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A True Sense of Security: How Kirschner v. J.P. Morgan Chase Illustrates the Failings of the Reves Family-Resemblance Test and the Need to Recognize Some Syndicated Loans as Securities for the Sake of the Financial System

Aidan D. Mulry

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A True Sense of Security

HOW *KIRSCHNER V. J.P. MORGAN CHASE* ILLUSTRATES THE FAILINGS OF THE *REVES* FAMILY RESEMBLANCE TEST AND THE NEED TO RECOGNIZE SOME SYNDICATED LOANS AS SECURITIES FOR THE SAKE OF THE FINANCIAL SYSTEM

INTRODUCTION

A little more than a decade removed from the 2008 financial crisis, it seems implausible to think that such a man-made disaster could be allowed to happen again. In fact, following the Great Recession and with an eye toward preventing the next financial crisis, Congress passed the Dodd-Frank Act, which instituted a variety of new regulations aimed at imposing accountability on banks and credit-rating agencies.[1] On the surface, these reforms appear successful; however, under the surface, there is currently a capital market that is effectively ignored, not only by the reforms of Dodd-Frank, but by virtually all securities regulation.[2] This capital market, which revolves around so-called syndicated loans, is estimated to be larger than the subprime-mortgage collateralized debt obligations (CDO)[3] market at its apex,[4] and yet it is unregulated.[5] If this market is so popular, and if we learned anything from the Great Recession, then where is the regulation?

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[1] Frank Partnoy, *The Looming Bank Collapse*, ATLANTIC (July/Aug. 2020), https://www.theatlantic.com/magazine/archive/2020/07/coronavirus-banks-collapse/612247/ [https://perma.cc/Q4PS-ZKY2].

[2] Elisabeth de Fontenay, *Do the Securities Laws Matter: The Rise of the Leveraged Loan Market*, 39 IOWA J. CORP. L. 725, 755 (2014).

[3] "A Collateralized Debt Obligation (CDO) is a synthetic investment product that represents different loans bundled together and sold by the lender in the market. . . . A mortgage-backed CDO owns parts of many individual mortgage bonds." *What Is a Collateralized Debt Obligation (CDO)?*, CORP. FIN. INST., https://corporatefinanceinstitute.com/resources/knowledge/trading-investing/collateralized-debt-obligation-cdo/ [https://perma.cc/VCV8-QWZZ].

[4] Partnoy, *supra* note 1.

[5] *See* de Fontenay, *supra* note 2, at 755 ("The [syndicated] loan market is at once the most dynamic and the least visible capital market in the U.S., which is exactly how its participants like it.").

To start, a syndicated loan is a source of financing offered by a group of lenders to a single borrower.[6] The primary reason for this loan structure is that the size of the loan required by the borrower may be too big for any one lender to stomach on its own.[7] However, when the financing—and therefore the risk—is distributed among a group of lenders, the borrower's needs can be met without exceeding the lenders' risk profiles.[8] Importantly, syndicated loans are not ordinarily made to financially-strong companies.[9] On the contrary, "[t]hese are loans made to companies that have maxed out their borrowing and can no longer sell bonds directly to investors or qualify for a traditional bank loan."[10] In sum, the syndicated loan market is the primary avenue by which troubled companies obtain loans from banks and other institutions, and the reason for this is fairly clear: the virtual absence of regulatory requirements makes the process of obtaining a syndicated loan significantly easier and cheaper than a traditional bond issuance or revolving line of credit.[11]

The syndicated loan market has grown rapidly in the last decade, with a value of approximately $1.5 trillion in 2020, which was up from $1.2 trillion in 2018.[12] This growth has primarily been driven by an increase in the issuance of B-rated loans—below investment grade loans made to troubled businesses[13]—which accounted for approximately $711 billion of the total syndicated loan market in 2020.[14] The majority of syndicated loans are held by

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[6] *What Is a Syndicated Loan?*, CORP. FIN. INST., https://corporatefinanceinstitute.com/resources/knowledge/finance/syndicated-loan/ [https://perma.cc/7N5E-G93R].

[7] Troy Segal, *Syndicated Loan*, INVESTOPEDIA (June 22, 2020), https://www.investopedia.com/terms/s/syndicatedloan.asp#:~:text=A%20syndicated%20loan%2C%20also%20known,project%2C%20or%20a%20sovereign%20government [https://perma.cc/8SSH-DFX4].

[8] *Id.*

[9] Partnoy, *supra* note 1.

[10] *Id.*

[11] S&P GLOB. MKT. INTEL., LEVERAGED COMMENTARY & DATA (LCD): LEVERAGED LOAN PRIMER 1 (2019), https://www.spglobal.com/marketintelligence/en/documents/lcd-primer-leveraged-loans_ltr_updated.pdf [https://perma.cc/58SK-W7VA].

[12] Bridget Marsh & Tess Virmani, *Loan Syndications and Trading: An Overview of the Syndicated Loan Market: Lending & Secured Finance Laws and Regulations*, INT'L COMPAR. LEGAL GUIDES (July 4, 2021), https://iclg.com/practice-areas/lending-and-secured-finance-laws-and-regulations/01-loan-syndications-and-trading-an-overview-of-the-syndicated-loan-market [https://perma.cc/FX2D-QEJG]; Seung Jung Lee et al., *The U.S. Syndicated Term Loan Market: Who Holds What and When?*, FED. RESERVE (Nov. 25, 2019), https://www.federalreserve.gov/econres/notes/feds-notes/the-us-syndicated-term-loan-market-20191125.htm [https://perma.cc/3NH4-F9V8].

[13] B-rated, or below investment grade-rated, loans are issued by companies with a "higher than average chance of default." Given this relatively high chance of default, these loans are relatively riskier than their higher rated counterparts—such as AAA-rated loans—because it is less likely that the issuing company will repay the loan. These ratings are assigned by rating agencies and "are based primarily upon the issuer's creditworthiness. This rating can, therefore, be interpreted as a direct measure of the probability of default" by the company issuing the loan. Adam Hayes, *B1/B+*, INVESTOPEDIA (Feb. 25, 2021), https://www.investopedia.com/terms/b/b1-b.asp [https://perma.cc/6K4V-UE3R].

[14] Marsh & Virmani, *supra* note 12.

instruments called collateralized loan obligations (CLOs).[15] A CLO is a structured special-purpose investment vehicle that pools together syndicated loans into various tranches—or layers—of debt, which are then issued to different investors.[16] In the same way that the 2008 financial crisis was fueled by the repackaging of home mortgages into CDOs, the majority of outstanding syndicated loans are acquired and repackaged into CLOs, with the added benefit that they are not subject to any of the same securities laws or regulations because the underlying asset—the syndicated loan—is not subject to securities laws or regulations.[17]

It should be noted that syndicated loans and CLOs are relatively stable investments with historically low default rates.[18] In fact, "CLO default rates in the U.S. peaked at over 0.4 [percent] in 2002, but since then have been zero or negligible," and although syndicated loan default rates peaked at around 4.5 percent in 2014, the rate of syndicated loan default was down to 1.6 percent in November 2018.[19] Nevertheless, the CLO market is currently experiencing a worrying amount of stress brought on by the COVID-19 pandemic, and if the quality of the underlying syndicated loans continues to deteriorate, the result could be reminiscent of the 2008 financial crisis.[20] Importantly, a significant portion of the CLO market is currently held by major US banks, which are crucial to the health of the financial system and whose overindulgence in subprime-mortgage CDOs precipitated the 2008 financial crisis.[21] If the syndicated loan market collapsed, taking the floor out of the CLO market with it, these banks could suffer losses comparable to those faced by the big banks in 2008.[22]

So why are syndicated loans, and thereby CLOs, largely unregulated?[23] The simple answer is that courts do not recognize syndicated loans as securities, and therefore, they are not subject to

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[15] Partnoy, *supra* note 1.

