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Are Syndicated Term Loans Securities? The SEC Declines to Weigh in on Kirschner

The Capital Commitment on **August 2, 2023**

Participants in the syndicated loan markets may have been relieved last month when the SEC declined to file the amicus brief requested by the Second Circuit Court of Appeals in *Kirschner v. JP Morgan Chase Bank*. In an unusual turn of events, the SEC choose not to weigh in on whether the syndicated term loans at issue are securities. In a July 18, 2023 letter to the court, the SEC explained that "despite the best efforts to respond to the court's request, the Staff was not in a position to file a brief on behalf of the Commission." *Id.* Whatever the reason, the SEC's decision leaves the Second Circuit panel without the agency's views, and to speculate over the agency's reasons for its clearly very deliberate decision not to act.

A decision by the Second Circuit is still pending, and the potential therefore remains for an adverse opinion by the court supporting the plaintiff and finding that the instruments at issue are indeed "securities." Such a finding, if left unchallenged, could materially impact current established market practices of syndicating and trading certain types of term loans.

Background

The dispute in *Kirschner* arose from a $1.775 billion syndicated loan to Millennium Laboratories LLC ("Millennium") that closed nineteen months before Millennium filed for bankruptcy. As part of that transaction, the defendant banks sold Millennium debt obligations to approximately 70 institutional investor groups, comprised of roughly 400 mutual funds, hedge funds, and other institutional investors. The trustee for the bankruptcy's litigation trust sued the banks asserting various claims, including that the loans should be treated as "securities" under the securities laws of several states.

The district court had granted the defendants' motion to dismiss and held that the syndicated terms loans were not securities under "family resemblance" test previously established by the Second Circuit and later adopted by the U.S. Supreme Court in *Reves v. Ernst & Young*.

The plaintiff appealed the district court's dismissal to the Second Circuit.

The Second Circuit's Request and the SEC's Response

The Second Circuit heard oral argument on March 9, 2023 before the court's three-judge panel. Early in the argument, Judge Bianco asked counsel for the trustee why the SEC had not expressed its position on such an important regulatory question and whether the court should interpret the SEC's silence as acquiescence in the position that the syndicated loans at issue were not securities. Later in the argument, Judge Bianco and Judge Cabranes returned to the question and asked counsel for the banks whether the court should solicit the views of the SEC or the banking regulators. Thereafter, the court issued an order soliciting the SEC's views as to "whether the syndicated term loan notes at issue in this appeal are securities under *Reves* . . . given the importance of the issue, the parties' diverging positions, and the policy implications that would result from our resolution of this case."

While the SEC has not publicly given a reason for its decision to decline the request to file its *amicus* brief (nor would it be customary for the SEC to do so), the submissions filed with the court on the briefing schedule do indicate that the SEC considered this to be an important issue, and therefore one that merited broad consultation with other federal agencies and also internally within the SEC before responding to the court. In initially requesting a 28-day extension until June 27 to respond to the court's Order, the SEC's motion noted:

> [T]his is an important issue and the Commission has an interest in ensuring that its views on this issue are considered by the Court … [T]his issue warrants consultation with other federal agencies. Commission counsel will also need to consult with counsel for the parties, as well as internally, before recommending a response. And the Commission itself needs to consider the recommended response.

In the interim period, one of the defendants requested that the court also directly solicit the views of the other relevant agencies—the OCC, Treasury Department, FDIC, and Federal Reserve—to file briefs (as opposed to merely relying on the SEC to consult with those agencies before filing its own brief), noting that those other agencies "could be of material assistance to the Court here given those regulators' familiarity with the syndicated loan market." However, the court promptly denied the request.

The SEC sought two more extensions thereafter, with the agency's papers on the second request suggesting, that a brief was forthcoming, noting that the seven-day extension would allow the SEC "to file an *amicus* brief setting forth its views on the Court's question." The motion referenced the internal approval process required to authorize the filing of the brief:

> Commission staff may not file an *amicus* brief without approval by a majority of Commissioners, and the additional seven-day extension will allow for adequate time for Commission review and approval. The Commission does not anticipate needing to request any additional extensions of time. *Id.*

What's next?

It has been over thirty years since the last time the SEC filed an *amicus* brief to weigh in on the status of similar instruments as "securities," also in the Second Circuit in *Banco Espanol de Credito v. Nat. Bank*. There, the Second Circuit ultimately did not adopt the SEC's reasoning that the loan participations at issue were securities under *Reves.* Since that time, however, the syndicated loan market has expanded to $2.5 trillion, and the instruments and practices within that market have evolved.

By taking a pass on *Kirschner* and leaving it for the Second Circuit to decide how to apply the *Reves* test to the instruments and practices at issue, the SEC has given up any chance of influencing the outcome at least at this stage of the case. Depending on how the court rules, the outcome could curtail the agency's ability to regulate the term loan market in the future.[1] As noted, a decision by the Second Circuit is forthcoming, and we will continue to closely monitor this case and provide updates as they occur.

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[1] We note that while this outcome could have ramifications under the state securities laws at issue as well as under the Securities Act of 1933 and the Securities Exchange Act of 1934, it would be unlikely to affect the application of the Investment Advisers Act of 1940 or the Investment Company Act of 1940 to credit market participants that are subject to those Acts, given that the latter two Acts (and related SEC rulemaking and interpretive guidance) utilize broader definitions of “securities” than the former two.

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