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ALERTS

Kirschner V. JP Morgan: Syndicated Term Loans Are Not Securities, But What About Digital Assets?

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Highlights

The Second Circuit's ruling was a relief for many market participants in the trillion-dollar syndicated loan market

By affirming the test used in *Reves*, the Second Circuit recognized that notes are used in a variety of settings, with different purposes, and not all uses involve investment

It remains to be seen whether the *Kirschner* decision will impact the SEC's attempts to regulate digital assets as securities. However, it seems unlikely that *Howey* will be displaced as the dominant standard by which digital assets and protocols will be analyzed by regulators and the courts

In a highly anticipated ruling, the U.S. Court of Appeals for the Second Circuit recently ruled in *Kirschner v. JP Morgan Chase Bank, N.A.*, that broadly syndicated term loan Bs are not securities and that securities laws may not serve as the basis of claims against parties such as those responsible for marketing such loans to potential lenders.

The case had been closely monitored by secondary loan market

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participants, private credit lenders, syndicate members, banks and borrowers, because a contrary finding that such loans were securities could have: 1) required all secondary market debt trading activity to include a registered broker-dealer subject to securities regulations; 2) limited borrowers' ability to issue syndicated term loans except through a public offering or qualified private placements; 3) limited US banks' ability to hold syndicated loans in compliance with the Volcker Rule's restrictions on bank investments in securities; and 4) resulted in higher expenses for both private fund managers that employ strategies in the credit space and borrowers - as transactions would need to comply with securities laws on federal and state levels.

The outcome was largely expected, following a similar ruling by the lower court in September 2021. However, the Second Circuit's ruling nonetheless was a relief for many market participants in the trillion-dollar syndicated loan market.

JPMorgan Chase & Co. and certain other banks (the Initial Lenders) agreed to make a $1.775 billion term loan, and a $50 million revolving loan, to Millennium Health LLC, Inc. f/k/a Millennium Laboratories (Millennium) in 2014. Concurrently with the loan closing, the Initial Lenders marketed the loan for syndication, ultimately syndicating the loan to a group of approximately 61 institutional investors who sub-allocated or participated their loans to approximately 400 entities.

Both in the lead up to and following the loan's April 2014 closing, Millennium was subject to all of the following: an ongoing U.S. Department of Justice (DOJ) investigation, litigation with one of its competitors, and a qui tam action alleging improper billing practices. Millennium ultimately reached a $256 million settlement with the DOJ. In November 2015, partly to address the financial hardship that paying that settlement caused, Millennium then filed for bankruptcy.

As part of Millennium's bankruptcy, a litigation trust was established with Marc Kirschner as trustee, which was empowered to pursue, inter alia, securities fraud claims against the Initial Lenders based on their syndication of the loan in question. In August of 2017, Kirschner instituted a lawsuit in New York state court against the Initial Lenders.

The Initial Lenders moved to dismiss the case, arguing that the loans in question were not "securities" and thus could not subject them to state law securities liability. The federal district court agreed and dismissed the case. Kirschner appealed to the Second Circuit.

Second Circuit Decision

The Second Circuit affirmed the lower court's finding that the loans in question were not "securities" and Kirschner's state securities law claims therefore had to be dismissed.

In that regard, the Second Circuit agreed with the district court that the proper test to apply was the "family resemblance" test enunciated by the

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Supreme Court in *Reves v. Ernst & Young* as applied by the Second Circuit itself in *Banco Espanol de Credito v. Security Pacific National Bank*, two cases from the 1990s. That test begins with a presumption that every note is a security. But that presumption can be overcome if the notes at issue bear a strong "family resemblance," based on four factors, to one of the enumerated categories of instruments excluded from the definition of a security.

These four factors are: 1) the motivation of parties in entering into the transaction (i.e., if transaction for "investment" purposes more likely to be a security; if transaction for "commercial" purposes, less likely to be a security); 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 thereby rendering the application of securities laws unnecessary.

Applying those four factors to the facts at issue with respect to the Millennium loan, the Second Circuit agreed that the notes associated with that loan, post-syndication, were not securities.

- With respect to the first factor, the Second Circuit found the parties' motivations were mixed, with the lenders' motivations being investment focused (i.e., to profit from their purchase of the notes) and Millennium's being motivation commercial (i.e., to raise money for its business). The court found those mixed bases to favor a finding that the notes tied to these loans were securities.
- With respect to the second factor, the Second Circuit found that the notes were not available on an unrestricted basis to the general public due to the assignment restrictions applicable to transferees and loan participants contained in the loan documents, thus favoring a finding that such notes were not "securities."
- With respect to the third factor, the Second Circuit found that the note assignees were all sophisticated entities who were given ample notice that the notes were loans and "not investments in a business enterprise." That factor thus also favored finding that the notes were not securities.
- With respect to the fourth and final factor, the Second Circuit found that several aspects of the transaction reduced its risk, including that the notes were secured by collateral and that the OCC, Federal Reserve and FDIC all issued specific policy guidelines addressing syndicated term loans thus obviating the need for protection also from securities laws. That final factor also favored a finding that the notes were not securities.

Based on the above, the Second Circuit held that the notes related to the loans bore "a strong resemblance" to one of the enumerated categories of notes that are not securities, namely "loans issued by banks for commercial purposes." Given that there was no basis for Kirschner's claims under state law, the Second Circuit affirmed their dismissal.

Takeaways; Impact on Digital Asset Regulation?

The key takeaway from *Kirschner* is that the syndicated debt market does not need to be wholly reworked so as to incorporate registered broker-dealers or public offerings or to take the Volcker rule into effect. While such an impact was unlikely in light of the lower court's 2021 decision, the adverse impact a counter-decision could have had was enough to keep the industry on edge. That cloud has now been lifted, and the industry can breathe a sigh of relief.

The *Kirschner* decision may offer some hope to the digital asset community that remains in limbo without relief in sight. By affirming the test used in *Reves*, the Second Circuit recognized that notes are used in a variety of settings, with different purposes, and not all uses involve investment. Even though certain debt instruments are securities under the Securities Act, the court developed an "investment versus commercial" test to recognize that there are many types of instruments that are securities, but not all instruments are investments and therefore need not be regulated as securities.

The overlap between the *Kirschner* case and the digital asset space was made evident by the SEC's refusal, during the appeal process, to provide its own view as to whether the loans at issue should be deemed securities – the Second Circuit expressly requested the SEC's view, but the SEC declined to provide it. Commentators have speculated that the SEC was concerned with providing a position regarding one type of financial instrument that has traditionally not been viewed as a security while it was, at the same time, attempting to regulate digital assets that may bear some resemblance to a loan in some respects.

It still remains to be seen whether the *Kirschner* decision will impact the SEC's attempts to regulate digital assets as securities. The SEC has been active and outspoken in their attempted regulation of cryptocurrency, taking the position that essentially all crypto tokens are securities – regardless of commercial application; relying on the seminal *SEC v. W.J. Howey Co*. case to determine whether digital assets are "investment contracts" subject to federal securities laws. Howey defines "investment contract" as a contract, transaction, or scheme whereby a person 1) invests his money; 2) in a common enterprise; and 3) with the reasonable expectation of profits based on the managerial efforts of a promoter or a third party. *Kirschner* demonstrates the court has the ability to differentiate even when Congress paints with a broad brush. It seems unlikely that *Howey* will be displaced as the dominant standard by which digital assets and protocols will be analyzed by regulators and the courts – but the situation nonetheless bears watching.

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