[16] S&P GLOB. MKT. INTEL., *supra* note 11, at 2.

[17] Partnoy, *supra* note 1; de Fontenay, *supra* note 2, at 747.

[18] Katie Kolchin et al., *SIFMA Research: Leveraged Loans Fact Sheet*, SEC. INDUS. & FIN. MKTS. ASS'N 1, 4 (June 2021), https://www.sifma.org/wp-content/uploads/2019/03/Leverage-Loans-Fact-Sheet.pdf [https://perma.cc/8PP8-DRZV].

[19] *Id.*

[20] *See* Alexandra Scaggs, *These Loan Securities May Offer Double-Digit Yields but They Are Getting Riskier*, BARRON'S (Apr. 28, 2020, 11:02 AM), https://www.barrons.com/articles/why-collateralized-loan-obligations-are-getting-riskier-51588086156 [https://perma.cc/X9FA-8DTM].

[21] Partnoy, *supra* note 1 (noting that, while "not every bank has loaded up on CLOs[,] . . . for the 30 'global systemically important banks,' the average exposure to leveraged loans and CLOs was roughly 60 percent of capital on hand").

[22] *See id.*

[23] *See* de Fontenay, *supra* note 2, at 755 ("The [syndicated] loan market is at once the most dynamic and the least visible capital market in the U.S., which is exactly how its participants like it.").

securities laws or regulations.[24] This rationale is grounded within the legal framework established by the Supreme Court in *Reves v. Ernst & Young*,[25] although it largely ignores the major changes to the syndicated loan and CLO markets in recent years.[26] The *Reves* Court declared that courts must begin with the "presumption that every note is a security" "because the Securities Acts define 'security' to include 'any note.'"[27] Despite this presumption, the Court recognized that many notes do not fall within the category of "security."[28] Accordingly, the Court articulated a four-factor "family resemblance" test to determine whether an instrument shares a sufficient number of common features with a security and thus can be identified as part of the security family.[29]

The four factors of the *Reves* family resemblance test include: "(1) 'the motivations [of the buyer and the seller]'; (2) '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 the Securities Act unnecessary.'"[30] If these factors weigh in favor of finding that the instrument bears a strong family resemblance to a security, then that instrument is classified as a security and subject to applicable security regulations.[31]

In applying the *Reves* family resemblance test, no court has ever held a syndicated loan to be a security.[32] Despite this fact, the issue of whether a syndicated loan could ever be a security is still alive and well in the Southern District of New York. In a recent case, *Kirschner v. J.P. Morgan Chase Bank*, the plaintiff brought a number of state securities laws claims arising out of the issuance of a $1.775 billion syndicated loan.[33] Moving to dismiss the securities laws claims, the defendants argued that, because syndicated loans have never been found to be securities, they are not subject to state securities laws.[34] The district court agreed and dismissed the state securities law claims, reaffirming the widely held understanding that syndicated loans are not securities and thus not subject to state

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[24] *Id.* at 747.

[25] Reves v. Ernst & Young, 494 U.S. 56 (1990).

[26] Fontenay, *supra* note 2, at 747–48.

[27] *Reves*, 494 U.S. at 65; *see also* 15 U.S.C. § 78c(a)(10).

[28] *Reves*, 494 U.S. at 65.

[29] *Id.* at 67.

[30] Kirschner v. J.P. Morgan Chase Bank, No. 17 Civ. 6334 (PGG), 2020 WL 2614765, at *7 (S.D.N.Y. May 22, 2020) (second alteration in original) (quoting *Reves*, 494 U.S. at 66–67).

[31] *See Reves*, 494 U.S. at 67.

[32] *Kirschner*, 2020 WL 2614765, at *10.

[33] *Id.* at *1–2. The defendants—including J.P. Morgan Chase, Citibank, Bank of Montreal, and SunTrust Bank—were the banks responsible for the syndication of the loan at issue in this case. *Id.*

[34] *Id.* at *6.

securities laws.[35] In arriving at this decision, the district court applied the *Reves* family resemblance test, and found that, while the first *Reves* factor did not weigh dispositively in either direction, the other three *Reves* factors weighed in favor of the syndicated loan not being a security.[36] Thus, the district court concluded that the syndicated loan did not bear a strong family resemblance to a security, and therefore, was not a security.[37]

As demonstrated by *Kirschner*, the three-decades-old *Reves* family resemblance test[38] fails to adequately account for recent systematic changes to the syndicated loan market.[39] Moreover, the rationale that a syndicated loan should not be deemed a security because, in part, no court has ever held a syndicated loan to be a security ignores the ability of financial instruments to evolve and the demonstrable evolutions that have already taken place in the syndicated loan market. Unregulated and virtually invisible to the average investor, the syndicated loan and CLO markets have experienced dramatic growth in the last decade.[40] However, these markets have not been immune to the economic effects of COVID-19, and further declines in their value and quality could threaten major financial institutions, and in turn, the financial system itself.[41]

This note argues that the *Reves* family resemblance test is an outdated mode of determining whether a financial instrument should be subject to securities laws and regulations, and therefore, a revised test is needed that recognizes the recent shifts in the syndicated loan market and adjusts accordingly. In particular, this note argues that some syndicated loans are properly classified as securities and should be subject to securities regulations, and therefore, the Supreme Court should articulate an updated family resemblance test to properly classify modern day syndicated loans.

Part I of this note examines the syndicated loan and CLO markets, with a focus on the considerable changes to both markets in recent years and the risks that these changes pose to the financial system. It will also provide background on the *Reves* family resemblance test and its application to syndicated loans. Part II analyzes the facts and background of *Kirschner*, as well as the flaws in the district court's application of the *Reves* family resemblance test to the syndicated loan at issue in that case. Part III explores the problems with the *Reves* family resemblance

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[35] *Id.* at *10.
[36] *Id.* at *7–10.
[37] *Id.* at *10.
[38] Reves v. Ernst & Young, 494 U.S. 56, 66–67 (1990).
[39] de Fontenay, *supra* note 2, at 727.
[40] *Id.* at 755; Lee et al., *supra* note 12.
[41] Partnoy, *supra* note 1.

test. Part IV proposes a solution to these problems in the form of an updated family resemblance test that adequately accounts for the current state of the syndicated loan market. This solution recognizes that some syndicated loans can and should be classified as securities and thus should be subject to securities laws and regulations. Moreover, this solution will promote increased accountability and diligence in the syndicated loan and CLO markets, which is a necessity at a time when both are facing a troubling financial outlook.

I. Background of the Syndicated Loan and CLO Markets

Given that the majority of syndicated loans are held by CLOs, it should come as no surprise that the recent explosive growth and change in the syndicated loan market can also be seen in the market for CLOs.[42] However, despite the pervasive change in the markets for these financial instruments, the actual test that is used by courts to determine if these instruments should be subject to securities regulation—the *Reves* family resemblance test—has not evolved since it was first articulated by the Supreme Court three decades ago.[43] Importantly, the modern day syndicated loan bears little resemblance to the traditional bank loan that existed when the *Reves* family resemblance test was first articulated,[44] and as such, the *Reves* test is ill-equipped to deal with the current state of the syndicated loan market.

A. Evolution of the Syndicated Loan Market

Historically, bank loans have escaped the constraints of securities laws because it was thought—by Congress, courts, and the banking industry—that the characteristics of traditional bank loans rendered application of securities regulations unnecessary.[45] In particular, traditional bank loans would ordinarily involve a single lender bank, and that lender bank would hold the loan to its maturity while closely monitoring the borrower.[46] In exchange for low interest rates on these loans, banks would condition issuance of the loan on the inclusion of contractual protections for the bank in the loan instrument. These protections, which took the form of

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[42] *Id.*

[43] *Kirschner*, 2020 WL 2614765, at *6–7.

