatements and omissions actionable under state securities laws because the offering materials failed to disclose Millennium's underlying wrongdoing.[8]

On June 28, 2019, Defendants moved to dismiss the complaint, contending in part that the syndicated 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."[9]

The District Court's Decision

On May 22, 2020, the district court granted Defendants' motion to dismiss in its entirety, including holding that Plaintiff had failed to adequately allege that the syndicated loan was a security.[10]

In determining that the syndicated loan at issue was not a security, the district court applied the "family resemblance" test of *Reves v. Ernst & Young*, 494 U.S. 56 (1990).[11] In *Reves*, the Supreme Court held that "because the Securities Acts define 'security' to include 'any note,'" courts "begin with a presumption that every note is a security."[12] 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.[13] *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

[4] A syndicated loan is a commercial credit provided by a group of lenders that is arranged by one or more commercial or investment banks.

[5] *Kirschner as Tr. of Millennium Lender Claim Tr. v. JPMorgan Chase Bank, N.A.*, No. 17 CIV. 6334 (PGG), 2020 WL 2614765, at *1 (S.D.N.Y. May 22, 2020).

[6] *Id.* Plaintiff brought claims under the state-securities statutes of California, Colorado, Illinois, and Massachusetts. *Id.* at *5.

[7] *Id.* at *5.

[8] *Id.*

[9] *Id.* at *7 (internal quotation marks omitted).

[10] *Id.* at *10. Plaintiff subsequently moved for leave to file a proposed amended complaint with respect to its common law claims, which was denied on September 30, 2021. *Kirschner as Tr. of Millennium Lender Claim Tr. v. JPMorgan Chase Bank, N.A.*, No. 17 CIV. 6334 (PGG), 2021 WL 4499084 (S.D.N.Y. Sept. 30, 2021). For more coverage of the district court's decision, please refer to Cleary Gottlieb's previous Alert Memorandum, "SDNY Holds Syndicated Loans Are Not Securities, Rejecting Challenge That Threatened To Disrupt $2 Trillion Market During COVID-19 Crisis," published May 26, 2020. https://www.clearygottlieb.com/news-and-insights/publication-listing/sdny-holds-syndicated-loans-are-not-securities.

[11] *Kirschner*, 2020 WL 2614765 at *6. For purposes of resolving Defendants' motion to dismiss, the district court accepted Plaintiff's assertion that *Reves*, which considered the definition of a "security" for the purposes of the federal securities laws, applied to Plaintiff's state law securities claims. *Id.*

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

[13] *Id.*

the" categories of excluded instruments.[14]

The four considerations to be addressed when comparing an instrument to other excluded instruments under the "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. other risk-reducing factors, including the existence of another regulatory scheme, to render the application of the Securities Acts unnecessary.[15]

Two years after *Reves* was decided, the Second Circuit applied the family resemblance test to loan participations in *Banco Español de Crédito v. Security Pacific National Bank*, 973 F.2d 51 (2d Cir. 1992), and found they were not securities.[16]

Almost thirty years later, the district court in *Kirschner*, relying on *Banco Español*, applied the *Reves* factors, concluding that the second, third, and fourth factors weighed strongly in favor of the syndicated loans at issue not qualifying as securities, and that the first factor did not weigh determinatively in either direction.[17] Accordingly, the district court granted Defendants' motion to dismiss the state securities law claims. Plaintiff appealed.

The Second Circuit's Affirmance

On August 24, 2023, the Second Circuit affirmed the district court's holding: Millennium's syndicated loan was not a security,[18] thereby maintaining long-held market expectations that syndicated loans are loans and not securities. In its opinion, the Second Circuit refers to the syndicated loans as "Notes" although it bears noting that in most Term Loan B syndications promissory notes are only provided at the option of the lender and therefore lenders do not receive a promissory note to evidence their loan.

Considering whether the district court properly dismissed the state-law securities claims on the basis that the syndicated loan Notes were not securities, the Court first rejected Plaintiff's argument that because "determining whether a note is a 'security' is 'fact-intensive,' it is 'not appropriately resolved on a motion to dismiss.'"[19] The Court held "[t]hat a claim is fact-intensive does not preclude dismissal under Rule 12(b)(6) if the plaintiff fails to allege facts plausibly supporting a claim upon which relief can be granted."[20] Thus, like the district court, on *de novo* review the Second Circuit applied the *Reves* factors:

Motivations of the Parties. Examining the complaint, the Court found that the "lenders' motivation was investment because the lenders expected to profit from their purchase of the Notes."[21] But, the Court held, Millennium's motivation was commercial in nature because the loan from which the Notes were syndicated was not meant to raise funds for its business or to finance its investments, but rather to pay back outstanding debt, to make a shareholder distribution, and to pay back fees and expenses related to the loan transaction itself.[22] Accordingly, the Court concluded that "the parties' motivations were mixed"

---

[14] *Id.* at 67.

