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# Kirschner: The Final Act?


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# KIRSCHNER
# THE FINAL ACT?

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On August 24, 2023, the US Court of Appeals for the Second Circuit issued its decision in the *Kirschner v. JPMorgan* litigation saga, rejecting the plaintiff's argument that syndicated term loans should be treated as securities.[iv] On February 20, 2024, the US Supreme Court denied the Kirschner petition for a writ of *certiorari*—an application for permission to appeal the Second Circuit's decision to the Supreme Court. This signaled the presumptive end for the "loans as securities" argument that Kirschner, a bankruptcy trustee in connection with Millennium Health, had pursued in various courts for nearly seven years.[v]

A range of loan market participants were concerned by the prospect that the Supreme Court could decide to take up the *Kirschner* case and could ultimately find that syndicated term loans should be treated as securities. There was concern among lenders, borrowers and investors that such a finding would create substantial negative implications for the origination and trading of broadly syndicated institutional term loans—"term loan Bs" ("TLBs")—which are typically syndicated to institutional lenders such as CLOs and hedge funds. As a result of the Supreme Court's decision to deny the petition for *certiorari*, these TLB market participants are now able to breathe a sigh of relief and continue with business as usual, taking comfort that TLBs are not to be treated as securities, as had been the judicially endorsed market view for decades.

We discuss the background of the *Kirschner* litigation—in particular the Second Circuit court's August 2023 decision—below.[vi]

## *KIRSCHNER*: A CHRONOLOGY

The "Notes" at issue in the *Kirschner* case actually related to a $1.775 billion syndicated loan—a TLB. While the loan, like all TLBs, was governed by a credit agreement, that credit agreement (as is typical) permitted lenders to request that short-form promissory notes be issued to further evidence their positions in the TLB. It is the underlying loan, not any such promissory notes, that was syndicated. The proceeds of the $1.775 billion TLB were used to refinance existing debt and pay dividends and bonuses.

As part of the Chapter 11 bankruptcy proceedings for Millennium Health, the plaintiff, Marc Kirschner, was appointed trustee of the Millennium Lender Claim Trust, the ultimate beneficiaries of which are lenders who purchased portions of the TLB issued by Millennium Health and had claims in the bankruptcy proceeding.

Kirschner filed suit in 2017 in New York State Court against several financial institutions that were

 

involved with the syndication, with claims that included violation of state securities laws. The case was removed to the US District Court for the Southern District of New York, pursuant to the Edge Act 1919, as amended ("Edge Act").

**District Court's initial holding**

In May 2020, US District Judge Paul Gardephe granted the defendants' motion to dismiss.[vii] With respect to the state securities laws claims, Judge Gardephe applied to the Millennium TLB the four-factor "family resemblance" test outlined by the US Supreme Court in *Reves v. Ernst & Young*, 494 U.S. 56 (1990). Judge Gardephe determined that "the limited number of highly sophisticated purchasers of the [Millennium] Notes would not reasonably consider the Notes 'securities' subject to the attendant regulations and protections of Federal and state securities law."[viii]

Kirschner appealed Judge Gardephe's decision in October 2021.

**Second Circuit Affirms: Under *Reves*, TLBs are not securities**

**The four-factor "family resemblance" test**

Writing for the three-judge panel, longtime Second Circuit Judge Jose Cabranes walked through the *Reves* test, noting that each factor "helps to uncover whether the note was issued in an investment context (and is thus a security) or in a consumer or commercial context (and thus is not a security)." Judge Cabranes identified the four *Reves* factors as:

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 Acts unnecessary.