[44] de Fontenay, *supra* note 2, at 727.

[45] *Id.* at 737–38.

[46] *Id.* at 736–37.

covenants[47] and collateral,[48] were intended to minimize the risk of the bank's investment.[49]

Thus, the traditional bank loan would establish a long-term relationship between the bank and the borrower, and the close monitoring by the bank, coupled with the contractual protections in the loan agreement, meant that the additional protection of securities laws would be unnecessary.[50] Moreover, given that traditional bank loans were only issued by a single bank and held by that bank until maturity, the traditional bank loan was a wholly illiquid[51] instrument.[52] This lack of liquidity meant that retail investors were not active in the traditional bank loan market, further negating any need for additional regulation.[53] In sum, the traditional bank loan is widely considered to be the quintessential "nonsecurity."[54]

At the other end of the traditional investment-vehicle spectrum are bonds, which have always been understood to be securities, and thus, have always been subject to securities regulations.[55] Unlike traditional bank loans, bonds are highly liquid and are widely traded among retail investors.[56] Given this dispersion in the investor base for bonds, there is necessarily far less lender monitoring occurring in the bond market as compared to the traditional loan market, where the single lender bank could pay close attention to its single borrower.[57] Moreover, unlike traditional bank loans, bonds generally do not contain covenants and are not secured by

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[47] *See generally* Adam Hayes, *Covenant*, INVESTOPEDIA (June 28, 2020), https://www.investopedia.com/terms/c/covenant.asp [https://perma.cc/KJ23-VALD] (defining a covenant as "a promise in an indenture, or any other formal debt agreement, that certain activities will or will not be carried out or that certain thresholds will be met . . . . Covenants are often put in place by lenders to protect themselves from borrowers defaulting on their obligations due to financial actions detrimental to themselves or the business.").

[48] *See generally* Julia Kagan, *Collateral*, INVESTOPEDIA (Dec. 27, 2020), https://www.investopedia.com/terms/c/collateral.asp [https://perma.cc/U4MN-7K32] (defining collateral as "an asset that a lender accepts as security for a loan . . . . [I]f the borrower defaults on their loan payments, the lender can seize the collateral and sell it to recoup some or all of its losses.").

[49] de Fontenay, *supra* note 2, at 737–38.

[50] *See id.* at 736–38.

[51] "In financial markets, liquidity refers to how quickly an investment can be sold without negatively impacting its price. The more liquid an investment is, the more quickly it can be sold (and vice versa), and the easier it is to sell it for fair value or current market value." *Liquidity*, CORP. FIN. INST., https://corporatefinanceinstitute.com/resources/knowledge/finance/liquidity/ [https://perma.cc/66FU-Q8JT].

[52] *See* de Fontenay, *supra* note 2, at 737–38.

[53] *Id.*

[54] *Id.* at 737.

[55] *Id.*

[56] Miranda Marquit & Benjamin Curry, *Understanding Liquidity and Liquid Assets*, FORBES ADVISOR (Aug. 10, 2021, 11:09 AM), https://www.forbes.com/advisor/investing/liquidity-and-liquid-assets/ [https://perma.cc/QS7K-J6W4]; de Fontenay, *supra* note 2, at 737.

[57] de Fontenay, *supra* note 2, at 737.

collateral.[58] Thus, given the bond market's diversified lender base, high liquidity, lack of lender monitoring, and lack of contractual protections, it has historically required the additional protections that securities laws provide.[59]

If bank loans had retained their traditional characteristics, then there would be no need for the regulatory protections provided by securities laws. However, the bank loan market has undergone radical changes in recent years, resulting in many bank loans being "virtually interchangeable" with bonds.[60] This radical change has primarily been driven by the advent of two mechanisms: (1) loan syndication, which allows multiple lender banks to pool their financing in a single loan; and (2) secondary trading, which allows the new syndicated loan to be sold to investors on a secondary market.[61] It is no longer the case that a single bank makes the loan to a single borrower and then holds that loan through to maturity. Now, multiple banks act as lenders for the syndicated loan, which is then sold on a secondary market to investors like CLOs.[62] Consequently, the traditionally illiquid bank loan market has been transformed by syndication and secondary trading into a deeply liquid market that includes a wide variety of dispersed investor participants.[63] This brave new market has exploded in popularity among investors, even outstripping the high-yield bond market in trading volume.[64]

As a result of these changes, there is no longer any relationship between the holder of a syndicated loan and the borrower; in fact, there are likely many transactions separating the two.[65] Furthermore, the contractual protections prevalent in traditional bank loans have largely disappeared with the rise in popularity of "cov-lite" syndicated loans,[66] which contain loose

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[58] *Id.*

[59] *Id.* at 738.

[60] *Id.* at 727.

[61] *Id.* at 740. A "secondary market is where investors buy and sell securities they already own . . . . In secondary markets, investors exchange with each other rather than with the issuing entity." Will Kenton, *Secondary Market*, INVESTOPEDIA (Nov. 27, 2020), https://www.investopedia.com/terms/s/secondarymarket.asp [https://perma.cc/MCS6-M5ZU]. With respect to bonds, "[a]fter being initially issued, bonds then trade in *secondary markets*. This is where ordinary investors purchase them alongside large investors." David Hollingsworth & Emily Liner, *The Bond Market: How It Works, or How It Doesn't*, THIRD WAY (Feb. 26, 2016), https://www.thirdway.org/report/the-bond-market-how-it-works-or-how-it-doesnt [https://perma.cc/6FMT-EN8B].

[62] de Fontenay, *supra* note 2, at 740.

[63] *Id.* at 740–41.

[64] *Id.* at 743.

[65] *Id.* at 742.

[66] James Chen, *Covenant-Lite Loan Definition*, INVESTOPEDIA (Nov. 30, 2020), https://www.investopedia.com/terms/c/covenant-lite-loans.asp [https://perma.cc/8VA6-2T7V] (describing cov-lite or "covenant-lite loan [a]s a type of financing that is used with fewer restrictions on the borrower and fewer protections for the lender. By contrast,

contractual covenants[67] that closely resemble bond covenants.[68] In sum, syndicated loans have shifted to the other end of the investment-vehicle spectrum and now share many of the prototypical characteristics of bonds, including high liquidity, a dispersed investor base, lax investor monitoring, and lenient contractual protections.[69] Syndicated loans and bonds are "virtually identical from a functional standpoint,"[70] yet despite these similarities, these investment vehicles are treated entirely different from a securities regulation standpoint.[71]

B. *Evolution of the CLO Market*

The recent evolution of syndicated loans has fueled the rapid growth of CLOs, which are among the most popular buyers of syndicated loans on the secondary trading market.[72] CLOs buy syndicated loans on these secondary markets, pool them into tranches, and then distribute the proceeds to investors.[73] Importantly, the syndicated loans that make up CLOs are below investment grade, with an average investment rating of single-B.[74] This makes sense considering that the most profitable syndicated loans are made to leveraged businesses with speculative grade credit ratings.[75]

Regulation of CLOs has been decreasing in recent years. Congress initially sought to inject much-needed regulation into the CLO market through Dodd-Frank's risk-retention rule, which would have required that CLO managers keep at least a 5 percent interest in the capital structure of the CLO vehicles they manage.[76] The idea behind the risk-retention rules was that a CLO manager would not be able to carelessly pool a number of

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traditional loans generally have protective covenants built into the contract for the safety of the lender, including financial maintenance tests that measure the debt-service capabilities of the borrower. Covenant-lite loans, on the other hand, are more flexible with regard to the borrower's collateral, level of income, and the loan's payment terms.").

