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# Second Circuit Rules That Syndicated Term Loans Are Not Securities

**On August 24, 2023, the U.S. Court of Appeals for the Second Circuit held in *Kirschner* v. *JP Morgan Chase Bank, N.A. et al.*[1] that certain syndicated term loans[2] at the center of a transaction involving JP Morgan Chase and other banks were not securities under state law. While the Second Circuit did not foreclose the possibility that syndicated term loans could be securities under different circumstances,[3] for now *Kirschner* cements the long-standing view — following *Banco Espanol de Credito* v. *Security Pacific National Bank*[4] — that syndicated term loans are generally not treated as securities.**

## I. Factual and Procedural Background

In March 2014, JP Morgan Chase, Citibank, Bank of Montreal, and SunTrust Bank ("the Arrangers") signed a commitment letter with Millennium Laboratories ("Millennium") to fund a $1.775 billion financing through a term loan.[5] Millennium intended to use a portion of the financing to repay $304 million of a term loan provided by the same financial institutions two years earlier.[6] Proceeds would also be used to fund dividends and bonuses to Millennium directors, officers, and controlling shareholders of approximately $1.27 billion and the redemption of warrants, debentures, and stock options.[7]

The Arrangers syndicated the term loans to 61 "parent" lenders, many of which sub-allocated the loans to funds they managed, such that the number of individual legal entities constituting lenders would total approximately 400.[8] JP Morgan Chase funded the entire principal of the term loans on the closing date, and after the closing date assigned the term loans to the lenders. Pursuant to assignment agreements, the assignee lenders assumed all of JP Morgan Chase's rights and obligations with respect to the term loans.[9]

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[1] *Kirschner* v. *JPMorgan Chase Bank, N.A. et al.,* 2023 WL 5437811 (2d Cir. Aug. 24, 2023).

[2] "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." *Kirschner* v. *JPMorgan Chase Bank, N.A. et al.,* 2020 WL 2614765, at *1 (S.D.N.Y. May 22, 2020), *aff'd* 2023 WL 5437811 (2d Cir. Aug. 24, 2023)

[3] *Kirschner*, 2023 WL 5437811 at *11 n.104.

[4] 973 F.2d 51 (2d Cir. 1992). In *Banco Espanol*, the Second Circuit held that loan participations are not securities under federal law. *Id*. at 55–56.

[5] *Kirschner*, 2023 WL 5437811 at *2.

[6] *Id*.

[7] *Id*.

[8] *Id*. at *2–3.

[9] *Id*. at *3.

The credit agreements governing the term loans included fairly customary assignment provisions, permitting assignments of the loans subject to certain restrictions. These restrictions included (1) prohibitions on assignments to "a natural person," (2) a requirement to obtain written consent from Millennium and the administrative agent (subject to certain exceptions), and (3) minimum assignment amounts.[10]

In June 2014, two months after the transaction closed, a jury found that Millennium violated federal anti-kickback laws.[11] In February 2015, the Centers for Medicare and Medicaid Services investigated Millennium for alleged illegal billing.[12] And in March 2015, the U.S. Department of Justice intervened in False Claims Act proceedings against Millennium for alleged violations of federal healthcare laws.[13] Millennium settled with the DOJ for $256 million and, shortly thereafter, defaulted on the term loan and filed for bankruptcy.[14] The U.S. Bankruptcy Court appointed Mark S. Kirschner as Trustee to represent 70 groups of term loan holders, including mutual funds, hedge funds, and other institutions.[15]

In August 2017, Kirschner sued the Arrangers in the Supreme Court of the State of New York, alleging that the Arrangers violated the securities laws of California, Colorado, Massachusetts, and Illinois.[16] He argued that the arrangers misrepresented and omitted material facts in the syndication materials concerning Millennium's legal risks and sales and marketing practices that exposed the company to litigation.[17] He also claimed that the Arrangers failed to "contemporaneously" inform potential lenders about material developments.[18] According to Kirschner, the alleged misrepresentations and omissions "were designed to, and did, induce the Investors' purchases of the Millennium" term loans.[19] After removing the action to the U.S. District Court for the Southern District of New York,[20] the Arrangers moved to dismiss, arguing among other things that a syndicated loan is not a "security" and a loan syndication is not a "securities distribution."[21]

In May 2020, the district court granted the Arrangers' motion to dismiss, holding that Kirschner failed to plead facts plausibly suggesting that the term loans were securities.[22] The court employed the "family resemblance test" set forth in *Reves* v. *Ernst & Young*[23] and held that "the limited number of highly sophisticated purchasers . . .

