Finance Alert

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Syndicated Loans are [Still] Not Securities

To the relief of the syndicated loan industry, and the world financial markets overall, the U.S. Supreme Court has denied the petition for certiorari filed by the plaintiff in *Kirschner v. JPMorgan Chase Bank, N.A.* By declining to hear the plaintiff's appeal, the Supreme Court leaves in place the U.S. Court of Appeals for the Second Circuit's ruling that the syndicated loans at issue are not securities under federal securities laws.

Key Takeaways

- Because the *Reves* "family resemblance" test is intensely fact-dependent, the holding in *Kirschner* does not mean that we can say conclusively that all syndicated loans are not securities. The holding applies to the specific loans at issue. Therefore, we would not be surprised if the same issue is raised in future litigation.
- The Second Circuit strongly relied on its own precedent in *Banco Espanol de Credito v. Security Pacific National Bank.* Leveraged lending and banking lawyers who are not familiar with that case, or who haven't read it in a while, should consider reviewing the case before negotiating their next loan agreement.
- "If it ain't broke, don't fix it." An apparently significant factor in the Second Circuit's decision was that key language in the loan agreement, such as the assignment restrictions and the lender certifications of experience and independent assessment of the borrower, closely mirrored or was substantively identical to the language that was present in the loan agreement at issue in *Banco Espanol de Credito.* Although banking lawyers can be criticized for stubbornly sticking with their form agreements and language, the similarities in the *Kirschner* loan agreement to earlier transactions had a clear substantive benefit.

What Did the Second Circuit Conclude in Its Earlier Decision?

In *Kirschner,* the Second Circuit looked to its own existing precedent: the 1992 Second Circuit case *Banco Espanol de Credito v. Security Pacific National Bank,* in which the court applied the family resemblance test outlined in the 1990 Supreme Court case *Reves v. Ernst & Young.* Based on the application of the *Reves* test to the facts presented, the court of appeals concluded that the lower court properly dismissed the plaintiff's state law securities claims on the basis that the facts did not plausibly suggest the loan participations at issue are securities.

The *Reves* Test

The *Reves* family resemblance test contains four factors:

- The motivations that would prompt a reasonable seller and buyer to enter into the transaction (i.e., commercial or investment motivations)
- The plan of distribution of the instrument
- The reasonable expectations of the investing public

- Whether some factor such as the existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering application of the Securities Act of 1933 and the Securities Exchange Act of 1934 unnecessary

Applying the *Reves* Test to the Kirschner Facts

The Second Circuit analyzed each *Reves* factor based on the facts presented:

Commercial or investment motivations: The Second Circuit concluded that there was a plausible allegation that the notes were securities. The parties involved had mixed motivations. The lenders appeared to have an investment motivation in the form of expectations of a rate of return in the form of interest to be paid by the borrower, while the borrower's motivation appeared to be commercial in that it planned to use the funds to pay outstanding debt and make a shareholder distribution.

Plan of distribution: The Second Circuit concluded that the facts did not plausibly suggest that the notes were securities. The notes were not offered and sold to a broad segment of the general public, and the restrictions on the assignment of the notes, such as borrower and agent consent, limited their availability in the secondary market.

Reasonable expectations of the investing public: The Second Circuit concluded that the facts did not plausibly suggest that there was a reasonable expectation of the purchasers that the notes were securities. The loan documents often referred to the buyers as "lenders" and the notes as "loans." In addition, the purchasers were sophisticated entities, were given ample notice that the notes were loans and each certified that they had independently appraised the business, operations and creditworthiness of the borrower and had come to an independent decision to make the loans.

Risk-reducing factors make application of the securities laws unnecessary: The Second Circuit concluded that the facts did not suggest that the application of the securities laws to the notes was necessary. There are notable risk-reducing factors that protect the purchasers of the notes. The loans were secured by a perfected first-priority security interest in all of the borrower's tangible and intangible assets. In addition, in 2013 the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation issued "Interagency Guidance on Leveraged Lending," which outlines the regulators' minimum expectations with respect to a number of leveraged lending topics, including underwriting standards, validation standards, risk weighting and purchasing participations in leveraged lending transactions.

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