Akin

Second Circuit Holds That Syndicated Term Loans Are Not Securities

By Parvin Daphne Moyne, Peter I. Altman, Michael A. Asaro, Jesse Michael Brush, Brian T. Daly, Daniel I. Fisher, Katherine R. Goldstein, Ranesh Ramanathan and Kendall Lewis Manlov

August 29, 2023

- On August 24, 2023, a three-judge panel of the 2nd Circuit **unanimously held** that the syndicated term loans at issue were not "securities" under the test articulated by the Supreme Court in *Reves v. Ernst & Young*.
- The syndicated loan market and the financing markets, in general, will welcome the 2nd Circuit's decision, which comports with customary practices that have been in place for decades. The decision also provides further specific guidance to market participants on the application of the *Reves* factors to these types of instruments.

Background

In 2017, the trustee of the Millennium Lender Claim Trust brought an action in New York state court against a syndicate of lenders alleging that a $1.8 billion syndicated loan transaction violated, inter alia, state securities laws. The defendants removed the case to federal court and then moved to dismiss on the basis that the Millennium syndicated loan notes (the "Notes") are not securities under the "family resemblance test" articulated in *Reves v. Ernst & Young*, 494 U.S. 56 (1990).

In *Reves*, the Supreme Court recognized that a presumption exists that notes are securities. 494 U.S. at 65. *Reves* then directs courts to uncover 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 Supreme Court directed courts to determine whether the particular notes bear a "family resemblance" to securities or non-securities. The four factors of the "family resemblance test" 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." *Id.* at 66-67.

On May 22, 2020, Judge Paul G. Gardephe of the U.S. District Court for the Southern District of New York granted the defendants' motion to dismiss, holding that the Notes were analogous to bank loans—not securities. On October 28, 2021, the plaintiff appealed to the U.S. Court of Appeals for the 2nd Circuit[1], and the case was argued on March 9, 2023. Shortly after oral argument, on March 16, 2023, the 2nd Circuit solicited the Securities and Exchange Commission's opinion regarding whether a syndicated term loan note is a security. The Commission sought three extensions of time to file its amicus brief before ultimately informing the court that it was not in a position to provide its views on the issue.

The 2nd Circuit Decision

On August 24, 2023, in a unanimous opinion authored by Judge José A. Cabranes, the 2nd Circuit affirmed the lower court's dismissal. In applying the "family resemblance test," the 2nd Circuit found that three of the four factors weighed against finding that the plaintiff had adequately alleged that the Notes constituted securities under *Reves*.

- ***Factor 1 – Motivations***: In assessing the first *Reves* factor, the court held it "must determine 'whether the motivations [of the seller and buyer] are investment (suggesting a security) or commercial or consumer (suggesting a non-security).'" Slip Op. at 27. The court found that the parties' motivations were mixed. On one hand, the lenders' motivation was "investment" because they expected to profit from the Notes. On the other hand, the borrower's motivation was "commercial" because it planned to use the Note proceeds to pay down existing debt; make a shareholder distribution; redeem or repay outstanding warrants, debentures and stock options; and pay fees and expenses related to issuing the Notes. *Id*. at 28. Altogether, the court concluded that the plaintiff had plausibly alleged the Notes constituted securities under the first factor. *Id*. at 28-29.
- ***Factor 2 – Distribution***: In assessing the second *Reves* factor, the court "examine[d] the plan of distribution of the instrument to determine whether it is an instrument in which there is common trading for speculation or investment." *Id*. at 29. The court focused on the fact that the Notes were unavailable to the general public, in particular highlighting the importance of limitations on the distribution of the Notes to a "natural person" or without the consent of the Issuer and the administrative agent. The Notes could not be assigned to natural persons or without the consent of the borrower and administrative agent. The credit agreement also included restrictions on transfers in amounts less than $1 million. Notably, the court rejected plaintiff's argument that the presence of a secondary market was dispositive given these assignment restrictions. *Id*. at 30.[2] The second factor thus weighed against finding that the plaintiff had plausibly alleged that the Notes constituted securities. *Id*. at 32.
- ***Factor 3 – Expectations***: In assessing the third *Reves* factor, the 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." at 32. The court found that this factor also weighed against concluding that the Notes constituted securities because, in the documents governing the Notes, the lenders had to certify that they were sophisticated and experienced in extending credit and that they had made an independent appraisal of the loans without reliance on any agent or borrower. The court was not persuaded by the intermittent references in the loan documents to the buyers (i.e., the lenders) as "investors," finding that "[t]hese isolated references could not have plausibly created the *reasonable* expectation that the buyers were investing in securities." *Id*. at 34.
- ***Factor 4 – Other Regulatory Factor(s)***: In assessing the fourth factor, the court "examine[d] 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." *Id*. at 35. The court concluded that the fact that the Notes were secured by collateral and that federal regulators had issued specific policy guidance addressing syndicated loans further weighed against concluding that the Notes are securities. *Id*. at 36. The court was not persuaded by arguments that these guidelines were meant to minimize risks to banks, finding that "in doing so it also aims to protect consumers." *Id*. at 37.

Implications

Had the 2nd Circuit held that syndicated term loans are securities, it would have disrupted decades of market conventions in the syndicated loan market. Moreover, as we discussed in our prior **client alert** on the subject, a contrary decision from the 2nd Circuit could have exposed commercial lenders, secondary market participants and borrowers to increased risk of liability for insider trading and tender offer requirements, and would have significantly restricted existing CLOs from owning syndicated term loans. In short, there would have been significant chaos in the loan markets. The 2nd Circuit's decision should assuage these immediate concerns and provides further guidance to lenders and borrowers seeking to minimize the risk of having loans classified as securities in the future.

If you have questions about this client alert, please contact any Akin lawyer or advisor below:

Parvin Daphne Moyne
pmoyne@akingump.com
+ 1 212.872.1076

Peter I. Altman
paltman@akingump.com
+ 1 310.728.3085

Michael A. Asaro
masaro@akingump.com
+ 1 212.872.8100

Jesse Michael Brush
jbrush@akingump.com
+1 212.872.1046

Brian T. Daly
bdaly@akingump.com
+1 212.872.8170

Daniel I. Fisher
dfisher@akingump.com
+1 212.872.7450

Katherine R. Goldstein
kgoldstein@akingump.com
+1 212.872.8057

Ranesh Ramanathan
ramanathanr@akingump.com
+1 212.872.1098

Kendall Lewis Manlove
kmanlove@akingump.com
+1 212.872.8026

[1] Plaintiff also appealed the district court's ruling that it had subject matter jurisdiction pursuant to the Edge Act, 12 U.S.C. § 632. The 2nd Circuit held that the district court properly concluded that it had jurisdiction.

[2] In so finding, the court found that the Notes contained restrictions on assignments similar to those placed on the loan participations at issue in *Banco Espanol de Credito v. Security Pacific National Bank*, 973 F.2d 51 (2d Cir. 1992). There, the 2nd Circuit found the limitations placed on the reselling of the loan participations without express written permission of the issuer weighed against the conclusion that the loan participations were securities. *Id.* at 55.