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[10] *Id*.

[11] *Kirschner*, 2020 WL 2614765, at *4.

[12] *Id*.

[13] *Id*.

[14] *Id*. at *5.

[15] *Id*. at *1,*5.

[16] *Kirschner*, 2023 WL 5437811 at *7 n.58.

[17] *Id*. at 5; *Kirschner*, 2020 WL 2614765, at *1,*5.

[18] *Kirschner*, 2020 WL 2614765, at *5.

[19] *Id*. at *5.

[20] 12 U.S.C. § 632.

[21] *Kirschner*, 2020 WL 2614765, at *6.

[22] *Id*. at *10; *Kirschner*, 2023 WL 5437811 at *1.

[23] 494 U.S. 56 (1990). Under the "family resemblance test," courts begin with the "presumption that every note is a security," given that the "Securities Acts define 'security' to include 'any note.'" *Kirschner*, 2020 WL 2614765, at *7. That presumption is then rebutted if the note "bears a strong [family] resemblance" to any of the following instruments: (1) notes delivered in consumer financing; (2) notes secured by a mortgage on a home; (3) short-term notes secured by a lien on a small business or some of its assets; (4) notes evidencing a "character" loan to a bank customer; (5) short-term notes secured by an assignment of accounts receivable; (6) notes that "simply formalize[]" an open-account debt incurred in the ordinary course of business; and (7) notes evidencing loans by commercial banks for current operations. *Id.* (citing *Reves*, 494 U.S. at 65, 67).

would not reasonably consider [the term loans to be securities] subject to . . . [f]ederal and state securities law[s]," and that it "would have been reasonable for [them] to believe that they were lending money" without "the disclosure and other protections" of the securities laws.[24] Kirschner moved for leave to amend his complaint, which the district court denied as futile.[25] Kirschner then appealed to the Second Circuit.[26]

## II. Second Circuit's Decision

On August 24, 2023, a Second Circuit panel unanimously affirmed.[27] The Second Circuit held that the district court properly dismissed Kirschner's state-law securities claims because he failed to plead facts plausibly suggesting that the term loans were securities pursuant to *Reves*'s "family resemblance" test.[28] Under *Reves*, courts employ a four-factor test to determine whether a "note" was "issued in an investment context (and thus is a security) or in a consumer or commercial context (and is thus not a security)."[29] The four factors are:

(1) whether the buyer and seller were motivated for investment or commercial reasons;

(2) whether the plan to distribute the notes involved common trading for speculation or investment;

(3) the reasonable expectations of the investing public; and

(4) whether other factors, such as additional regulations, significantly reduce risk created by the notes, rendering the protection of the securities laws unnecessary.[30]

The court found that while the first factor tilted in favor of finding the term loans were securities, the remaining factors weighed against that conclusion.[31] According to the Second Circuit, the term loans strongly resembled a category of non-security instruments: "loans issued by banks for commercial purposes."[32]

According to the court, the motivation of the parties — the first factor — was mixed.[33] Under the first *Reves* factor, courts assess whether the "motivations [of the buyer and seller] are investment (suggesting a security) or commercial or consumer (suggesting a non-security)."[34] The court referred to quarterly interest payments over the life of the term loans as a "valuable return," and stated that the lenders' expectations of receiving such interest payments point to the lenders' investment motivation.[35] On the other hand, the motivation of Millennium (the

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

[25] *Kirschner*, 2021 WL 4499084, at * 25.

[26] *Kirschner*, 2023 WL 5437811, at *5.

[27] *Id*. at *1.

[28] *Id*. at *13.

[29] *Id*. at *8.

[30] *Id*.

[31] *Id*. at *13.

[32] *Id*.

[33] *Id*. at *9 ("A buyer's motivation is investment if it expects to profit . . . , including through earning either variable or fixed-rate interest . . . A seller's motivation is investment if its purpose is to raise money for the general use of a business enterprise or to finance substantial investments. A seller's motivation is commercial if, for example, the note is exchanged to facilitate the purchase and sale of a minor asset or consumer good, to correct for the seller's cashflow difficulties, or to advance some other commercial or consumer purpose.").

[34] *Id*. at *8.

