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In The Know

Leveraged Finance Newsletter

By Ben Bierwirth, Adam Buehler, John Lawlor and Serge Diaz
of Baker McKenzie's London, Chicago and Miami offices

Kirschner v. JP Morgan Chase, N.A. lends further support to the established view that syndicated loans are not "securities"

On 24 August 2023, the US Court of Appeals for the Second Circuit examined the question of whether a syndicated term loan was a security in the case of *Kirschner v. JP Morgan Chase Bank, N.A.*[1] The court applied the "family resemblance" test set forth in the US Supreme Court case of *Reves v. Ernst & Young*[2] in holding that the loan was not a "security." Accordingly, the securities law action in relation to the loan was dismissed, upholding the long-standing market convention that correctly structured syndicated loans are not securities.

In this edition, we look at several key takeaways for market participants to follow to ensure that syndicated loans are not characterized as securities.

1. No. 21-2726 (2d Cir., Aug. 24, 2023). **2.** 494 U.S. 56 (1990).

Background

The question of whether a loan, an investment or another instrument is classified as a security under US federal and state laws is of critical importance to issuers and financial institutions. Firstly, under Section 5 of the US Securities Act of 1933, unless an exemption applies, it is unlawful for any person to offer to sell any security unless a registration statement is first filed with the Securities and Exchange Commission (the "**SEC**"), and it is unlawful to sell such security unless a registration statement is declared effective by the SEC.

Complying with the SEC's disclosure requirements requires the issuer to go through a rigorous diligence exercise and provide broad disclosure about its business and operations, resulting in a lengthy prospectus that comes at a considerable cost in terms of transaction fees and management's time diverted from the business. In addition, elaborate securities fraud laws apply to securities both at federal level and at state level (those applying at state level being known as "**Blue Sky Laws**"). This means increased scope for exposure to both civil and criminal liability for issuers and underwriters, as the disclosure documentation in connection with such securities offerings must not contain any material misstatement or omission. Given these costs and the enhanced liability of a US securities offering, it is crucial to know when an instrument is, and is not, a security. The recent ruling by the US Court of Appeals for the Second Circuit in *Kirschner v. JP Morgan Chase Bank, N.A.* handed down on 24 August 2023 provides significant comfort for secondary loan market participants not wishing to find their activities under the purview of US securities regulators.

Facts

Kirschner, in his capacity as trustee of the Millennium Lender Claim Trust (the "**Plaintiff**") acted in the interests of the beneficiaries who purchased debt issued by Millennium Health LLC (the "**Borrower**"), a California urine drug testing company. In April 2014, the Borrower entered into a term loan agreement for USD 1.775 billion (the "**Term Loan**") and a revolving loan agreement for USD 50 million with JP Morgan Chase Bank, N.A. and other banks as lenders (the "**Initial Lenders**"). The Initial Lenders syndicated the Term Loan by inviting subsequent lenders (the "**Subsequent Lenders**") to purchase allocations of the Term Loan represented by the notes issued by the Borrower (the "**Notes**").

In October 2015, the Borrower entered into a settlement agreement with the US Department of Justice (the "**DOJ**"), agreeing to pay USD 256 million in connection with allegations of false billing and contraventions of anti-kickback statutes. The DOJ investigation was launched before the Notes were issued. Shortly afterwards, in November 2015, the Borrower filed for Chapter 11 bankruptcy.

In 2017, the Plaintiff brought an action in New York state court against JP Morgan Chase Bank, N.A. and other defendants arguing, among other things, that the defendants made actionable misstatements and omissions with respect to the Term Loan in communications with the lenders under the Blue Sky Laws of California, Colorado, Illinois and Massachusetts. Following removal of the state court action to federal court, on 22 May 2020 the United States District Court for the Southern District of New York held that the Notes were not securities subject to the Blue Sky Laws and dismissed the Blue Sky Laws claims. The Plaintiff brought an appeal challenging the finding in the Second Circuit.