Furthermore, under the *Reves* test, courts are to begin with the presumption that every "note" is a security. This presumption may then be rebutted by a showing that the subject "note" bears a strong "family resemblance" to notes in a list of instruments that courts have recognized as not being securities. Judge Cabranes elaborated that if the "note" at issue does not bear a strong resemblance to an instrument on such list, that is not dispositive. "The [*Reves*] test allows courts to expand the list of non-security instruments to include the type of note at issue if, based on the four factors, a court concludes that the note is not a security."[ix]

**The test, applied to *Kirschner***

1. The Motivations of the Parties

Applying the first of the four factors, the Second Circuit panel determined that the "motivations" factor "tilts in favor of concluding that the complaint plausibly alleges that the Notes are securities."[x] The Second Circuit found that the parties' motivations were mixed. On the one hand, the Second Circuit found that it appeared Millennium's motivations were commercial—to use the subject loans to pay down another facility as opposed to, for example, using the financing for its urine-testing business. But "the

 

pleaded facts," the Second Circuit determined, "plausibly suggest that the lenders' motivation was investment because the lenders expected to profit from their purchase of the Notes"[xi] given the interest payable on them.

2. Plan of Distribution

Judge Cabranes wrote that the second factor in the *Reves* test requires courts to "'examine the plan of distribution of the investment to determine whether it is an instrument in which there is common trading for speculation and investment.'"[xii]

Judge Cabranes elaborated, "[t]his factor weighs in favor of determining that a note is a security if it is 'offered and sold to a broad segment of the public.' This factor weighs against determining that a note is a security if there are limitations in place that 'work to prevent the [notes] from being sold to the general public.'"[xiii]

The Second Circuit was unequivocal that this factor weighed against concluding that the Millennium loans were securities. Judge Cabranes noted that:

1. The lead arrangers offered the loans only to sophisticated institutional entities;
2. One of the lead arrangers, JP Morgan, proceeded to allocate the loans to "only the sophisticated institutional entities that submitted 'legally binding offer[s]'"; and
3. There were substantial "restrictions on any assignment"—transfer restrictions—with respect to the Millennium loans that "rendered them unavailable to the general public." These restrictions included, among others, a prohibition on assignments to natural persons as well as a requirement that any assignment be for more than $1 million unless the assignment is to an affiliate or an "approved fund".

The Second Circuit found that the assignment restrictions were "akin" to those in the longtime Second Circuit precedent *Banco Espanol de Credito v. Security Pacific National Bank*, 973 F.2d 51 (2d. Cir. 1992), where the Circuit applied *Reves* and found that the transfer restrictions weighed against finding that the subject loan participations were securities.[xiv]

3. The Public's Reasonable Perception

Judge Cabranes noted that the third *Reves* factor requires courts to "examine the reasonable expectations of the investing public." If buyers of loans or notes, Judge Cabranes wrote, were "'given ample notice that the instruments were… loans and not investments in a business enterprise,' it suggests that the instrument are not securities."[xv]

The Second Circuit found that the facts did not plausibly suggest that the lenders acquiring Millennium loans reasonably perceived any notes associated therewith to be securities.

Judge Cabranes noted that before purchasing the Millennium loans, "lenders certified that they were 'sophisticated and experienced in extending credit to entities similar to [Millennium].' They also certified that they had 'independently and without reliance upon any Agent or any Lender, and based on such documents and information as [they] ha[ve] deemed appropriate, made [their] own appraisal of and investigation into the business, operations, property, financial and other condition and creditworthiness

 

of [Millennium] and made [their] own decision to make [their] Loans hereunder.'"[xvi] Judge Cabranes observed that this certification regarding sophistication and experience was "substantively identical" to the certification made by the purchasers of loan participations in *Banco Espanol*.[xvii]

Significantly, the Second Circuit was not swayed otherwise on this factor by the fact that the documents provided to prospective lenders "at times" referred to the prospective lenders as "investors." Judge Cabranes reasoned that (1) there were only isolated references to "investors" in the documents, and "these isolated references could not have plausibly created the reasonable expectation that the buyers were investing in securities," and (2) the loan documents "more consistently" referred to the buyers as "lenders." Judge Cabranes concluded, "[t]his label aligns with the reasonable expectations of the experienced entities that the Notes were not securities."[xviii]

4. Whether Some Other Risk-reducing Factor Renders Application of Securities Laws Unnecessary

Judge Cabranes noted that the final *Reves* limb is whether some other factor, such as the existence of another regulatory scheme, significantly reduces the risk of the instrument, rendering application of the Securities Acts unnecessary.[xix]

