COURT PROVIDES ADDITIONAL GUIDANCE ON WHEN NOTES ARE NOT SECURITIES

The loan market breathed an immense sigh of relief this spring with the ruling in *Kirschner v. JPMorgan Chase Bank, N.A.* [1] *("Kirschner")* affirming the prevailing market view that notes representing syndicated loans are not "securities." The leveraged loan market has been operating for decades under the assumption that syndicated loans are not securities, perhaps shockingly without firm judicial or regulatory certainty to that effect.

This uncertainty stems from the fact that "notes" and "evidences of indebtedness" are enumerated types of security in the definition of "security" under federal securities laws. Further, under a test known as the "Howey Test," a contract is deemed to be a security if it involves an investment of money in a common enterprise with an expectation of profits from the efforts of others.[2] This could have also resulted in the note being an investment contract if the act of syndication itself caused the holders of the notes to be reliant on the effort of others.

In 1990, in the case *Reves v. Ernst & Young ("Reves")* the U.S. Supreme Court first acknowledged that notes might not be securities despite the fact that they are specifically included in the definition of "security" in the Securities Act of 1933.[3] In 1992, the Second Circuit Court of Appeals held that loan participations are not securities in *Banco Espanol de Credito v. Security Pacific National Bank ("Banco Espanol").* [4] However, in the intervening 30 years the syndicated loan market has grown considerably, particularly in the number of secondary market transactions. This may have led some to question whether the ruling in *Banco Espanol* would still apply to loans today. Further, *Banco Espanol* did not expressly address promissory notes that were syndicated via a purchase and immediate resale to investors

While the Court's decision in *Kirschner* to grant dismissal of the case was favorable to the loan industry, it does not constitute precedent for other courts and therefore does not create certainty. Accordingly, the characteristics of syndicated loans will continue be analyzed on a case-by-case basis even in light of this decision. That said, the Court's application of *Reves* rather than the Howey test solidifies the thinking that debt instruments should be analyzed using the *Reves* test, described in more detail below.

Even a small risk of the classification of loans as "securities" needs to be taken seriously, as such classification would dramatically alter the structure and regulation of leveraged loans, and likely diminish, if not, destroy the asset class. The recent economic downturn caused by the global pandemic is likely to increase loan defaults and result in legal actions to recover losses. This new

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[1] *Kirschner v. JP Morgan Chase Bank, N.A.*, 2020 U.S. Dist. LEXIS 90797 (S.D.N.Y., May 22, 2020). [2] *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946). [3] *Reves v. Ernst & Young*, 110 S. Ct. 945 (1990). [4] *Banco Espanol de Credito v. Security Pacific National Bank,* 973 F.2d 51 (2nd Cir. 1992). [5] The dissent to *Banco Espanol* also noted that the Securities and Exchange Commission submitted a brief amicus curiae advocating the use of the Howey Test rather than the *Reves* test.

paradigm raises the possibility of another plaintiff obtaining a different result. Importantly, there are several similarities between the structure of syndicated loans (which historically have not been treated as securities) and bonds (which clearly are securities) that could lead a court to utilize the Howey Test rather than following the *Reves* test.[5] Finally, as the loan market considers automating the loan trading process, potentially through the use of a blockchain, it is important to consider how these technologies might affect the security law analysis of loans.

THE CASE:

Kirschner involved a $1.775 billion syndicated loan transaction, in which Millennium Laboratories LLC ("Millennium") sold a portion of a term loan to investors. Defendants [6] served as arrangers and underwriters in the transaction. Two months after the loan closing, Millennium lost a litigation against it for Stark Law and Anti-Kickback statute violations. Millennium was also in the target of other proceedings, including a Department of Justice investigation in connection with False Claims Act violations, all of which impacted Millennium's valuation. Given all of these actions and other issues, Millennium filed for bankruptcy protection in New York. After Millennium's bankruptcy filing, the bankruptcy trustee of the Millennium Lender Claim Trust ("Plaintiff"), filed suit against Defendants alleging securities law violations and other violations. The case considered whether the origination and distribution of a syndicated bank loan was subject to State security laws, often called blue sky laws, in California, Colorado, Illinois and Massachusetts. Ultimately, the Court granted the defendants' motion to dismiss on the ground that the ground that a syndicated bank loan is not a "security." Sidestepping the Howey Test completely, the Court applied the "family resemblance" test set forth in Reves to determine whether the Millennium notes were "securities."

REVES TEST ANALYSIS:

Under *Reves* and its progeny, a note is presumed to be a "security" unless it bears a strong family resemblance to instruments denominated as notes but are not securities, such as mortgage loans, consumer financing loans, accounts receivable factoring agreements, notes evidencing debt incurred in the ordinary course of business (particularly if collateralized) and notes evidencing loans by commercial banks for current operations. The four factors of the family resemblance test are the: (1) motivations that would prompt a reasonable seller and buyer to enter in the transaction; (2) plan of distribution of the instrument; (3) reasonable expectations of the investing public; (4) existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering application of the Securities Act unnecessary. [7] Ultimately, the Court in Kirschner concluded that the second, third and fourth *Reves* factors weighed in favor of finding that the Notes were "analogous to the enumerated category of loans issued by banks for commercial purposes," and as such, not a security. [8]

1. Motivations of the Seller and Buyer:

The Court found that the first factor did not weigh heavily in either direction. In *Reves*, the first factor considers whether the motivations that would prompt a reasonable seller and buyer to enter into a transaction are for investment, thus suggesting a security, or to advance some other commercial or consumer purpose, suggesting a non-security.[9] The Court found that from the seller's perspective, the Millennium notes resembled the advancement of a commercial purpose for loan repayment and the payment of a dividend rather than an investment. However, from the buyer's perspective, the purpose of acquiring Millennium notes appeared to be for investment purposes since the purchasers acquired the notes for their investment portfolios. Thus, the first factor could go either way and was not determinate of whether the Millennium notes should be deemed a "security."