[67] The loose contractual covenants that are typically found in bond contracts "include restrictions on the issuer's ability to take on additional debt, requirements that the issuer provide audited financial statements to bondholders, and limitations on the issuer's ability to make new capital investments." Adam Hayes, *Bond Covenant*, INVESTOPEDIA (July 12, 2021), https://www.investopedia.com/terms/b/bond-covenant.asp [https://perma.cc/XNP5-HQV2].

[68] de Fontenay, *supra* note 2, at 744–46; S&P GLOB. MKT. INTEL., *supra* note 11, at 15.

[69] de Fontenay, *supra* note 2, at 747.

[70] *Id.* at 746.

[71] *Id.* at 737.

[72] *See* S&P GLOB. MKT. INTEL., *supra* note 11, at 1, 6, 19.

[73] *Id.* at 19.

[74] Jennifer Johnson, *Collateralized Loan Obligations (CLOs) Primer*, NAT'L ASS'N OF INS. COMM'RS, at 3, https://content.naic.org/sites/default/files/capital-markets-primer-collateralized-loan-obligations.pdf [https://perma.cc/JY7P-CLWG].

[75] S&P GLOB. MKT. INTEL., *supra* note 11, at 1.

[76] Johnson, *supra* note 74, at 7.

syndicated loans into a CLO and then completely sell off its interest in that CLO to other investors.[77] Rather, the CLO manager would be required to retain a financial stake in the CLO, thereby ensuring that it had a continuing interest in the CLO's performance and would be more careful in how it constructed and managed the pool of syndicated loans underlying the instrument.[78] Although Dodd-Frank's risk-retention rule sounds like a good idea in theory, it did not last long. In 2018, a court ruling exempted CLOs from Dodd-Frank's risk-retention rules,[79] thus invalidating one of the only regulations of the CLO market.

This lack of regulation is doubly concerning given the stress that the CLO market is currently experiencing.[80] At the height of the COVID-19 pandemic in 2020, syndicated loans were being downgraded at a record rate,[81] and while 2021 saw a sharp decline in syndicated loan default rates,[82] rising inflation and expected interest rate increases call into question whether distressed borrowers will be able to stay current on their loan payments.[83] Furthermore, the continued downgrading of syndicated loans presents doubts as to whether the CLOs, which rely on the cash flow from the distressed companies, will be able to continue paying their investors.[84]

At this point, it bears repeating that CLOs have been historically stable investments.[85] This stability is primarily attributable to default correlation, or the likelihood that all of the syndicated loans in a CLO will default at the same time.[86] In order to minimize their default correlation, CLO managers will pool together syndicated loans made to a diverse set of companies.[87] Thus, if one sector of the economy is underperforming and companies in that sector begin to default, the overall CLO will likely be fine because it is made up of loans in many different sectors, which are unlikely to all take a significant downturn at the

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[77] *Id.*

[78] *See id.* at 7.

[79] *See id.*

[80] *See generally* Partnoy, *supra* note 1.

[81] Scaggs, *supra* note 20.

[82] *U.S. Leveraged Finance and CLO Weekly (Low Default Rate Forecasts Across Sectors in 2022; LIBOR Transition in Focus)*, FITCH RATINGS (Jan. 10, 2022), https://www.fitchratings.com/research/structured-finance/us-leveraged-finance-clo-weekly-low-default-rate-forecasts-across-sectors-in-2022-libor-transition-in-focus-10-01-2022 [https://perma.cc/5X24-E966].

[83] James Greene & Eric Klar, *Rising Inflation Represents Risks and Opportunities for Leveraged Finance Markets*, JD SUPRA (Aug. 18, 2021), https://www.jdsupra.com/legalnews/rising-inflation-represents-risks-and-4021461/ [https://perma.cc/C76B-W3R6].

[84] Scaggs, *supra* note 20.

[85] Kolchin et al., *supra* note 18, at 3–4.

[86] Partnoy, *supra* note 1.

[87] *Id.*

same time.[88] That is, until a black swan event[89] like the COVID-19 pandemic hits and takes the entire economy down with it.[90]

It would not take a great deal of syndicated loan defaults to really spell trouble for the CLO market; in fact, the S&P 500 found that, while a 10 percent default rate in syndicated loans would be "manageable" for CLOs, a 20 percent default rate would be dramatically worse and would result in an inverse-waterfall of losses throughout all CLO tranches, even at the highest rated layers.[91] Moreover, we are already seeing these defaults start to pile up. In April of 2020, there were more defaults in the syndicated loan market than ever before,[92] and although default rates throughout the remainder of 2020 proved to be "minimal, in part because of Federal Reserve and government rescue programs,"[93] the underlying danger of default is still present.[94] Crucially, this entire system is built on loans made to distressed businesses that relied on syndicated loans as a last resort.[95]

C. *Lack of Evolution in the* Reves *"Family Resemblance Test"*

Despite the recent upheaval in the syndicated loan and CLO markets, the test used to determine whether a financial instrument is a security—and thus should be subject to securities laws—has remained stubbornly unchanged since it was first articulated by the Supreme Court in *Reves*.

In *Reves*, the Supreme Court was faced with the issue of whether a note is a security, and therefore subject to the Securities and Exchange Act of 1934 (Securities Act).[96] The Court advised that, "because the Securities Act[] define[s] 'security' to include[, *inter alia*,] 'any note,' [courts] begin with a presumption that every note is a security."[97] Despite this presumption, the Court reasoned that there are actually many types of notes that are not properly

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[88] *Id.*

[89] "A black swan event, a phrase commonly used in the world of finance, is an extremely negative event or occurrence that is impossibly difficult to predict. In other words, black swan events are events that are unexpected and unknowable." *What Is a Black Swan Event?*, CORP. FIN. INST., https://corporatefinanceinstitute.com/resources/knowledge/finance/black-swan-event/ [https://perma.cc/UQE2-RYXD].

[90] *See* Partnoy, *supra* note 1.

[91] Scaggs, *supra* note 20.

[92] Partnoy, *supra* note 1.

[93] Adam Tempkin & Charles E. Williams, *U.S. CLO Sales Hit Annual Record Amid Leveraged Buyout Loan Boom*, BLOOMBERG (Oct. 1, 2021, 3:54 PM), https://www.bloomberg.com/news/articles/2021-10-01/u-s-clo-sales-hit-annual-record-amid-leveraged-buyout-loan-boom [https://perma.cc/45VM-78HB].

[94] Partnoy, *supra* note 1.

[95] *Id.*

[96] Reves v. Ernst & Young, 494 U.S. 56, 58 (1990).

[97] *Id.* at 65.

classified as securities, "includ[ing] 'the note delivered in consumer financing, the note secured by a mortgage on a home, [and] the short-term note secured by a lien on a small business or some of its assets," among others.[98] These notes are not characterized by an investing intent, and therefore, since the Securities Act was intended to regulate investments, these notes should fall outside of the purview of the Securities Act and should not be classified as securities.[99] Thus, the Court held that parties can rebut the presumption that a note is a security with a showing that the note in question "bear[s] a strong family resemblance" to one of the judicially enumerated categories of nonsecurities.[100]

In deciding whether an instrument bears a strong family resemblance to a nonsecurity, courts apply the following four *Reves* factors: (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."[101] If, on balance, these factors weigh in favor of the instrument bearing a strong family resemblance to one of the enumerated categories of nonsecurities, then the instrument is properly classified as a nonsecurity and will not be subject to securities laws and regulations.[102]

II. *KIRSCHNER V. J.P. MORGAN CHASE BANK*

In 2020, three decades after the Supreme Court articulated the *Reves* family resemblance test, the Southern District of New York applied the test to a $1.775 billion syndicated loan made to Millennium Laboratories LLC (Millennium Labs).[103] This case, *Kirschner v. J.P. Morgan Chase Bank*, illustrated the flawed ways that courts apply the *Reves* family resemblance test, as well as the flaws inherent in the test itself.

