Syndicated Loans as Securities

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There is no bright line test for determining whether loan participations or syndications fall within the ambit of the federal securities laws. However, there is useful judicial guidance on the subject. While the U.S. Supreme Court has not addressed this specific issue, lower courts have held that, absent unusual circumstances, loan participations and syndications are *not* securities. Summarized below are the leading cases on this subject and the factors the courts have used to distinguish commercial loans from securities. Based on the courts' guidance, we have set out some practical guidelines for minimizing the likelihood that loan participations or syndications may be characterized as securities. Loan participations or syndications that are deemed to be securities must be sold through a registered broker-dealer.

In holding that loan participations and syndications are not securities, the lower courts which have considered the question have applied tests previously employed by the Supreme Court in analyzing notes (and stock) as securities. In this regard, the Supreme Court has analyzed whether an instrument may be viewed as an "investment contract,"[1] is issued in an "investment" as opposed to a "commercial" or "consumer" context,[2] or bears a strong "family resemblance" to a judicially recognized exception to the definition of a security.[3] If an instrument is not sufficiently similar to one of the enumerated exceptions, then the following four factors also must be considered:

1. *Motivations of Buyer and Seller*: If the seller's purpose is to raise capital for a business or to finance substantial investments and the buyer's interest is primarily in earning a profit, the instrument is likely to be a security. If, on the other hand, the instrument is issued to facilitate the purchase and sale of consumer goods (or to advance any other consumer purpose), the "security" designation is less appropriate;
2. *Plan of Distribution*: Distribution to a broad segment of the public may connote an instrument in which there is "common trading for speculation or investment";[4]

[1] *SEC v. W.J. Howey Co.,* 328 U.S. 293 (1946). Under this test, an instrument is a security if it evidences an investment in a common enterprise, with a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.

[2] *Reves v. Ernst & Young*, 494 U.S. 56 (1990), reh'g denied 494 U.S. 1092 (1990). In *Reves*, the Supreme Court established a framework for determining whether a note – such as a note evidencing a syndicated loan – is a security.

[3] *Id*. The Supreme Court enumerated various instruments commonly denominated as "notes" that nonetheless are *not* securities, including: (i) a note delivered in a consumer financing, (ii) a note secured by a mortgage on a home, (iii) a short-term note secured by a lien on a small business or some of its assets, (iv) a note evidencing a "character loan" to a bank customer, (v) a short-term note secured by an assignment of accounts receivable, (vi) a note that simply formalizes an open-account debt issued in the ordinary course of business (particularly if, as in the case of a customer of a broker, it is collateralized), and (vii) a note evidencing a loan by a commercial bank for current operations.

[4] *See SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 351 (1943).

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3. *Reasonable Expectations of Investors*: Public perception of an instrument as a security because, *e.g.*, it has been advertised as an investment, may weigh in favor of finding that the instrument *is* a security; and

4. *Existence of Another Regulatory Scheme*: An instrument is less likely to be considered a security if it is governed by another regulatory scheme that obviates the need for the protection of the securities laws.

The leading case regarding loan participations is *Banco Espanol de Credito v. Security Pacific National Bank*, in which the Second Circuit (while acknowledging that "participation in an instrument [may] in some circumstances be considered a security even where the instrument itself is not"[5]), concluded that the loan participations at issue were analogous to loans issued by banks for commercial purposes and, thus, were not securities.[6] The Court considered the participations in light of the four standards articulated by the Supreme Court (above), and found that the motivation of the participants was for commercial rather than investment purposes, the participations were offered exclusively to institutional and corporate entities and not to the general public, the investors were on notice through contractual provisions that the instruments were participations in loans and not investments in a business enterprise, and the Office of the Comptroller of the Currency provided regulatory oversight over the purchase and sale of the loan participations.

In his dissenting opinion, the Second Circuit's Chief Judge strongly disagreed with the Court's analysis. Siding with the views of the Securities and Exchange Commission ("SEC"), which had submitted a brief amicus curiae, the Chief Judge distinguished the subject program from a traditional loan participation program on the basis of the number and type of participants, the sales approach and the availability of information regarding the borrower. He observed that in a traditional program there would be only a small number of financial institutions as participants, financial institutions would become participants through referrals from the initiating bank's loan department and all information available to the initiating bank would be made available to participants. In the Security Pacific program, however, there were large numbers of diverse participants (including mutual funds and money managers), potential participants were contacted through "cold calls" from the bank's sales desk and, although the bank provided publicly available information to participants on request, it withheld nonpublic information from participants.[7]

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[5] The Second Circuit had previously held in *Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.,* 756 F.2d 230 (2d Cir. 1985), that a transaction may be subject to the securities laws even if the underlying instrument would not be a security if sold in other contexts. In *Gary Plastic*, the Court found that, notwithstanding that conventional certificates of deposit ("CDs") purchased from an issuing bank are not securities (*see Marine Bank v. Weaver*, 455 U.S. 551 (1982)), the CDs at issue *were* securities because they were sold in a manner that satisfied the Supreme Court's test for an "investment contract." The defendant had sold the CDs through a program in which it screened a variety of bank or savings and loan issuers against insolvency risks and negotiated rates of return on behalf of investors, and maintained a secondary market in the CDs so that investors who wished to liquidate their investments would not have to incur penalties imposed by issuers for early redemption. The Court found that the CDs sold through the program represented essentially a joint effort by the issuers of the CDs and the defendant, and held that the CDs were investment contracts because investors expected to receive profits through the extra services provided by the defendant.