[35] *Id*. at *9. Based on this conclusion, all debt obligations with non-de minimis interest payments would tilt the first *Reves* factor toward the "securities" finding.

borrower) was commercial because it did not plan to use the loans to raise funds or finance other investments.[36] Instead, Millennium sought to repay outstanding debt, issue bonuses and dividends, and redeem outstanding warrants, debentures, and stock options.[37] The court found that, at this "early stage of litigation," despite the "mixed" motivations between buyer and seller, the first factor weighed in favor of classifying the term loans as securities.[38]

The court found that the plan of distribution — the second factor — supported the finding that the term loans were not securities because they were not "offered and sold to a broad segment of the public."[39] The Arrangers offered the term loans only to sophisticated institutions pursuant to a confidential information memorandum, and potential lenders had to submit "legally binding offer[s]."[40] Although there was a secondary market, the Arrangers restricted assignment of the loans, which prevented "a broad-based, unrestricted sale[] to the general investing public."[41] The court also found these assignment restrictions akin to those from *Banco Espanol*,[42] where the plan of distribution "specifically prohibited resales of the loan participations without the express written permission"[43] of the borrower.

The court further held that the public's reasonable expectations — the third factor — also weighed in favor of finding that the term loans were not securities.[44] Here, the court emphasized that the lenders were provided "ample notice" that the instruments were loans rather than securities.[45] The lenders also certified before purchasing the loans that they were "sophisticated and experienced in extending credit to entities similar to [Millennium]" and that they had "independently and without reliance upon any Agent or any Lender" made their "own appraisal of and investigation into the business" of Millennium.[46] This certification was "substantially identical," the court noted, to the certification made by purchasers in *Banco Espanol*, which was "central" to the court's conclusion there that the buyers "could not have reasonably perceived the loan participations as securities."[47] The court also noted that the syndication materials for the Millennium loans contained only isolated references to "investors," and participants were generally referred to as "lenders."[48]

Finally, the court concluded that the existence of other risk-reducing factors rendering application of the securities laws unnecessary — the fourth factor — likewise weighed in favor of concluding that the loans were not

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[36] *Id*.

[37] *Id*.

[38] *Id*.

[39] *Id*. at *9 (noting that this factor also weighs against finding that notes are securities if there are "limitations in place that 'work[] to prevent the [notes] from being sold to the general public.'").

[40] *Id*.

[41] *Id*.

[42] 973 F.2d at 55–56.

[43] *Kirschner*, 2023 WL 5437811, at *10 (quoting *id.* at 55).

[44] *Id*. at *11. Significantly, the court explained that this factor is dispositive when it turns the other way. In other words, where "the public reasonably expects that the instrument is a security," the "instrument is a security," even "if the other three factors weigh *against* concluding that the instrument is a security." *Id.* at *10 n.96 (emphasis in original) (citing *Reves*, 494 U.S. at 66). On the other hand, if the public does not reasonably expect that an instrument is a security, the fourth *Reves* factor will be considered. *Id*.

[45] *Id*. at *10–11 ("If buyers were given ample notice that the instruments were . . . loans and not investments in a business enterprise, it suggests that the instruments are not securities.").

[46] *Id*. at *11.

[47] *Id*.

[48] *Id*.

securities.[49] The court found that the risk associated with the loans was "reduce[d]" because they were secured by a perfected first security interest in Millennium's tangible and intangible assets.[50] Another risk-reducing factor was that the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation had issued "specific policy guidelines" addressing syndicated term loans.[51] Those guidelines were aimed at least in part at protecting consumers.[52] Meanwhile, the Securities and Exchange Commission ("SEC"), the government agency entrusted with protecting the public's interest in securities offerings, declined to weigh in on the matter after the court solicited its views "given the importance of the issue, the parties' diverging positions, and the policy implications that would result from [the court's] resolution of this case."[53]

## III. Lessons for the Syndicated Loan Market

The Second Circuit's ruling confirmed market expectations that customary syndicated term loans are not securities under state or federal law, thus avoiding what could have been a substantial disruption to the syndicated loan market. That said, as detailed above, the court's analysis was fact-dependent, so the outcome in future cases may be different. The opinion highlighted factors that, although not exhaustive, provide some guidance to participants in the syndicated loan market for best practices to mitigate the risk of syndicated loans being recharacterized as securities.