[15] *See id.* at 66.

[16] *Banco Español*, 973 F.2d at 55–56.

[17] *Kirschner*, 2020 WL 2614765 at *10.

[18] *Kirschner v. JP Morgan Chase Bank, N.A.*, No. 21-2726, 2023 WL 5437811, at *1 (2d Cir. Aug. 24, 2023). Before reaching the question of whether the loan was a security, the Court initially determined that it had jurisdiction over the action pursuant to the Edge Act, 12 U.S.C. § 632, which would provide for federal jurisdiction so long as the action was (1) of a civil nature, (2) at least one party to the suit was an Edge Act bank or corporation, and (3) the suit arose out of international or foreign banking. *Id.* at *6. Plaintiff challenged only the final element: whether defendant bank JP Morgan Chase had itself engaged in international or foreign banking in the loan transaction. *Id.* at *7. The Court held that JP Morgan Chase had satisfied the third element by directly assigning its interest in Millennium's loan to foreign lenders. *Id.* at *7.

[19] *Id.*

[20] *Id.*

[21] *Id.* at *9 (italics omitted).

[22] *Id.*

such that on a motion to dismiss, the first *Reves* factor "tilts in favor" of Plaintiff.[23]

The Plan of Distribution. Because the defendant banks had offered the Notes "*only* to sophisticated institutional entities" and proceeded to allocate the Notes to sophisticated institutional entities exclusively, the Court held that "the pleaded facts do not plausibly suggest the Notes were 'offered and sold to a broad segment of the public.'"[24]

The Court rejected Plaintiff's argument that the presence of a secondary market meant that the Notes were offered and sold to a broad segment of the public. The Court pointed to several restrictions on the assignment of the Notes that "rendered them unavailable to the general public," including that the Notes could not be assigned to a "natural person," that they could not be assigned without prior written consent from both Millennium and JP Morgan Chase (with some limited exceptions), nor could an assignment be for more than $1 million unless it was to a lender, a lender's affiliate, or an approved fund.[25]

The Court further rejected Plaintiff's arguments that Millennium's loan restrictions were distinguishable from the loan in *Banco Español*, which had only 11 investors rather than the 400 institutional investment entities that participated in the syndication of Millennium's loan, concluding that the loan here similarly restricted the general public from participating as in *Banco Español*.[26] Thus, the Court concluded that the second *Reves* factor weighed against concluding that the Notes are securities.

The Public's Reasonable Perceptions. Evaluating whether the lenders or purchasers would have reasonably perceived the Notes as securities, the Court held that the "sophisticated" purchasers were provided "ample notice" that the Notes were investments in a business enterprise rather than securities.[27] In particular, the Court looked to certifications by the loan participants that they independently "made their own appraisal of an investigation into the business, operations, property, financial, and other condition and creditworthiness of Millennium and made their own decision" to lend.[28] Again, the Court relied on *Banco Español* noting that "[t]his certification is substantively identical" to the certification made by purchasers in that case, "which was central to our determination that the buyers there could not have reasonably perceived the loan participations as securities."[29] Moreover, the Court rejected Plaintiff's assertion that the occasional reference in the loan documents to the buyers as "investors" was indicative that the buyers expected that the Notes were securities.[30] The Court noted that the loan documents "more consistently refer to the buyers as 'lenders'"—aligning more with the understanding that the Notes were not securities.[31] Thus, the Court held that the third *Reves* factor weighed against the conclusion that the Notes are securities.[32]

Other Risk-Reducing Factors. The final *Reves* factor considers whether there are other risk-reducing considerations such that imposing the regime of the Securities Acts becomes unnecessary. In particular, this factor looks to whether another regulatory scheme applies and whether the instrument is secured by collateral or is insured.[33]

The Court noted that here the Comptroller of the Currency, the Federal Reserve and the FDIC had specific policy guidelines addressing syndicated loan

[23] *Id.*

[24] *Id.*

[25] *Id.*

[26] *Id.* at *10.

[27] *Id.*

[28] *Id.* at *11 (alterations omitted).

[29] *Id.*

[30] *Id.*

[31] *Id.*

[32] In a slight departure from the analysis of the district court, the Second Circuit was unpersuaded by the argument that, because a court had not yet held that a syndicated term loan was a security, a court could *never* find that the reasonable expectations of the investing public could be such that a loan could be a security. *Id.* at n.104. The Court emphasized that instead of making sweeping generalizations about all loans, courts should look to the economics of each particular loan transaction, as *Reves* instructs.