[6] *Banco Espanol de Credito v. Security Pacific National Bank,* 973 F.2d 51 (2d Cir. 1992), *cert. denied,* 509 U.S. 903 (1993).

[7] The Judge prefaced his opinion with the remark that the majority opinion "misreads the facts, makes bad banking law and bad securities law, and stands on its head the law of this circuit and of the Supreme Court in *Reves v. Ernst & Young*." He considered that the participants, "rather than being commercial lenders who engage in traditional loan participations, were instead in many cases non-financial entities not acting as commercial lenders but making an investment, and even though there were some banks that purchased the so-called loan notes, they generally did so not through their lending departments but through their investment and trading departments. These participants were motivated not by the commercial purpose of operating a lending business in which participations are taken as an adjunct to direct lending operations, but were motivated by an investment purpose. The promotional literature put out by Security Pacific advertised the so-called loan notes as competitive with commercial paper, a well-recognized security under the Securities Act, and on the basis of the return that they offered over that of other investments. Beyond that, and importantly to the Securities Act aspect of the case, these loan notes differ from traditional loan participants in the scope of information available to the purchasers. In the traditional loan participation, participants generally engage in one-to-one negotiation with the lead lender, and at times with the borrower, and can inspect all information, public and non-public, that is relevant, and consequently are able to do their own credit analysis. Here, Security Pacific did not provide the participants with non-public information it had, provided only publicly-available documents or ratings, and the purchasers were not in a position to approach the hundred or more possible borrowers in the program and conduct their own examinations."

Other courts that have considered syndicated loans have rejected arguments that a participation or syndication satisfies the "investment contract" test because participants are receiving profits (in the form of interest paid on the loan) from the efforts of the originating bank that negotiates the loan.[8] These courts have, in effect, interpreted the Supreme Court tests to require profit participation in the nature of an equity interest prior to finding that an investment contract exists, and have ruled that the benefit that participants derive in the form of interest payments on their interest in a syndicated loan does not constitute "profits" for this purpose. Rather, such interest payments are the normal rate of return one would expect in a commercial lending transaction. The decision of the Supreme Court in *SEC v. Edwards* has called this rationale into question, however.[9] In *Edwards*, which involved an arrangement for the sale and leaseback of payphones, the Supreme Court reversed the Eleventh Circuit's decision that "profits" require either a participation in earnings by the investor or capital appreciation, and held that fixed returns *can* constitute profits for purposes of the "investment contract" test.[10]

Mitigating the Possibility That Syndicated Loan Participations May Be Securities

In light of the uncertainty attaching to syndicated loans, lenders may wish to consider the following guidelines in the conduct of their business:

- Limit participation in syndicated loan facilities to funds or institutions that invest, as part of their business, in loans, or, at a minimum, limit the number of potential offerees.[11]
- Structure transactions with a high minimum participation on the part of each lender.
- Include a representation in the loan documentation regarding the sophistication of the lender.
- Place restrictions on the transfer of loans or participations and require consent of the administrative agent to approve transferees.[12]
- Include a representation in the loan documentation that the lender has entered into the transaction for a commercial purpose. (The loan documentation should not include language that refers to the lender as an "investor," the borrower as an "issuer," or the loan as a "security.")
- Provide information about the borrower and facilitate the performance of due diligence by lenders.[13] In this regard, the loan documentation should include affirmative covenants that mandate

[8] *See, e.g., McVay v. Western Plains Service Corp.,* 823 F.2d 1395 (10th Cir. 1987).

[9] *SEC v. Edwards,* 540 U.S. 389 (2004).

[10] The Eleventh Circuit had determined that the investors' entitlement to a fixed return meant that they did not have the requisite expectation of "profits," and that because the investors had a contractually guaranteed entitlement to a fixed return, any "profits" on their part would not have been derived solely from the efforts of others.

[11] The more broadly distributed and marketed a loan is, the more likely it will be treated as a security.

[12] In case syndicated loans would be deemed a sale of securities, transactions should be structured so as to avail of the private placement exemptions from registration under the Securities Act of 1933 and the rules thereunder. Accordingly, only entities that would qualify under the securities laws as accredited investors or qualified institutional buyers ("QIBs") should be permitted to participate. (QIBs are defined generally as entities that own or manage at least US$100 million in securities of unaffiliated issuers. Accredited investors generally include high net worth individuals and organizations with assets in excess of US$5 million.) The documentation also may include language to the effect that any assignment must be conducted in accordance with "applicable law" (thus, if the securities laws were found to apply, any transfer would have to conform to their requirements), and prohibit any transfer that would require the lender to make "any filing" with a government authority (such as the SEC).

[13] This is a right that commercial banks have traditionally enjoyed. Extending the right to non-bank lenders more closely aligns a syndicated loan with a traditional bank loan.

the borrower to furnish periodic financial information to lenders (or to the agent for provision to the lenders), as well as any other information that the lender or the agent may reasonably request.

> Include a representation by the lender that it has had sufficient access to information to make its own credit decision and that it has done so.

> Exercise caution with respect to marketing and promotional materials and refrain from comparing returns on loan participations to those of traditional securities.

Although not determinative, a secured loan is also less likely to be viewed as a security than an unsecured loan.

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Please contact us if you would like to discuss the law's treatment of syndicated loans or our suggested guidelines further.