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[98] *Id.* (quoting Chemical Bank v. Arthur Anderson & Co., 726 F.2d 930, 939 (2d Cir. 1984)).

[99] *Id.* at 61, 65.

[100] *Id.* at 64 (quoting Chemical Bank v. Arthur Anderson & Co., 726 F.2d 930, 939 (2d Cir. 1984)).

[101] *Id.* at 66–67 (quoting Sec. & Exch. Comm'n v. C.M. Joiner Leasing Corp. 320 U.S. 344, 353 (1943)).

[102] *Id.* at 67.

[103] Kirschner v. J.P. Morgan Chase Bank, No. 17-6334, 2020 WL 2614765, at *1 (S.D.N.Y. May 22, 2020).

A. Background and Facts of Kirschner

The plaintiff in this case, the trustee of the Millennium Lending Claim Trust, had brought a number of state securities laws claims against the four banks that were responsible for syndicating the loan made to Millennium Labs.[104] After syndicating the loan, the defendant banks sold their interests in the loan to approximately four hundred institutional investors, including mutual funds, hedge funds, and CLOs.[105] When Millennium Labs defaulted on its obligations under the loan, the institutional investors formed the Millennium Lending Claim Trust and sued the four banks, alleging that the banks violated various state securities laws by misrepresenting and failing to disclose certain material facts about Millennium Labs' business.[106]

The defendant banks moved to dismiss the state securities laws claims, arguing that syndicated loans are not securities and therefore are not subject to state securities laws.[107] In order to determine whether the syndicated loan was a security, the district court turned to the *Reves* family resemblance test.[108]

B. The District Court's Application of the Reves *Family Resemblance Test*

With regards to the first *Reves* factor—the motivations of the buyer and the seller—the court reasoned that the motivations in this case were mixed, and therefore, the factor did not weigh in either direction.[109] In particular, the court found that, from Millennium Labs' perspective, the loan was meant to further "some other commercial purpose," which would weigh in favor of finding the loan to be a nonsecurity.[110] On the other hand, the court noted that from the banks' perspective, the loan was pretty clearly made as an investment, which supports a finding that the loan was a nonsecurity.[111] Given that the parties' motivations were mixed, the court found that this first factor did not weigh in either direction.[112]

Moving to the second *Reves* factor—"the plan of distribution" of the instrument—the court found that "the plan

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[104] *Id.*
[105] *Id.*
[106] *Id.* at *5.
[107] *Id.* at *6.
[108] *Id.* at *7.
[109] *Id.* at *7–8.
[110] *Id.* at *8.
[111] *Id.* at *7–8.
[112] *Id.* at *8.

of distribution" of the syndicated loan weighed in favor of finding the loan to be a nonsecurity.[113] The court stated that the loan's plan of distribution was actually quite narrow given that the notes distributed to institutional investors contained restrictions that prevented the notes from being assigned to natural persons.[114] Upon finding that the loan's plan of distribution was relatively narrow, the court then relied on the Second Circuit's holding in *Banco Espanol*,[115] which held that a loan whose plan of distribution prevents it from being distributed to the general public is not a security.[116] Applying this holding, the court found that the narrowness of the syndicated loan's plan of distribution weighed in favor of finding that the loan was a nonsecurity.[117]

The court then found that the third *Reves* factor—the reasonable expectations of the investing public—also weighed in favor of finding that the syndicated loan was a nonsecurity.[118] The court reasoned that a reasonable investor in this case would have understood that it was participating in a lending transaction as opposed to an investment in securities, as the offering memoranda that the banks distributed to potential investors used language indicating that this was a loan transaction and not a security.[119] In particular, the offering memoranda consistently used the terms "loan" and "lender," as opposed to "investor," and the offering memoranda consistently referred to the transaction documents as "loan documents."[120] Again relying on the Second Circuit's holding in *Banco Espanol*,[121] the court determined that the third *Reves* factor weighed in favor of finding that the syndicated loan was a nonsecurity because a reasonable investor would have believed that it was participating in a lending transaction as opposed to an investment in securities.[122]

Turning to the final *Reves* factor—the existence of another regulatory scheme that would render application of securities laws unnecessary—the court once again relied on *Banco Espanol*, where the Second Circuit held that the guidelines issued by the Office of the Comptroller of the Currency (OCC) governing the sale of loan participations constituted a sufficient regulatory scheme such that the additional application of securities laws to

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113 *Id.* at *8–9.
114 *Id.* at *8.
115 *Id.*
116 Banco Espanol de Credito v. Sec. Pac. Nat'l Bank, 973 F.2d 51, 55 (2d Cir. 1992).
117 *Kirschner*, 2020 WL 2614765, at *9.
118 *Id.* at *10.
119 *Id.* at *9.
120 *Id.*
121 *Banco Espanol de Credito*, 973 F.2d at 55.
122 *Kirschner*, 2020 WL 2614765, at *9.

the sale of loan participations would be unnecessary.[123] Following *Banco Espanol*, the court determined that the existing guidelines of the OCC, the Federal Deposit Insurance Corporation (FDIC), and the Federal Reserve Board governing the sale of loans constituted a sufficient regulatory scheme, and therefore, application of securities laws would be unnecessary.[124] Thus, the court found that the final *Reves* factor also weighed in favor of the syndicated loan being a nonsecurity.[125]

With three of the four *Reves* factors weighing in favor of finding that the syndicated loan was a nonsecurity, the court held that the defendants had overcome the presumption that the loan was a security, and accordingly, granted the defendants' motion to dismiss the state securities laws claims.[126] The court emphasized that the plaintiff had failed to cite a single case where the court had determined that a syndicated loan was a security, and the court was similarly unable to find such a holding in its own research.[127]

C. Flaws in the District Court's Application of the Reves *Family Resemblance Test*

Even under the outdated *Reves* family resemblance test, the syndicated loan at issue in *Kirschner* still should have been deemed a security, and therefore, the plaintiff's state securities laws claims should not have been dismissed.

In particular, the second *Reves* factor should weigh in favor of finding that the *Kirschner* loan is a security because the loan's plan of distribution allows it to reach the general public through mutual funds.[128] Mutual funds pool capital from many different investors and use that capital to invest in a diverse portfolio of assets.[129] Mutual funds are incredibly popular among individual investors because they allow individuals to invest in a diverse portfolio through the singular purchase of shares of the mutual fund.[130] Importantly, syndicated loans are one of the many different types of assets that mutual funds invest in,[131] and in *Kirschner*, mutual funds were among the four hundred institutional investors

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[123] *Banco Espanol de Credito*, 973 F.2d at 55–56; *Kirschner*, 2020 WL 2614765, at *10.

[124] *Kirschner*, 2020 WL 2614765, at *10.

[125] *Id.*

[126] *Id.*

[127] *Id.* at *9.

[128] *See Mutual Funds*, INVESTOR.GOV, https://www.investor.gov/introduction-investing/investing-basics/investment-products/mutual-funds-and-exchange-traded-1 [https://perma.cc/P8XR-2UZK].

[129] *See id.*

[130] *Id.*

[131] S&P GLOB. MKT. INTEL., *supra* note 11, at 1.

that acquired the loan participation from the defendant banks.[132] Given that mutual funds took part in the sale of the *Kirschner* loan, and that individual investors invest in these mutual funds, it cannot accurately be said that the plan of distribution prevented the loan from reaching the general public. Rather, through mutual funds, the general public was actually quite capable of taking part in the syndicated loan transaction. Therefore, the second *Reves* factor should have been found to weigh in favor of the *Kirschner* loan being a security since it was quite capable of reaching the general public, and did in fact reach the general public through mutual funds.