[33] *See id.* at*11.

terms.[34] In addition, the Notes were secured by a perfected first-priority security interest in tangible and intangible assets of Millennium.[35]

On this basis, the Court rejected Plaintiff's arguments that those factors may have minimized risks to the defendant banks but not the risks to non-bank lenders (who were not directly regulated under such a banking regulatory scheme).[36] The Court explained that it had previously been unpersuaded by that same argument in *Banco Español*, citing to policy statements by bank regulators indicating that the purpose of their guidelines is to protect consumers.[37] The Court further explained that the SEC had submitted an amicus brief in *Banco Español* that argued for the application of the Securities Act to loan participations because, in its view at the time, the guidelines issued by the Comptroller of the Currency were insufficient to render the Securities Act unnecessary—a position that Court found unpersuasive in that case.[38] Here, the Court noted that it had solicited views on whether the Notes were securities in this case from the SEC, but after granting several extensions of time for the SEC to respond with its views, the SEC notified the Court that it was "not in a position to file a brief."[39] As such, neither Plaintiff nor the SEC offered a compelling reason to revisit its ruling on this point from *Banco Español*. The fourth *Reves* factor therefore weighed against concluding that the Notes are securities.

With three of the four factors weighing clearly against concluding that the complaint plausibly pleads the Notes are securities under *Reves*' "family resemblance" test, the Court held that the district court properly dismissed Plaintiff's state-law securities claims, such that the case would not proceed to discovery.[40]

Key Takeaways

In affirming the district court's ruling, the Second Circuit maintained the present regulatory framework under which syndicated term loans do not constitute securities. A different ruling could have caused significant disruption to the syndicated term loan market, based on a number of factors including securities registration and disclosure requirements; requirements for broker-dealer (rather than bank) involvement in syndicating, distributing and transferring loans; and application of a broad securities law framework not amenable to loan transactions. Effects could have included limiting financing opportunities for smaller or privately held companies that are not in a position to access the capital markets for debt.

Nevertheless, to minimize the risk of other loans being viewed as securities, we expect to see arrangers and borrowers in the Term Loan "B" market, which is the mostly widely distributed loan market, be more disciplined around their disclosure practices so that the disclosures provided to potential lenders distinguishes the loans from securities even more clearly. In particular, legal boilerplate and legends should be specific to the loan context and differentiated from similar disclosures in the bond context. Lenders may also seek to use the decision to argue that the terms of these loans should be more distinct from high yield bonds than they are in the current market, although that was not a point of emphasis for the Second Circuit.

We do not expect the decision to affect traditional commercial lending, which includes the vast majority of loans to investment grade borrowers, whether in the form of a revolver, bridge loan or term loan. Similarly, we would not expect the decision to have a significant impact on syndication and disclosure practices for "pro rata" or Term Loan "A" loans, which are amortizing loans often made to non-investment grade borrowers that are originated and held by commercial banks, although we could see lenders under those facilities seeking to further distinguish the terms of their loans from Term Loan "B" loans in reaction to this challenge to the status of Term Loan "B" facilities presented by

[34] *Id.* at *12.

[35] *Id.*

[36] *Id.*

[37] *Id.*

[38] *Id.*

[39] *Id.* at n.117.

[40] *Id.* at *13.

Kirschner.[41]

It remains to be seen if the decision will further feed the growth of the direct lending market, which has exploded from a largely middle market product to a real competitor to the Term Loan "B" market. Direct loans generally are not subject to broad syndication and instead are originated and held by non-bank lenders, such as funds. To the extent that the larger commercial banks are shier about providing commitments for Term Loan "B" facilities as a result of the decision, direct lending may have the upper hand. At the same time, it is worth noting that the Court's decision in *Kirschner* relies, in part, on the fact that the commercial banks originating the syndicated loans are subject to a scheme of regulation to which direct lenders are generally not subject, rendering the latter potentially more susceptible to challenges of this sort.

Finally, a key aspect of the Court's decision relies on the existence of restrictions on assignments of loans. In fact, loan settlement is significantly less efficient than settlement for bonds or other types of securities because such restrictions require borrower or agent bank approval. It is possible that the decision could have a chilling effect on efforts to improve the liquidity of the loan market by changing how settlements are completed.

…

CLEARY GOTTLIEB

[41] Pro Rata Term Loans or Term Loan "A" loans generally include additional terms such as a financial covenant that are no longer present in most broadly syndicated Term Loan "B" loans. Notwithstanding this, in recent years some of the more borrower-favorable provisions in the Term Loan "B" market have carried over to this market as well.