Judgment

The Second Circuit upheld the District Court's holding that the Notes were not securities. In doing so, the Second Circuit applied the "family resemblance" test laid down by the US Supreme Court in *Reves v. Ernst & Young.*[3]

3. Technically, *Reves* set forth a rule for determining whether notes are "securities" for the purposes of federal securities law, not state securities laws. The Plaintiff asserted that Reves applied to its state securities law claims, and both the district court and the Second Circuit accepted this assertion and applied *Reves. Kirschner,* supra n. 1, at footnote 58.

The definitions of "security" in section 2(a)(1) of the Securities Act of 1933 and in section 3(a)(10) of the Securities Exchange Act of 1934 each contain a specific reference to "any note." In *Reves,* the Supreme Court held that these references did not literally encompass all notes, but needed to be read in context with what Congress was attempting to accomplish. The Court found that Congress's goal in enacting the 1933 and 1934 securities acts was to regulate the investment market and not to provide a "broad federal remedy for all fraud." The Court held that only notes issued in an "investment context" are "securities," and that notes issued in a "commercial or consumer context" are not.[4]

Under the *Reves* test, the starting presumption is that every note is a security. The courts are then directed to consider four factors, the combination of which assists the courts in determining whether the particular note in question is to be characterized as a security. The four factors are as follows:

(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) whether some factor such as the existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering application of the 1933 Act and 1934 Act unnecessary.

1. MOTIVATIONS THAT WOULD PROMPT A REASONABLE SELLER AND BUYER TO ENTER INTO THE TRANSACTION

Parties that enter into the transaction for "investment" rather than "commercial" purposes are more likely to be dealing in securities. It was held that the Borrower's motivations were primarily commercial as they did not seek to borrow for general corporate purposes or to use the proceeds of the Term Loan for substantial capital investments. Rather, the proceeds of the Term Loan were destined to refinance the Borrower's existing facilities, make distributions to shareholders and redeem the Borrower's outstanding warrants and stock options.

However, the Second Circuit held that the lenders' motivations here were of an investment nature, namely to profit from the Notes by collecting the interest payments due.

The differing motivations of the Borrower and the lenders led the court to conclude that, in the context of a motion to dismiss (what the court referred to as "this early stage of litigation"), the first limb of the *Reves* test was tilted in favor of the Notes being securities.

2. THE PLAN OF DISTRIBUTION

If notes are being "offered and sold to a broad segment of the public," they are more likely to be treated as securities by US courts. In *Kirschner,* the Notes were marketed to the Subsequent Lenders, who were all sophisticated institutional entities. Whilst the Plaintiff argued that there was a secondary market for the Notes, the restrictions on any assignment of the Notes rendered them unavailable to the general public. These restrictions were as follows:

- the Notes could not be assigned to natural persons;
- the Notes could not be assigned without written consent from both the Borrower and JP Morgan Chase Bank, N.A.; and

4. Reves, 494 U.S. at 61-63.

- no assignment could be in an amount less than USD 1 million unless it was to a Lender, an affiliate of a Lender or an Approved Fund or an assignment of the entire remaining amount of the assigning Lender's allocation.

Accordingly, the unavailability of the Notes to the general public weighed against the conclusion that the Notes were securities. The Second Circuit also likened the assignment restrictions to those in a prior Second Circuit case, *Banco Espanol de Credito v. Security Pacific National Bank,*[5] in which the court held that loan participations were not securities.

3. THE INVESTING PUBLIC'S REASONABLE PERCEPTIONS

The test in *Reves* required the court to analyze the Subsequent Lenders' state of mind and determine whether they could have reasonably expected or perceived the Notes to be securities. The court agreed with the defendants that it was unlikely and that the Subsequent Lenders were given ample notice that the Notes were loans and not investments in a business enterprise. Before purchasing the Notes, the Subsequent Lenders certified that they were "sophisticated and experienced in extending credit to entities similar to [the Borrower]" and that they "independently and without any reliance [...] made [their] own appraisal and investigation into the business, operations, property, financial and other condition and creditworthiness of [the Borrower]."