Moreover, the *Kirschner* court's reasoning with respect to the third *Reves* factor is flawed because, in finding that a reasonable investor would not believe that the syndicated loan in *Kirschner* was a security, the district court relied in part on the fact that no court has ever found a syndicated loan to be a security.[133] Based on this circular logic, the third *Reves* factor would never weigh in favor of a syndicated loan being a security.[134] Furthermore, the district court's analysis of the third *Reves* factor is entirely inconsistent with the first *Reves* factor. When considering the motivations of the buyer and the seller, the district court found that the institutional investors had investing intent.[135] However, when considering the third *Reves* factor, the district court determined that no reasonable investor would believe that it was investing in a security, but rather, that it was taking part in a lending transaction.[136] These outcomes cannot be reconciled; if the institutional investors had investing intent, then they must have believed they were investing and not merely lending. Given these flaws, the third *Reves* factor should not have weighed determinatively in either direction.

Finally, the court's analysis of the fourth *Reves* factor is flawed. Relying on the Second Circuit's holding in *Banco Espanol*, the district court found that the existing guidelines from the OCC, the FDIC, and the Federal Reserve Board provided a sufficient regulatory scheme such that there was no need for the additional protections of the securities laws.[137] The problem here is that, despite these existing guidelines, the institutional investors in

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[132] *Kirschner*, 2020 WL 2614765, at *1.

[133] *Id.* at *10.

[134] de Fontenay, *supra* note 2, at 754 (reasoning that the "[third] *Reves* factor's framing thus suffers from a circularity problem. Should the fact that investors are aware that leveraged loans are treated as non-securities imply that they can never be regulated as securities? That result seems implausible.").

[135] *Kirschner*, 2020 WL 2614765, at *8.

[136] *Id.* at *9–10.

[137] *Id.* at *10.

Kirschner were still not provided with enough information about the health of Millennium Labs' underlying business.[138] In particular, the institutional investors were unaware of an ongoing Department of Justice investigation into Millennium Labs, which eventually resulted in a $256 million settlement, nor were they aware of allegations concerning Millennium Labs' unlawful sales practices.[139] By allowing the defendant banks to hide these material facts, the existing guidelines failed to adequately protect the institutional investors, and therefore, the court should have applied securities laws to provide them with additional protection.

Even if the fourth *Reves* factor weighed in favor of a nonsecurity finding, the second factor should still have been found to outweigh the fourth factor because it more closely relates to the goal of the *Reves* family resemblance test. In *Reves*, the Supreme Court noted that Congress's goal in enacting the Securities Act was to regulate investments.[140] Accordingly, the Court articulated a test that would determine whether an instrument is an investment, and thus, a security.[141] The second *Reves* factor is much closer to the heart of this goal because it seeks to determine whether an individual investor in the general public could invest in an instrument.[142] In contrast, the fourth *Reves* factor is more concerned with the existing regulatory structure surrounding the instrument, as opposed to the parties taking part in the transaction.[143] Thus, the second *Reves* factor tells us more about whether the instrument bears investment-like qualities, and therefore, in weighing the second factor against the fourth, the second should be given more weight. Accordingly, with the second factor outweighing the fourth, and with factors one and three not weighing determinatively in either direction, the syndicated loan in *Kirschner* should have been deemed a security, and the plaintiff's state securities laws claims should not have been dismissed.

III. FLAWS IN THE *REVES* FAMILY RESEMBLANCE TEST

As discussed, even under the current *Reves* family resemblance test, the court should have found the syndicated loan in *Kirschner* to be a security. However, the deeper and more fundamental problem is that the current *Reves* family

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[138] *Id.* at *5.
[139] *Id.*
[140] *Reves*, 494 U.S. at 61.
[141] *Id.* at 67.
[142] *Id.* at 66.
[143] *Id.* at 67.

resemblance test, which has not changed since it was first articulated by the Supreme Court in 1990,[144] is outdated and fails to adequately account for the radical shifts in the syndicated loan and CLO markets in recent years.

A. Flaws in the First Reves *Factor*

The first *Reves* factor is flawed because it equates the singular motivation of the borrower of the loan with the many motivations of the investors in the loan.[145] For example, in *Kirschner*, the district court found that, even though the four hundred institutional investors had investing intent, the borrower of the loan was motivated by a commercial purpose other than investing.[146] Thus, the district court concluded that the factor was mixed and did not weigh determinatively in either direction.[147]

The problem here is that the motivations involved in the syndicated loan were overwhelmingly driven by investment intent.[148] However, because a single party was motivated by other commercial purposes, all other motivations were negated, and the court concluded that the factor was a wash.[149] This result is inconsistent with the underlying purpose of the *Reves* family resemblance test. In *Reves*, the Supreme Court noted that the purpose of securities laws was to regulate investments,[150] and therefore, the Court crafted the family resemblance test to allow loans that were investments to be classified as securities, while allowing loans that were not characterized by an investing intent to escape securities regulations. If the *Reves* family resemblance test seeks to classify loans with investment characteristics as securities, then it should not be possible for the noninvestment motivations of a single borrower to negate the investment motivations of four hundred institutional investors.

Moreover, the borrowers of modern day syndicated loans often have investment intent.[151] One of the most popular sources of new syndicated loan issuances is the financing of mergers and acquisitions (M&A),[152] often through the use of a leveraged

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[144] *See Kirschner*, 2020 WL 2614765, at *6–7.

[145] *Id.* at *7.

[146] *Id.* at *1, 8.

[147] *Id.* at *8.

[148] *See id.*

[149] *Id.*

[150] Reves v. Ernst & Young, 494 U.S. 56, 61 (1990).

[151] *See* S&P GLOB. MKT. INTEL., *supra* note 11, at 1.

[152] *Id.* at 3; *see also* Adam Hayes, *Guide to Mergers and Acquisitions*, INVESTOPEDIA (Aug. 19, 2021), https://www.investopedia.com/terms/m/mergersandacquisitions.asp [https://perma.cc/9YGG-H3SV] ("Mergers and acquisitions (M&A) is a general term that describes the consolidation of companies or assets through various types of financial transactions . . . . In

buyout, where a private equity firm finances its M&A transaction through the use of a leveraged loan.[153] At their core, M&A transactions are investments, and therefore, when M&A transactions are financed by syndicated loans, those loans are entirely motivated by investing intent.[154] Given that M&A transactions are one of the most popular sources of new syndicated loans, it is increasingly odd that no court has ever found a syndicated loan to be a security.[155]

B. Flaws in the Second Reves *Factor*

The second *Reves* factor is similarly ill-equipped to scrutinize the modern syndicated loan market. In *Reves*, the Supreme Court explained that "we examine the 'plan of distribution' of the instrument . . . to determine whether it is an instrument in which there is 'common trading for speculation or investment.'"[156] While it is true that direct investment in syndicated loans is generally only available to institutional investors, that does not mean that speculation in these instruments is closed off to the general public, and in fact, "the *Reves* Court confirmed that offerings to sophisticated parties may nonetheless amount to public distribution."[157] If a syndicated loan is assignable to a mutual fund, as was the case in *Kirschner*, then it necessarily follows that there can be common trading for speculation[158] on the loan through trading of the mutual fund.[159] Moreover, retail investors looking to tap into the syndicated loan market may now invest in new exchange-traded funds (ETFs) that specifically track CLOs, allowing for direct exposure to the CLO market, and by extension, the syndicated loans that CLOs invest in.[160] These CLO-tracking ETFs "mean[] that any investor, from

an acquisition, one company purchases another outright. A merger is the combination of two firms, which subsequently form a new legal entity under the banner of one corporate name.").

[153] S&P GLOB. MKT. INTEL., *supra* note 11, at 3.