Market participants should continue to take care in use of terminology for loans, which affects the reasonable perception of the instruments as loans (vs. securities). In *Kirschner*, the court pointed out that the cover page of the confidential information memorandum used the term "Public Side *Investors* [emphasis added]," although the court found that this use of "investors" was outweighed by the consistent use of the term "lender" (vs. "investor") in the rest of the confidential information memorandum and the loan documents. Loan market participants should take care to use loan-related terms and to avoid securities-related terms:

[49] *See id.* at *11–12 ("The fourth *Reves* factor requires us to examine whether 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 . . . . Among the factors that reduce the risks associated with an instrument are whether the instrument is secured by collateral or is insured and whether specific policy guidelines issued by federal regulators address the type of instrument at issue.").

[50] *Id*. at *12.

[51] *Id*.

[52] *Id*.

[53] After repeated extensions of the deadline to submit the SEC's views, on July 18, 2023, the General Counsel of the SEC submitted a letter stating, somewhat cryptically, "Despite diligent efforts to respond to the Court's order and provide the Commission's views, the staff is unfortunately not in a position to file a brief on behalf of the Commission in this matter." Commentators speculated that banks, banking regulators (including the U.S. Treasury Department) and the Loan Syndications and Trading Association lobbied strongly against the SEC's holding a view that the Millennium loans were securities. *See* Brief of Americans for Financial Reform as *Amicus Curiae* in Support of Plaintiff-Appellant, *Kirschner* v. *JPMorgan Chase Bank, N.A. et al.,* 2023 WL 5437811 (2d Cir. Aug. 24, 2023).

| Use loan-related terms like the following: | Avoid securities-related terms like the following: |
|---|---|
| loans | notes[54], investment |
| borrower | issuer |
| lender | investor |
| borrow, incur | issue |
| syndication, assignment | offering |
| information memorandum, lender presentation | offering memorandum, prospectus |

In addition, loan documentation should continue to include the type of language included in the Millennium credit agreement and cited by the court as affecting the reasonable perception of the instrument as loans. Under the Millennium credit agreement, each lender represented that it had independently, and without reliance on any agent, arranger or other lender, made its own investigation of the borrower and its own credit decision to make the loans. This type of language is customary in agented credit agreements and is non-controversial.[55]

Assignment restrictions also played an important role in the court's analysis. The court focused on (1) the prohibition on assignment to "natural persons," presumably those who would benefit most from securities law protections, (2) the consent requirements, which limited assignments to those with the capacity to acquire information about the debtor, and (3) the $1 million minimum assignment threshold, which presumably would preclude the proverbial "moms and pops" from holding loans. The court noted that the collective impact of the assignment restrictions worked to prevent the loans from being sold "to the general public."[56] Other assignment restrictions sought by some borrowers in both syndicated and private debt markets, such as prohibitions on assignments to "disqualified lenders," would also be consistent with a "loan" treatment.

On the other hand, loan market participants should also take note of the *Kirschner* court's discussion of the risk-mitigating factors for the Millennium term loans — they were secured by Millennium's assets and were subject to specific policy guidelines from bank regulators (*e.g.*, the 2013 Interagency Guidance on Leveraged Lending). The absence of risk-reducing factors such as these could weigh in the direction of a "securities" characterization by a future court.

Particularly when syndicated loans share many attributes with bonds (such as similar covenant protections and market participants), it would be prudent for arrangers and borrowers of syndicated loans to be mindful of the factors that steered the *Kirschner* court to its conclusion.

Furthermore, since banks are restricted from owning or having certain relationships with funds holding securities, firms designing collateralized loan obligations, or CLOs, should take care to ensure that the underlying loans entering the structure meet the loan characteristics emphasized by the *Kirschner* court.

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[54] In the loan context, in most cases, "notes" should refer only to promissory notes evidencing loans. (Under most credit agreements, a promissory note may be issued at a lender's request to facilitate such lender's pledge of its interest in the loan to secure such lender's own loans from a Federal Reserve Bank.)

[55] Some arrangers have added language in their credit agreements pursuant to which lenders represent that, in participating as lenders under the credit agreement, they are engaged in making, acquiring, or holding commercial loans and not for the purpose of investment in the general performance or operations of the borrower. *See, e.g.*, Charles W. Tricomi, *In Kirschner Fallout, Lenders May Be Asked To Rep That They Aren't Investors*, XTRACT RESEARCH (Sept. 6, 2023), https://www.creditflux.com/Funds/2023-09-11/In-Kirschner-fallout-lenders-may-be-asked-to-rep-that-they-arent-investors?d=1.

[56] *Kirschner*, 2023 WL 5437811, at *10

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