INVESTMENT COMPANY INSTITUTE

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Second Circuit Rules That Certain Syndicated Loan Notes are Not Securities

[35442]

September 19, 2023

TO: ICI Members SUBJECTS: Compliance
Fixed Income Securities
Fund Governance
Investment Advisers
Operations
Portfolio Oversight
Risk Oversight RE: Second Circuit Rules That Certain Syndicated Loan Notes are Not Securities

In its August 24, 2023 decision, a three-judge panel of the United States Circuit Court of Appeals for the Second Circuit held in Kirschner v. JP Morgan that notes issued as part of a syndicated term loan transaction ("Notes") were not securities.[1] In doing so, the court applied the "family resemblance" test, also known as the "Reves Factors," outlined in the US Supreme Court case Reves v. Ernst & Young.[2] The ruling maintains the legal status quo in this area, which the court helped establish in a similar case in 1992.[3]

Legal Background

Under the Securities Act of 1933 ("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act"), the definition of "security" includes, among many other things, "notes." However, federal courts have not interpreted this term to mean literally that any note would be a security under these statutes.

The test created by the Supreme Court in Reves begins with a presumption that every note is a security. But that presumption can be overcome if the notes at issue bear a strong "family resemblance," based on four factors, to one of the judicially-crafted categories excluded from the definition of a security. The four Reves factors are:

- the motivations that would prompt a reasonable seller and buyer to enter into the transaction;
- the plan of distribution of the instrument;
- the reasonable expectations of the investing public; and

- 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.[4]

In 1992, the Second Circuit itself applied the Reves test in Banco Espanol, holding in that case that the loan participations in question were not securities under the Securities Act.[5] The court's analysis of the facts under the "family-resemblance" test in Reves pointed to the participation loans not being securities within the meaning of the Securities Act of 1933.

Views of Other Relevant Entities

In March, following oral argument before the Second Circuit in Kirschner, the court issued an order "solicit[ing] any views that the United States Securities and Exchange Commission may wish to share" regarding "whether the syndicated term loan notes at issue in this appeal are securities under Reves."

In May, the Loan Syndications and Trading Association (LSTA) submitted to the SEC a letter explaining the adverse consequences that would arise for market participants if the SEC were to call into question the decades-long understanding that syndicated loans are not securities. LSTA's letter urged the SEC to submit a brief that reaffirms the market understanding that syndicated term loans are not securities. LSTA's letter argued that a statement from the SEC that syndicated loans are securities would lead to potential market disruption and inefficiencies.

In June, ICI joined several other trade associations in a letter to the SEC, expressing support for the points presented in the LSTA's letter, urging the SEC to confirm that syndicated loans are not securities, and underscoring other considerations that may bear on the SEC's response.[6] ICI's primary concern was that a regulatory change in status of these loans would create immediate uncertainty and disruption. This in turn could lead to interruptions or impediments to secondary market trading, harming mutual funds that invest in these loans.

In July, the SEC responded: "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." The SEC's short letter did not offer an explanation.

Summary of Kirschner

Facts and Lower Court Ruling

Millennium Health LLC ("Millenium") was a California-based urine drug testing company. In 2012, Millenium entered into a credit agreement with JP Morgan Chase and other financial institutions, but legal troubles and investigations began to affect its financial condition. In 2014, the initial lenders entered into a new lending agreement with Millenium, and new institutional investors joined the lending syndicate by purchasing Notes. After Millennium filed for bankruptcy in 2015, Marc Kirschner, as trustee of the Millennium Lender Claim Trust, sued the lender defendants, claiming, among other things, that the Notes were securities and violated state securities laws.

The lender defendants moved to dismiss the securities law claims on the grounds that the Notes were not securities. In May 2020, the U.S. District Court for the Southern District of New York held that the Notes were not securities and granted the defendants' motion to dismiss all such claims. The trustee then appealed to the Second Circuit.

Second Circuit's Decision

The court affirmed the lower court's ruling, holding that Kirschner did not plausibly suggest that the Notes are securities under Reves.

Applying Reves, the court examined the four factors to see "whether the note was issued in an investment context (and is thus a security) or in a consumer or commercial context (and is thus not a security)." The court found that:

- the first factor (i.e., the motivation of the parties) "tilts in favor of concluding that the complaint plausibly alleges that the Notes are securities."[7]
- the second factor (i.e., the plan of distribution) "weighs against concluding that the complaint plausibly alleges that the Notes are securities."[8]
- the third factor (i.e., the investing public's reasonable expectations) weighs against concluding that the complaint plausibly alleges that the Notes are securities.[9]
- the fourth factor does not plausibly suggest that application of securities laws is necessary because (i) the Notes were secured by a first-priority security interest in all Millennium's assets, reducing risk, and (ii) the bank regulators issued specific guidelines addressing syndicated term loans.

The court concluded that the Notes, "like the loan participations in Banco Espanol, 'bear a strong resemblance' to one of the enumerated categories of notes that are not securities: '[L]oans issued by banks for commercial purposes.'" Thus, the court held that Kirschner "failed to plead facts plausibly suggesting that the Notes are securities" under Reves.

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Notes

[1] Kirschner v. JP Morgan Chase Bank, N.A. et al., No. 21-2726 (2d Cir. 2023) ("Kirschner"), available here.

[2] Reves v. Ernst & Young, 494 U.S. 56 (1990) ("Reves").

[3] Banco Espanol de Credito v. Sec. Pac. Nat'l Bank, 973 F.2d 51, 55-56 (2d Cir. 1992) ("Banco Espanol").

[4] In Reves, an agricultural cooperative sold promissory notes to members and non-members, marketed as an "investment program." The cooperative filed for bankruptcy, and the note holders sued Ernst & Young (the cooperative's auditor), claiming that it violated the antifraud provisions of the Exchange Act. In this case, the Supreme Court concluded that the notes were securities under the Exchange Act.

[5] In this case, Security Pacific made short-term loans to a company and sold these loans

(in whole in in part) to various institutional investors. The borrower declared bankruptcy, and purchasers of these loan participations sued to rescind their agreements, claiming the loans were securities under the Securities Act and Security Pacific did not disclose the borrower's financial problems.

[6] See ICI Memo to Members No. 35347, dated June 12, 2023, for a more detailed summary of and link to this joint letter.

[7] The court stated that the lenders' motivation was investment because the lenders expected to profit from their purchase of the Notes. In contrast, Millenium's motivation was commercial because Millenium planned to use the term loan to pay the outstanding amount due under the 2012 Credit Agreement; make a shareholder distribution; redeem outstanding warrants, debentures and stock options; and pay fees and expenses related to the transaction.

[8] The court found that in this case, the facts did not support the notion that the Notes in question were offered to the general public. They were exclusively offered to sophisticated institutional entities through a controlled allocation process. While the presence of a secondary market is cited as evidence, the assignment restrictions effectively prevented the Notes from being sold to the general public.

[9] The court found that the lenders that purchased the Notes were sophisticated entities, certified as such before buying the Notes, and were aware that they were entering into loans, "not investments in a business enterprise."