[154] *Id.*

[155] *Id.*; Kirschner v. J.P. Morgan Chase Bank, No. 17-6334, 2020 WL 2614765, at *10 (S.D.N.Y. May 22, 2020).

[156] Reves v. Ernst & Young, 494 U.S. 56, 66 (1990) (quoting Sec. & Exch. Comm'n v. C.M. Joiner Leasing Corp., 320 U.S. 344, 351, 353 (1943)).

[157] de Fontenay, *supra* note 2, at 753.

[158] James Chen, *Speculation*, INVESTOPEDIA (Dec. 28, 2020), https://www.investopedia.com/terms/s/speculation.asp [https://perma.cc/5SRZ-RNMA] ("[S]peculation, or speculative trading, refers to the act of conducting a financial transaction that has substantial risk of losing value but also holds the expectation of a significant gain or other major value. With speculation, the risk of loss is more than offset by the possibility of a substantial gain or other recompense . . . . Mutual funds and hedge funds often engage in speculation in the . . . bond and stock markets.").

[159] *Kirschner*, 2020 WL 2614765, at *1.

[160] Sam Potter, *Riskier CLOs Are Coming to the Masses via an ETF Buying BBB Debt*, BLOOMBERG (Sept. 30, 2021), https://www.bloomberg.com/news/articles/2021-09-30/riskier-clos-are-coming-to-the-masses-via-an-etf-buying-bbb-debt [https://perma.cc/MXY4-QN6C].

mom and pop to the Reddit crowd, can have access to packages of [syndicated] loans issued to riskier U.S. companies."[161]

By ignoring the general public's ability to speculate on syndicated loans through mutual funds and ETFs, the second *Reves* factor fails to capture the complete plan of distribution of syndicated loans. Furthermore, retail investors are similarly closed off from direct investment in high-yield bonds, but high-yield bonds continue to be treated as securities, making the disparate treatment of these two instruments even more irrational.[162]

C. Flaws in the Third Reves *Factor*

The third *Reves* factor is also flawed because courts applying this factor are applying circular logic by reasoning that investors cannot reasonably expect syndicated loans to be securities because no court has ever found a syndicated loan to be a security.[163] This reasoning is flawed because it is rooted in the idea that loans are not able to evolve, which we know is possible based on the staggering changes to syndicated loans in recent years.[164] Courts still treat syndicated loans as the traditional bank loans of the past, and in applying this logic, are making it exceedingly difficult for a future syndicated loan to ever be deemed a security. This outcome does not align with the goals of the *Reves* family resemblance test.[165]

The district court in *Kirschner* also demonstrated another problem with the third *Reves* factor when it reasoned that a reasonable investor would not believe that the loan was an investment because the offering memoranda used language like "loan" and "lender," as opposed to "investor."[166] If this distinction is all that is required to dispose of the third *Reves* factor, then banks that wish to avoid securities regulations would simply make sure to draft their offering memoranda with terms such as "loan" and "lender," in order to convince the court that there is no investing going on. By looking only at the terms of the loan documents, the third *Reves* factor opens the door for parties to manipulate the test and circumvent securities regulations.

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[161] *Id.*
[162] de Fontenay, *supra* note 2, at 753.
[163] *Kirschner*, 2020 WL 2614765, at *10.
[164] de Fontenay, *supra* note 2, at 747.
[165] *Reves*, 494 U.S. at 61.
[166] *Kirschner*, 2020 WL 2614765, at *9.

D. *Flaws in the Fourth* Reves *Factor*

Finally, in applying the fourth *Reves* factor, courts are failing to look at whether the existing guidelines actually provide enough protection for the parties to syndicated loan transactions. For example, in *Kirschner*, the court noted the existence of policy guidelines governing the assignment of loan participations.[167] However, it failed to examine whether those guidelines actually protected the four hundred institutional investors who invested in the loan participations.[168] By simply asking whether another regulatory scheme exists, but not going further to understand whether that regulatory scheme is actually providing enough protection for investors, the fourth *Reves* factor fails to accomplish its goal of providing the protections of securities laws to those investors who need it.

IV. SOLUTION TO FLAWS IN THE *REVES* FAMILY RESEMBLANCE TEST

Despite the myriad of flaws examined above, the Supreme Court could easily tweak each *Reves* factor so that the analysis more adequately aligns with the Court's original goal when it articulated the test three decades ago. Moreover, by adapting the *Reves* family resemblance test to the realities of the modern syndicated loan market, the Court can better achieve Congress's intent in passing the Securities Act.

A. *Solution for the First* Reves *Factor*

To fix the flaws of the first *Reves* factor, the Supreme Court should modify the factor to prevent one party's motivations from negating all other motivations inherent in the syndicated loan. In order to do this, the revised first factor should weigh the motivations of all parties and decide whether, in the aggregate, the motivations are driven more by investing intent or more by noninvesting intent. If the motivations are mostly driven by investing intent, then the first factor should weigh in favor of the loan being a security; if the motivations are mostly driven by noninvesting intent, then the factor should weigh in favor of the loan being a nonsecurity.

Applying this updated first *Reves* factor to *Kirschner*, the motivations of the investors, which the district court found to be driven by investing intent, should outweigh the singular motivation

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[167] *Id.* at *10.

[168] *See id.*

of the borrower, which was driven by other commercial purposes.[169] Since the aggregate motivations behind the *Kirschner* syndicated loan were overwhelmingly driven by investing intent,[170] the updated first *Reves* factor would weigh in favor of the loan being a security if applied to the facts of *Kirschner*.

B. Solution for the Second Reves *Factor*

The Court can alleviate the flaws in the second *Reves* factor by simply requiring that, when examining the instrument's plan of distribution, courts acknowledge the loan's ability to reach the general public if it is assignable to mutual funds or ETFs. If, as the Supreme Court instructed in *Reves*, the goal of the second factor is to determine whether it is possible for the general public to speculate or trade on the loan,[171] then the second factor should necessarily take into account the general public's ability to use investment vehicles such as mutual funds and CLO-tracking ETFs to invest in syndicated loans. Accordingly, under the updated second *Reves* factor, if a syndicated loan is assignable to mutual funds, which are then able to be invested in by individual investors, then the loan's plan of distribution must be said to reach the general public, and the factor should weigh in favor of the loan being a security.

Applying this updated second factor to *Kirschner*, this factor would have also weighed in favor of the loan being a security since the loan's plan of distribution allowed it to be assigned to mutual funds, and by association, to the general public.[172]

C. Solution for the Third Reves *Factor*

The Supreme Court can ameliorate the problems with the third *Reves* factor by amending it to restrict courts from basing their determination on the fact that no prior court has ever found a syndicated loan to be a security. Instead of taking into account whether previous syndicated loans have been found to be securities, the updated factor should look to the syndicated loan at issue, and ask whether a reasonable investor, in considering this loan, would believe it to be an investment in a security. To aid in this analysis, courts should look at four subfactors that indicate whether the loan behaves like a security: (1) the liquidity of the loan, (2) the level of dispersion among the lender base, (3) the level of monitoring among

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[169] *See id.* at *8.
[170] *See id.*
[171] Reves v. Ernst & Young, 494 U.S. 56, 66 (1990).
[172] *See supra* text accompanying notes 128–133.

investors, and (4) the restrictiveness of the loan covenants.[173] These four characteristics all relate to the recent changes in syndicated loans that have made them seem more like securities.[174] If the syndicated loan is highly liquid, highly dispersed among its investor base, lacks monitoring among its investor base, and lacks restrictive covenants, then the third factor should weigh in favor of the loan being deemed a security since a reasonable investor would likely find it to be a security based on these security-like characteristics.

