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Insights

Secured Lender: Second Circuit Court Affirms Syndicated Loans are [STILL] Not Securities

September 6, 2023

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OVERVIEW

On August 24, 2023, the United States Court of Appeals for the Second Circuit (the "Second Circuit Court") ruled that syndicated term loans are not considered to be "securities" – meaning syndicated loans are not subject to federal securities regulations or state-specific securities regulations known as "blue sky laws". The Second Circuit Court's ruling confirms that the long-standing lending mechanics in the syndicated lending market will not face drastic changes in its regulatory landscape due to a re-classification of syndicated loans as "securities".

ANALYSIS

In its recent holding, a three-judge panel of the Second Circuit Court unanimously affirmed the 2020 ruling of the District Court of the Southern District of New York in *Kirschner v. JP Morgan Chase N.A.*, *et al.* In examining the question of whether syndicated loans are considered to be securities, both the District Court and, on appeal, the Second Circuit Court, applied the federal "family resemblance test" as articulated in *Reves v. Ernst & Young*, 494 U.S. 56 (1990). In *Reves*, the Supreme Court established a four-prong test to be utilized in determining whether financial instruments bear more of a resemblance to securities or non-securities. The four factors established under *Reves* are: (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 Securities Act unnecessary."

In affirming the District Court's ruling that syndicated loans are not securities, the Second Circuit Court provided an analysis of the *Reves* "family resemblance" factors, as summarized below:

Factor #1: Party Motivations

- In evaluating Factor #1, the Second Circuit Court acknowledged that the parties involved in the syndicated loan had mixed motivations. On the one hand, the lending parties had an expectation of making a profit return based on interest payments over the term of the loan – indicating an "investment motive". On the other hand, the borrower intended to utilize the proceeds of the syndicated loan for business purposes – indicating a "commercial motive". In balancing the weight of the motivations, the Second Circuit Court determined that the syndicated loan leaned more towards an "investment motive" and therefore Factor #1 was determined to weigh in favor of security.

- Second Circuit Court determination: Factor #1 weighs in favor of security.

Factor #2: Distribution

- In evaluating Factor #2, the Second Circuit Court examined the distribution practices of the administrative agent associated with the loan. The Second Circuit Court focused on the fact that assignment or allocation in the syndicated loan was only available to lenders that met specific qualifications and assignments were not available to the general public. Most notably, allocations of the syndicated loan were not considered to be available to the general public based on the following facts: (1) the minimum allocation amount was $1,000,000.00; (2) assignment of any allocation in the loan to a non-lender required the consent of both the administrative agent and the borrower; and (3) assignments in the syndicated loan to natural persons was prohibited. In consideration of the distribution mechanics and participation requirements, the Second Circuit Court held that the syndicated loan was not available to the general public and therefore Factor #2 weighed in favor of non-security.
- Second Circuit Court determination: Factor #2 weighs in favor of non-security.

Factor #3: Expectations of Investing Public

- In evaluating Factor #3, the Second Circuit Court explained that "[i]f buyers were given ample notice that the instruments were loans and not investments in a business enterprise, it suggests that the instruments are not securities." The Second Circuit Court gave significant weight to the fact that the lenders that were allocated assignments in the syndicated loan were sophisticated lenders that were each required to: (1) certify their experience in participating in similar syndicated loans; and (2) conduct their own independent credit evaluation of the borrower and the loan. The Second Circuit Court determined that such requirements indicated that the syndicate lenders could not reasonably have perceived the syndicated loan to be a security rather than a loan.
- Second Circuit Court Determination: Factor #3 weighs in favor of non-security.

Factor #4: Other Regulations

- In evaluating Factor #4, the Second Circuit Court focused on two factors: (1) the syndicated loan was secured by collateral; and (2) the syndicated loan was subject to specific policy requirements set forth by the principal federal banking regulators (i.e. the OCC, the Federal Reserve and the FDIC). The Second Circuit Court determined that consumer risks associated with syndicated loans were sufficiently protected by the collateralization of the loan and by the federal banking regulations, and, as such, the application of securities laws to syndicated loans is unnecessary.
- Second Circuit Court determination: Factor #4 weighs in favor of non-security.

Based on its analysis and weighing of the *Reves* factors as briefly discussed above, the Second Circuit Court held that syndicated loans do not constitute securities and are therefore not subject to state or federal securities regulations.

IMPLICATIONS

The Second Circuit Court's holding means, in practice, current market mechanics and practices relating to syndicated loans are sufficient under the law and no further regulations based on securities laws will be imposed on administrative agents or syndicate lenders. In order to maintain such legal landscape for syndicated loans, in consideration of the *Reves* factors, syndicated loan market participants should ensure the

following existing market practices remain in place:

1. Terminology utilized in syndicated loan documentation should continue to reflect terms such as "Lender", "Administrative Agent", "Borrower", "Loan", etc. Such loan-related terminology ensures that all market participants understand and acknowledge that the financial instruments being executed and utilized in connection with the syndication are in the form of a loan (rather than a security).
2. Lead lenders and administrative agents should continue to have specific requirements in place for potential assignees in syndicated loans, including but not limited to: (1) potential syndicate lenders must be corporate and institutional entities; (2) allocations of the loan to syndicate lenders should have clear minimum dollar amounts; (3) assignments to individuals should be prohibited; and (4) assignments of interests in syndicated loans to unaffiliated third-parties should continue to require the written consent of borrower and administrative agent.
3. Distribution of syndicated loan opportunities should be strictly limited to institutional lenders (rather than individuals and/or the general public).

The requirements set forth above in relation to syndicated loans are consistent with our firm's current practices and documentation of syndicated loans. If you have questions regarding the documentation of syndicated loans, please contact any member of the Krieg DeVault LLP **Commercial and Real Estate Lending Practice**.

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