The Second Circuit found that this factor also weighed against a finding that the subject Millennium loans were securities.[xx]

First, the Second Circuit cited the fact that the Millennium loans were secured: "That perfected first priority security interest reduces the risk associated with the Notes."[xxi]

Second, the Second Circuit cited policy guidelines issued by Federal agencies addressing syndicated term loans. Judge Cabranes acknowledged Kirschner's argument that the bank regulators' guidance simply addresses risk management controls to ensure sound banking practices. However, Judge Cabranes found that the guidance, in fact, does aim to protect consumers. Moreover, Judge Cabranes noted that the Court had previously considered and rejected this same argument regarding bank regulatory guidance in *Banco Espanol*.[xxii]

Judge Cabranes notably cited *Banco Espanol* in the Second Circuit's ultimate conclusion: "Upon our review of the pleaded factors, we conclude that the Notes, like the loan participations in *Banco Espanol*, 'bear[] a strong resemblance' to one of the enumerated categories of notes that are not securities:[xxiii] '[L]oans issued by banks for commercial purposes.'"

**Supreme Court denies *certiorari***

On November 10, 2023, Kirschner's counsel signaled Kirschner's intent to appeal the Second Circuit court's decision and applied to the Supreme Court for an extended time period to petition for *certiorari*. Justice Sotomayor granted this application on November 15, 2023, and allowed Kirschner's counsel until December 19, 2023 to file their petition.

On December 19, 2023, Kirschner's counsel petitioned for a writ of *certiorari* seeking to have the Supreme Court decide his case on appeal from the Second Circuit. As noted above, on February 20, 2024, the Supreme Court denied Kirschner's petition, putting an end to the litigation and allowing the Second Circuit decision to stand.

 

## IMPLICATIONS OF *KIRSCHNER* AND THE SUPREME COURT'S DENIAL OF *CERTIORARI*

### Syndicated Loans

The decision has validated and reconfirmed the long-standing overall approach of the TLB market (and debt markets generally) to treat TLBs as loans and not securities.

Among the parties celebrating the end of the road for *Kirschner* was the Loan Syndications and Trading Association ("LSTA"), the leading trade association for the US Dollar loan market. "Holding that loans are securities would have had a devastating effect on the $1.4 trillion market for leveraged syndicated term loans," the LSTA opined, with such effects being avoided through the Second Circuit's decision and the Supreme Court's denial of *certiorari*.[xxiv] The LSTA further noted that the adverse impacts of a holding that loans are securities—increased costs, potential requirements for market participants to register as broker-dealers, and an inability to receive material non-public information (to name a few)—have now been avoided.[xxv]

It should be noted that, technically, the Supreme Court has not ultimately and finally decided the issues presented by *Kirschner*; rather, the Supreme Court declined to take up the petition for *certiorari* and give Kirschner's arguments any further judicial consideration. This is the same outcome as in the *Banco Espanol* litigation, where there also the Supreme Court denied *certiorari* and declined to rule on the "loans as securities" issue.[xxvi] There are two plausible takeaways from these *certiorari* denials: (1) the optimistic inference is that, having been presented with, and having declined, the opportunity to rule on these issues twice over, the Supreme Court considers the matter settled; or (2) the necessarily "glass-half-empty" conclusion is that, without binding precedent from the Supreme Court, there is some encouragement given to would-be plaintiffs to pursue the *Kirschner*/*Banco Espanol* plaintiffs' arguments again in future in the hope that a court may reach the opposite conclusion, and perhaps some at the Securities and Exchange Commission will be of the view that the SEC can issue some sort of interpretative guidance that would cut against the Second Circuit's decision, at least in part. Moreover, without a Supreme Court ruling, it is conceivable that circuit courts outside of the Second Circuit could decide these issues differently than the Second Circuit, thereby creating a split of authority. Only time will tell whether any of this will materialize.

