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A decades-old question answered: Term loans are not securities

By Danielle Li, Esq., and Adriane Sanchez, Esq., Skadden, Arps, Slate, Meagher & Flom LLP*

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Key points

- Terms in a typical syndicated term loan B have converged to an increasing extent with those of high-yield bonds in recent decades, leading some to argue that such loans should be considered securities.
- A recent Second Circuit case rejected that argument, holding that syndicated term loans are not securities; a contrary ruling would have caused enormous disruption in the trillion-dollar syndicated loan market.
- The syndicated loan market offers borrowers and lenders greater flexibility, and avoids the registration, ongoing disclosure costs and burdens imposed by securities laws as well as the trading and information-sharing restrictions of that regime.

A recent appellate ruling, *Kirschner v. JPMorgan Chase Bank N.A.*,[1] rejected the contention that syndicated term loans should be treated as securities, affirming the long-held view by market participants that these loans are not (and should not be) subject to the complex registration, disclosure and trading rules under securities laws.

The decision is a relief to those operating in the syndicated loan market. An adverse ruling would have caused upheaval in an enormous and essential area of financing. While *Kirschner* is not the first case to look at whether loans constitute securities, the ruling is the latest and most definitive with respect to term loan Bs as they exist today and sends a clear message to those thinking of litigating the issue in the future.

The Millennium Laboratories case

Historically, term loan Bs (TLBs) and high-yield bonds (a type of debt security) have been considered two distinct classes of debt with separate and identifiable characteristics. However, over the last few decades, the TLB market has evolved significantly and taken on many of the terms and characteristics of high-yield bonds.

Those include:

- Key covenants and baskets.
- Covenant-lite structures and other borrower-friendly terms.
- An increasing overlap of the lender/investor base.

These similarities have raised the question of whether a TLB should also be considered a security, subject to the requirements of federal and state securities laws. On August 24, 2023, the U.S. Court of Appeals for the Second Circuit rejected that contention in *Kirschner*, which involved a term loan B that was similar to most TLBs in the market today. The appellate court held that the loan was not a security.

A contrary ruling would have caused enormous disruption in the trillion-dollar syndicated loan market.

The Kirschner case arose out of a $1.75 billion term loan B made to Millennium Laboratories LLC in 2014. Millennium defaulted on the loan and filed for bankruptcy the following year. Marc Kirschner, the litigation trustee in the bankruptcy, sued the banks that arranged and syndicated the loan, alleging that they violated various state and federal securities laws by not disclosing that Millennium was under investigation by the Department of Justice (DOJ) prior to the issuance of the loan.

In 2020, the U.S. District Court for the Southern District of New York dismissed the claims against the banks, concluding that the Millennium loan was not a security and was therefore not subject to securities laws. The Second Circuit upheld the district court, finding that Kirschner failed to plausibly suggest that the Millennium loans were securities by applying the four-pronged "family resemblance" test established in 1990 by the U.S. Supreme Court in *Reves v. Ernst & Young*.

One important factor in the Second Circuit's ruling may have been the decision made by the Securities and Exchange Commission (SEC) to not respond with an *amicus* brief on the matter after the Second Circuit solicited its views.

Why it matters

If the Second Circuit had ruled in favor of Kirschner, there likely would have been extraordinary disruption across the entire

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leveraged loan market, which in turn could have had far-reaching effects on the broader U.S. economy. The syndicated term loan B market is estimated to be around $1.5 trillion, according to *LevFin Insights*, a publication that provides news and analysis on the global leveraged finance markets.

Impacts on lenders: Syndication and trading

Requiring TLBs to comply with securities laws would have caused a seismic shift in loan origination and trading practices, which now are fairly flexible because participating lenders are assumed to be sophisticated parties that are responsible for their own decisions to purchase and trade loans. By contrast, federal securities laws are designed to protect investors at large, including retail investors, who may not have access to the information necessary to make informed decisions about investments.

Securities must be registered with the SEC (or qualify for an exemption), and securities underwriters are subject to a higher level of liability to investors for material misstatements and omissions in disclosures made to investors.

Lenders are assumed to be sophisticated parties that are responsible for their own decisions to purchase and trade loans.

