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Second Circuit Confirms That Syndicated Bank Loan Is Not a "Security"

On August 24, 2023, in a highly anticipated decision, the Second Circuit in *Kirschner* v. *JPMorgan Chase Bank, N.A. et al.* affirmed dismissal of state-law securities claims because the syndicated term loan in question was not a "security" and therefore not subject to state and federal securities laws and regulations.[1]

Background

As explained in a prior client alert, *Kirschner* arose out of a $1.775 billion syndicated loan transaction in which several banks served as lenders to Millennium Laboratories LLC ("Millennium"), a private California-based drug testing company, and then syndicated that loan to a group of approximately 70 institutional investors. Shortly after the transaction was completed, Millennium lost a significant litigation involving alleged kickbacks and entered into a settlement with the U.S. Department of Justice to resolve alleged violations of the False Claims Act. Millennium thereafter filed for bankruptcy, and the bankruptcy trustee filed a lawsuit against the banks, claiming they had, among other things, violated state securities laws (so-called "blue sky" laws) by making misrepresentations to investors, including falsely assuring investors that Millennium had no exposure to material litigation. The defendants moved to dismiss the complaint for failure to state a claim, arguing that a syndicated bank loan is not a "security" under the state securities laws and that a loan syndication is not a "securities distribution."

In May 2020, the district court found that the syndicated bank loan at issue was not a security and dismissed the case.[2] On appeal to the Second Circuit, the plaintiff argued, among other things, that the Court had erroneously applied the "family resemblance test" established by the Supreme Court in *Reves* v. *Ernst & Young*, 494 U.S. 56, 63 (1990) when determining that the syndicated loan was not a security.

Opinion

The Second Circuit began by noting that "although the Act[3] defines 'security' to include 'any note,' the 'phrase 'any note' should not be interpreted to mean literally 'any note.''"[4] Instead, "only 'notes issued in an investment context' are securities," whereas "notes 'issued in a commercial or consumer context' are not."[5] In affirming the district court's dismissal, the Second Circuit

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[1] *Kirschner* v. *JP Morgan Chase Bank, N.A.*, Case No. 21-2726, 2023 WL 5437811 (2d Cir. Aug. 24, 2023).

[2] *Kirschner* v. *JPMorgan Chase Bank, N.A.*, Case No. 17-cv-6334 (PGG), 2020 WL 2614765 (S.D.N.Y. May 22, 2020).

[3] Securities Exchange Act of 1934 and the Securities Act of 1933.

[4] *Kirschner*, 2023 WL 5437811, at *7 (citing *Reves*, 494 U.S. at 60).

[5] *Id.*

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concluded that the syndicated bank loan on balance bore a "'strong resemblance' to one of the categories of 'notes' held not to be a security: '[L]oans issued by banks for commercial purposes. '"[6]

To reach this decision, the Second Circuit applied the family resemblance test from *Reves*,[7] which "begin[s] with a presumption that every note is a security" and then directs the court to examine four factors: (1) The motivations that would prompt a reasonable seller and buyer to enter in the transaction (i.e., the commercial purpose for seeking lending by the borrower, and the nature of the return expectations of the lender); (2) the breadth of the plan of distribution of the instrument; (3) the reasonable expectations of the investing public; and (4) the existence of another regulatory scheme to reduce the risk of the instrument.[8] When weighing these factors, the court compares the note at issue to an existing judicially crafted list of instruments that are not securities in order to determine if it bears a strong resemblance.[9]

On appeal, the Second Circuit found that while the first factor "tilt[ed] in favor of concluding that" the loan was a security because "the pleaded facts indicate the parties' motivations were mixed,"[10] the remaining factors pushed the scale in the other direction. On the second factor*,* the Second Circuit noted that the complaint had failed to plead that the loan was "offered and sold to a broad segment of the public" because the notes "were unavailable to the general public by virtue of restrictions on assignments."[11] The Second Circuit also concluded that the third factor weighed against finding that the loan was a security because "the sophisticated entities that purchased the [n]otes 'were given ample notice that the [notes] were . . . loans and not investments in a business enterprise'" based on the lenders' certification, which was "substantively identical to the certification made by the purchasers" in *Banco Espanol de Credito* v. *Security Pacific National Bank*[12]—a case in which the Second Circuit previously found that certain loan participations were not securities.[13] Finally, the fourth factor did not suggest the loan was a security because the Second Circuit reasoned that other risk-reducing factors were present: the loan was "secured by collateral and federal regulators have issued specific policy guidance addressing syndicated loans."[14]

Implications

The syndicated loan market has experienced significant growth and maturation in recent years, including the increased prevalence of secondary-market transactions. The Second Circuit's highly anticipated decision in *Kirschner* affirms the long-standing view that syndicated bank loans are not securities, likely assuaging concerns that a decision to the contrary could have significantly disrupted the market. While this decision may reflect a general unwillingness to classify such instruments as securities, the ruling also illustrates the fact-specific nature of the *Reves* framework and offers guidance on steps market participants can take to limit the risk that a syndicated loan may be deemed a "security." For example, the Court relied on the fact that restrictions were placed on assignments so that the notes were not available to the general public and that the lenders' certification confirmed the purchasers' understanding that the notes were loans rather than investments in a business enterprise. Finally, because the *Reves* framework incorporates the reasonable expectations of the investing public as a factor,

6 *Kirschner*, 2023 WL 5437811, at *13.

7 Although the complaint alleged state securities law claims under California, Colorado, Illinois, and Massachusetts law, the Court deemed *Reves* applicable to the plaintiff's claims.

8 *Id.* at *8.

9 *Id.*

10 *Id.* at *9.

11 *Id.* at * 13; *see also id.* at *9–*10.

12 *Banco Espanol de Credito* v. *Security Pacific National Bank*, 973 F.2d 51, 56 (2d Cir. 1992).

13 *Kirschner*, 2023 WL 5437811, at *13; *see also id.* at *10–*11.

14 *Id.* at *11–*13.

the Court's decision should serve to solidify such expectations, making this decision helpful precedent for defending future similar lawsuits.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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