There are some best practice points for loan market participants to take heed of from the Second Circuit's decision. Careful structuring of loan documentation is prudent, and parties should always remain cognizant of how they are advertising and framing participation in any funding. In particular:

1. Note that a loan taken out to fund a significant investment is likely to mean that an analysis under the first *Reves* factor will conclusively tilt towards a finding that the loans are securities. A loan for the "general use of a business enterprise" is also likely to have the same outcome, although *Kirschner* does not detail the differences between such loans and loans for "some other commercial or corporate purpose," which loans tilt the balance *away* from a finding that the loans are securities.[xxvii] Without further explication it is possible to read these two ostensibly different categorizations as presenting a distinction without a difference, making it somewhat difficult for lenders and borrowers to determine how a given TLB might be viewed;
2. *Kirschner* placed much emphasis on the sophistication of the financing parties involved with the Millennium loans in finding that the subject notes were not securities. Consider giving an

 

increased amount of notice, information and explanation to any financing parties who may be less mature or newer to the relevant lending space;
3. Labels may be pivotal: consistently use the term “lender” versus “investor” and “loan” versus “note”;
4. Apply customary exacting eligible-lender limitations and requirements and assignment restrictions, such as minimum dollar amount assignment rules (including borrower/administrative agent consents); and
5. Granting lenders a security interest in the borrower’s assets is helpful in tilting the balance under the fourth *Reves* factor in favor of a finding that the loans are not securities. The fourth factor is always likely to tilt this way, however, given the existence and enduring nature of banking regulatory guidance.

**The Edge Act**

Loan market participants should be aware of the jurisdictional reach of the Edge Act, per *Kirschner*, as this opens a potential avenue by which a party can be hauled into Federal court.

Judge Cabranes noted that, among other factors, Federal jurisdiction under the Edge Act is dependent on: (1) a party to the litigation being an Edge Act bank/corporation (essentially, a bank/corporation with Federal authorization to engage in foreign banking); and (2) the suit arising out of international or foreign banking, banking in a U.S. dependency or insular possession, or other international or foreign financial operations.[xxviii]

With regard to this second limb, the Second Circuit made clear that assigning a portion of a loan to a foreign bank is sufficient to meet the threshold of engaging in “international or foreign banking”.[xxix] It does not matter, said Judge Cabranes for the Second Circuit panel, whether international banking participants are actively solicited by the Edge Act party; rather, it is the purely mechanical act of granting such international participants involvement in the funding through a loan assignment that brings the Edge Act party within the scope of the Act’s Federal jurisdiction provisions.[xxx]

Footnotes

i. Global Head of Leveraged Finance
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iv. Kirschner v. JPMorgan Chase Bank, N.A., 2023 WL 5437811 (Aug. 24, 2023).
v. Order List: 601 U.S., February 20, 2024 at 23-670, page 6.
vi. The substance of much of the forgoing analysis first appeared in Scott Zemser, Frederick C. Fisher, Adam C. Wolk, J. Bradley Keck, Stuart M. Litwin, Arthur S. Rublin, Michael O. Ware, Mayer Brown LLP, “Kirschner: Implications for Syndicated Term Loans,” 2023 available here.
vii. Kirschner v. JPMorgan Chase Bank, N.A., 2020 WL 2614765 (2020); J. Paul Forrester, Mayer Brown LLP, “Millennium Health Judge Finds Loans at Issue Not Securities, Dismisses Related Blue Sky Claims; US Leveraged Loan Market Breathes a Sigh of Relief,” 2020 available here.
viii. Kirschner, 2020 WL 2614765 at *10.
ix. Kirschner, 2023 WL 5437811 at *8.
x. Id. at *8.

 

xi. Id.
xii. Id.
xiii. Id.
xiv. Id. at *9-10.
xv. Id. at *10.
xvi. Id.
xvii. Id. at *11.
xviii. Id.
xix. Id.
xx. Id. at *12-13.
xxi. Id. at *12.
xxii. Id.
xxiii. Id. at *13.
xxiv. Elliot Ganz; LSTA, “The Kirschner Case: This is the End,” 2024 available here.
xxv. Id.
xxvi. United States Reports Volume 509 at 92-913, page 903.
xxvii. Kirschner, 2023 WL 5437811 at *8.
xxviii. Id. at *6.
xxix. Id. at *7.
xxx. Id.

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