Thus, to arrange a TLB compliant under securities laws, underwriting banks would need to conduct extensive due diligence and require cumbersome disclosures from the borrower, and then prepare detailed offering documentation. These added steps would result in significant delays and add costs to the loan origination process.

Unlike bond investors, who rely on the disclosures mandated by securities laws, as they have no direct relationship with the issuer, TLB lenders conduct their own diligence on a borrower's business and have a direct contractual relationship with the borrower. Moreover, often TLB lenders receive non-public information from a borrower (for instance, financial projections), which may be a key factor in their decision to make the loan but the sharing of which is not allowed under securities laws.

Treating TLBs as securities would also severely limit secondary trading of TLBs and make the market less liquid, as trading would likely need to be conducted through registered broker-dealers. Trades would also be subject to transfer restrictions imposed by securities laws, including on trading securities based on material non-public information (MNPI) and additional reporting requirements and rules governing settlement.

Finally, certain lenders would no longer be able to participate, as they could be restricted from investing in securities.

The recharacterization of TLBs as securities would effectively paralyze and result in an immediate freeze of the entire loan market, since existing TLBs would not be in compliance with securities registration requirements.

Impacts on borrowers

Borrowers, too, would suffer if TLBs were treated as securities.

- **Higher costs and slower execution**. Borrowers would bear the additional costs of registering a security, producing detailed, ongoing disclosures and satisfying extensive due diligence requirements. The additional costs and burdens borne by underwriting banks and other lenders would also likely be passed on to borrowers in the form of higher pricing or additional fees. With the extra steps, it would take more time for borrowers to access capital, which could be critical in time-sensitive situations, or where there is a "hot" market window.
- **Required disclosures and restrictions on providing MNPI**. Some borrowers may not want to publicly reveal information that would be required in securities filings, which are much more extensive than those provided for TLBs. In today's TLB market, borrowers may share MNPI, such as financial projections or information about a pending acquisition or litigation, with private lenders (which are a subset of lenders choosing to receive MNPI). Indeed, such MNPI may provide the reason for a lender to offer financing. Public lenders (*i.e.*, those lenders who cannot receive MNPI) agree not to receive such MNPI and knowingly participate in the financing based on publicly available information. The public/private lender distinction is not applicable in a securities offering, and securities laws would prevent the borrower from sharing MNPI selectively with a subset of lenders.
- **Reduced flexibility**. Given the smaller group of lenders in a typical TLB and standard lender voting provisions in credit agreements, borrowers can modify many provisions in loan documents and obtain waivers of them with consent from only those lenders holding 50.1% of the loan. By contrast, bonds are generally held more widely, and consequently changes to the terms of the indentures governing bonds can be more time-consuming and costly to obtain.
- **Inability to control the lender syndicate**. A TLB borrower typically has a consent right with respect to assignments of the loan by lenders and has the ability to exclude certain parties, such as competitors, from the lender group. If TLBs were securities, however, the borrower could not assert this type of control, as bondholders have the ability to freely assign without needing any consent from the borrower.

In sum

While the syndicated loan market may continue to evolve and changing structures may result in a different application of the *Reves* factors in the future, the Second Circuit's ruling in *Kirschner* should reassure the syndicated loan market and ensure that TLBs, in their current form, can continue to be an available financing option to a large class of borrowers, some of which may not be able to access the bond markets.

At the same time, lenders and borrowers alike should continue to remain vigilant in following current market practices that protect against the risk of a loan being treated as a security.

Notes

[1] 79 F.4th 290 (2d Cir. 2023).

About the authors

Danielle Li (L) is a banking partner at **Skadden, Arps, Slate, Meagher & Flom LLP**. She represents investment banks, commercial banks, private equity funds and corporations in connection with acquisition financings, leveraged buyouts, bridge loans, margin loans, asset-based loans, corporate recapitalizations, first- and second-lien financings and other types of U.S. and international financings. She can be reached at danielle.li@skadden.com. **Adriane Sanchez** (R) is a banking associate at the firm. She can be reached at adriane.sanchez@skadden.com. The authors are based in New York. This article was originally published Dec. 13, 2023, on the firm's website. Republished with permission.

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