This certification was substantively identical to the certification made by the purchasers in *Banco Espanol,* which was central to the Second Circuit's determination that the Subsequent Lenders could not have reasonably perceived the Notes to be securities.

The court noted that the loan documents referred to the Subsequent Lenders as "lenders" and not "investors" in most instances in alignment with the reasonable expectations that the Notes were not securities.

4. SOME OTHER RISK-REDUCING FACTOR THAT RENDERS APPLICATION OF SECURITIES LAWS UNNECESSARY

If an instrument is already subject to comprehensive oversight by another regulatory framework or some other factor is present that protects investors against the risk of loss, the courts are less likely to rule that the application of securities laws is warranted or called for. In *Kirschner,* the Notes were secured by collateral. In addition, policy guidelines issued by federal regulators outlined risk management controls specifically with respect to syndicated loans.[6] The Second Circuit therefore held on balance that the application of securities laws was not necessary on the facts.

Ruling

The combined effect of the application of the "family resemblance" test was that the Notes were held not to be securities. The District Court's order dismissing the Plaintiff's Blue Sky Laws securities claims was upheld.

5. 973 F.2d 51 (2d Cir. 1992). The Second Circuit also referred to its reasoning in *Banco Espanol* with respect to the third and fourth *Reves* factors.
6. See, e.g., Interagency Guidance on Leveraged Lending, 78 Fed. Reg. 17766 (Mar. 22, 2013); and OCC, Leveraged Lending: Comptroller's Handbook (Feb. 2008).

Conclusion and takeaways

Leveraged finance market participants should welcome the Second Circuit's ruling, which maintains the status quo that syndicated loans are not securities. This decision is consistent with market expectations that have been in place for many years.

The distinction between loans, which are not securities, and bonds, which are, continues to run deep in US jurisprudence, and there appears to be little desire to tamper with it, at least for now. This is in spite of the evolving economic reality where the assumptions that bonds are often sold to lay investors in need of protection and loans are made by banks that are more than capable of looking after themselves do not hold at all times.

However, there are several important takeaways from *Kirschner* to help loan market participants and their advisors avoid falling afoul of US securities laws:

- continue to use strict assignment restrictions to ensure that the loans remain in the hands of sophisticated institutional investors and do not get sold to the general public;
- use loan market rather than capital markets terminology in documentation, including confidential information memoranda (i.e., "borrower" as opposed to "issuer," "lender" as opposed to "investor," etc.);
- seek robust representations from other lenders that they have carried out their own diligence, have not relied on any disclosures or statements made by the agent or any other lender, are experienced in lending to similarly situated entities, and understand that they are not lending for investment purposes; and
- include other acknowledgments by the parties, such as that the loans are not securities and that securities laws do not apply to them or the transactions

Finally, *Kirschner* was decided on a set of specific facts and not every syndicated loan will necessarily receive identical treatment in US courts. For instance, if the syndication in question were to involve unsecured loans being allocated to unregulated institutions, a court might determine that, under the fourth prong of the *Reves* test, there was not a risk-reducing factor that would suggest that the application of the securities laws was unnecessary.[7]

7. See *Kirschner,* supra n. 1, at footnote 104 ("As *Reves* instructs, in assessing whether a given note is a security, 'we are not bound by legal formalisms, but instead take account of the economics of the transaction under investigation.' 494 U.S. at 61 (emphasis added). It is possible that a court faced with a different transaction could find that the reasonable investing public perceived an instrument labelled a 'syndicated term loan' to be a 'security.' Cf. id. ('Congress' purpose in enacting the securities laws was to regulate investments, in whatever form they are made and by whatever name they are called.')")

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CONTACTS

Ben Bierwirth
Partner | London
Ben.Bierwirth@bakermckenzie.com

John Lawlor
Attorney | Chicago
John.Lawlor@bakermckenzie.com

Adam Buehler
Senior Associate | Miami
Adam.Buehler@bakermckenzie.com

Serge Diaz
Trainee Solicitor | London
Serge.Diaz@bakermckenzie.com

bakermckenzie.com