2. Plan of Distribution:

The second *Reves* factor considers whether the plan of distribution is subject to common trading for speculation or investment. [10] The Court's application of the second factor relied on the analysis in *Banco Espanol*, where restrictions on the notes "worked to prevent the loan participations from being sold to the general public." [11] The *Kirschner* Court concluded that the plan of distribution was relatively narrow because the solicitation and purchasers of the Millennium notes were limited to small group of sophisticated

[6] *JPMorgan Chase Bank, N.A.*, JPMorgan Securities LLC, Citigroup Global Markets Inc., Citibank, N.A., BMO Capital Markets Corp. [7] Id. at *21. [8] *Banco Espanol,* 973 F. 2d 51, 56 (1992).
[9] Kirschner at *22.

investors, rather than to the general public. Transfer restrictions on trades of the notes in the secondary market were also consistent with limitations on distribution. Therefore, the second factor weighed "strongly in favor of finding that the Notes are not securities." [12]

3. Reasonable Expectations of the Investing Public:

The third *Reves* favor is dependent on "the reasonable expectations of the investing public," [13] even where an economic analysis of the circumstances of a particular transaction suggest that the instruments are not securities as used in that transaction. [14] In *Kirschner,* the language of the transactions documents weighed in favor of finding that the Millennium notes were not securities because consistent reference to "loan" and "lender" throughout the credit agreement and confidential informational memorandum made clear that the parties had participated in a lending transaction, and not an investment in securities.

4. Existence of Another Regulatory Scheme

The fourth *Reves* factor is the "existence of another regulatory scheme to reduce the risk of the instrument, thereby rendering application of the Securities Act unnecessary." [15] The Court compared the circumstances to *Banco Espanol*, where the Second Circuit had distinguished the "entirely unregulated scenario at issue" in *Reves* because the Office of the Comptroller of the Currency had issued specific policy guidelines that addressed the sale of loan participations to sophisticated purchasers. It concluded that this factor weighed in favor of finding that the notes were not securities.

Given the determination that the notes at issue in the *Kirschner* case "passed" 3 out of the 4 factors of the Reves test to not be a security, the Court dismissed the action ruling that the notes were not securities.

IMPLICATIONS ON THE LOAN INDUSTRY IF LOANS WERE DEEMED SECURITIES

It is hard to overestimate the profound effect that would come about should syndicated loans be re-classified as securities. Indeed, the market as we know it would cease to exist. The transaction at issue in involved a standard term loan B. A determination that such transaction is a "security" would likely disrupt the $1.2 trillion leveraged loan industry. Though the case was dismissed, Plaintiff is permitted to amend its complaint and other similar cases may follow. Particularly, the current recession in the leveraged loan industry may lead to a rise in legal actions.

Further, if loans were to be categorized as securities, possibly even broadly syndicated instruments would be subject to Federal and State securities laws, exposing loan market participants in areas like underwriting, syndication and trading obligations. At a minimum, leveraged loan transactions would require more extensive disclosures and due diligence, resulting in a prolonged closing process that would be more expensive. This, in turn, could make loans less accessible to smaller classes of borrowers who cannot afford the higher costs of a securities offering. Classifying loans as securities could also result in less flexibility in loan terms for both borrowers and lenders, and further impact which loans would be suitable for secondary markets. Additionally, it is likely that the structure of the CLO market (which currently purchases about 60% of all syndicated loans issued) would not transition well to a regulatory environment where loans are deemed securities. Another unintended consequence of classifying notes as securities is the possibility that more borrowers will seek financing from less desirable sources, such as entirely unregulated private lenders.

REDUCING THE RISK OF DEBT BEING CONSIDERED A SECURITY

The *Kirschner* opinion and prior case law suggests that the facts and circumstances of a transaction will largely determine whether a note will be deemed a "security," as the *Reves* family resemblance test is analyzed on a case-by-case basis.

To minimize the risk of loans becoming considered securities, leveraged loan products should be structured in a manner that is consistent with general principles in the LSTA Code of Conduct and the *Reves* family resemblance test. One of the reasons why the leveraged loan market has been able to thrive thus far without being regulated as a security is because loan syndications have steered clear of the retail market and have done a good job of policing themselves. Therefore, loan market participants should

[10] *Id.* at *25. [11] *Banco Espanol,* 973 F. 2d at 55. [12] *Kirschner* at *27. [13] *Id.* at 27-28. [14] *Id.* [15] *Id.* at *31; *Reves,* 494 U.S. at 67. [16] *Id.* at *32.

make note of the features in the *Kirschner* transaction that weighed against classification of the transaction as a "loan" and not a "security," including but not limited to the following precautions:

- the language of transaction documents should use the explicit language of loan transactions (reference to "loan" and "lender" throughout the governing documents weighed against classification as a security in *Kirschner*);
- the composition of purchasers and potential purchasers that are solicited should be sophisticated, and ideally qualified institutional buyers;
- consider the minimum hold requirements that preclude retail investors; and
- the administrative agent and or the borrower should have control of who becomes a lender.

We note that this analysis may continue to evolve over time. For instance, advancements that create efficiencies in the loan market, such as continued automation of the loan trading process or the use of a blockchain, may require further analysis. Further, it is unclear whether an instrument with identical characteristics to a syndicated loan would be considered a security simply because the debt is tokenized rather than represented by a note.

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