The Court must also further amend the third *Reves* factor to prevent courts, like the district court in *Kirschner*, from merely looking at the surface-level language of the loan documents when determining the reasonable expectations of the investing public.[175] Instead of inquiring as to whether the offering memoranda contain terms such as "loan" or "lender," the third *Reves* factor should look at the characteristics of the loan as laid out above. This inquiry will prevent a bank from avoiding securities regulation simply by using certain terminology in its offering memoranda regardless of the actual characteristics of the instrument.

Applying this updated third *Reves* factor to *Kirschner*, this factor would have also weighed in favor of finding that the loan was a security. In particular, the syndicated loan in *Kirschner* clearly had a high level of liquidity given that, following syndication, it was readily assigned to roughly four hundred institutional investors, including hedge funds, mutual funds, and other institutional investors.[176] These assignments dually demonstrate the loan's high level of dispersion among its investor base, given that it was assigned to a large number of institutional investors, many of which had investors of their own.[177] Moreover, the loan likely had a low level of investor monitoring because these dispersed institutional investors are far less equipped to monitor the borrower when compared with the banks that syndicated the original loan.[178] Finally, based on the district court's opinion, it is unclear whether the loan contained restrictive covenants. Nevertheless, given the high

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[173] *See supra* Section I.A for discussion of typical characteristics of securities.

[174] *See* de Fontenay, *supra* note 2, at 747 (explaining that syndicated loans now share critical characteristics with high-yield bonds, which are treated as securities under US law); *see also supra* text accompanying notes 60–71.

[175] *See supra* text accompanying notes 119–122.

[176] Kirschner v. J.P. Morgan Chase Bank, No. 17-6334, 2020 WL 2614765, at *1 (S.D.N.Y. May 22, 2020).

[177] *See id.*

[178] *See* de Fontenay, *supra* note 2, at 736–37, 740 (noting banks are able to devote significant resources toward closely monitoring a loan, while a syndicated loan lender base, being significantly dispersed, is only able to lightly monitor a loan).

level of liquidity, the high level of investor base dispersion, and the relative lack of lender monitoring, it is clear that this updated third *Reves* factor would have weighed in favor of the loan being a security as well.

D. Solution for the Fourth Reves *Factor*

The Court can resolve the flaws in the fourth *Reves* factor by requiring courts to consider whether the existing regulatory scheme is actually sufficient to protect the investors of the instrument in question. The fourth *Reves* factor is primarily concerned with whether there is an existing regulatory scheme in place such that the application of securities laws is unnecessary.[179] In order to achieve this goal, courts must examine whether the actual investors in a syndicated loan are adequately protected by existing regulations governing accountability and transparency, which were two of the primary concerns of Dodd-Frank.[180] If the existing regulatory scheme is insufficient to protect investors, then the updated fourth factor should weigh in favor of the loan being a security.

Applying this updated fourth *Reves* factor to *Kirschner*, the existing guidelines issued by the OCC, the FDIC, and the Federal Reserve Board were insufficient to provide adequate protection to the institutional investors.[181] The institutional investors in *Kirschner* were not informed of material facts related to Millennium Labs' underlying business, and as a result, the institutional investors were harmed when Millennium Labs defaulted on its obligations under the syndicated loan.[182] The existing guidelines were not sufficient to prevent this harm; however, the state securities laws under which the *Kirschner* plaintiff brought its claims would have provided adequate protection for the investors through their mandatory disclosure requirements.[183] Thus, since the existing guidelines in *Kirschner* failed to adequately protect the investors, the updated fourth *Reves* factor would have weighed in favor of finding the syndicated loan to be a security.

E. Summary of the Updated Reves *Family Resemblance Test*

Under this updated *Reves* family resemblance test, in order to determine whether an instrument is rightly classified as a

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[179] Reves v. Ernst & Young, 494 U.S. 56, 67 (1990).

[180] Adam Hayes, *Investor Protection Act*, INVESTOPEDIA (Jan. 24, 2021), https://www.investopedia.com/terms/investor-protection-act.asp [https://perma.cc/32RP-TVRU].

[181] *Kirschner*, 2020 WL 2614765, at *10.

[182] *Id.* at *5.

[183] *Id.* at *10.

security and thus subject to securities laws and regulations, courts should consider the following four factors.

(1) *Whether, in the aggregate, the motivations inherent in the syndicated loan are driven by investing-intent or noninvesting intent.* If the aggregate of the motivations lean toward investing intent, then the factor should weigh in favor of the loan being a security.[184]

(2) *Whether the syndicated loan's plan of distribution allows it to reach the general public.* If the plan of distribution allows the loan to be assigned to mutual funds, then the loan is said to reach the general public, and the second factor should weigh in favor of finding the syndicated loan to be a security.[185]

(3) *Whether a reasonable investor would understand that it was investing in a security rather than participating in a lending transaction.* In determining this third factor, courts should examine the following characteristics of the syndicated loan: (1) liquidity, (2) level of dispersion of investor base, (3) level of investor monitoring, and (4) restrictiveness of covenants. If the loan has a high level of liquidity, a high level of investor dispersion, a lack of investor monitoring, and a lack of restrictive covenants, then the third factor should weigh in favor of the loan being a security.[186]

(4) *Whether another regulatory scheme exists such that application of the securities laws would be unnecessary.* If the existing regulations were unable to adequately protect the investors of the syndicated loan at issue, then the fourth factor should weigh in favor of the syndicated loan being a security.[187]

F. Benefits and Costs of Recognizing Some Syndicated Loans to Be Securities

Underlying this discussion is the fact that no syndicated loan has ever been found to be a security and thus subject to

[184] *See supra* Section IV.A for further explanation of the proposed changes to the first *Reves* factor.

[185] *See supra* Section IV.B for further explanation of the proposed changes to the second *Reves* factor.

[186] *See supra* Section IV.C for further explanation of the proposed changes to the third *Reves* factor.

[187] *See supra* Section IV.D for further explanation of the proposed changes to the fourth *Reves* factor.

securities laws or regulations.[188] Given this reality, it is important to examine the effects of injecting regulation into this currently unregulated market.

Securities laws and regulations provide a wealth of benefits to markets, mainly through their mandatory disclosure requirements, which aim to protect unsophisticated investors by demanding that issuers of securities disclose certain material information about the security to the public.[189] By ensuring that investors receive this baseline of critical information about the security, securities laws protect investors from making unduly risky investments and serve to prevent fraud among issuers and intermediaries.[190] Additionally, by protecting investors and preventing fraud, securities laws improve the efficiency of capital markets and facilitate the production of material information.[191] Finally, securities laws aid markets by standardizing the disclosure practices of issuers of securities and "controlling specific managerial or promoter agency problems."[192]

Allowing some syndicated loans to be classified as securities will also benefit the CLO market by giving CLO managers more information about the syndicated loans that they are pooling together in their CLO tranches.[193] Through the mandatory disclosure requirements of securities laws, CLO managers will have more material information about the borrowers' creditworthiness, and they will be better protected from fraudulent syndicated loan issuers that would like to hide certain information about the company that borrowed the syndicated loan.[194] Given the rising default rates of syndicated loans, as well as the continued growth of the CLO market, injecting some disclosure requirements into the syndicated loan market may help to minimize the default rate among CLO tranches.[195] Moreover, by allowing CLO managers to gain access to more information, securities laws may permit

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[188] *Id.* at *10.

[189] de Fontenay, *supra* note 2, at 726.

[190] *Id.* at 733–34.

[191] *Id.*

[192] *Id.* at 734; James Chen, *Agency Problem*, INVESTOPEDIA (Sept. 19, 2021), https://www.investopedia.com/terms/a/agencyproblem.asp [https://perma.cc/24VL-7KM7] (defining an agency problem as "a conflict of interest inherent in any relationship where one party is expected to act in another's best interests. In corporate finance, an agency problem usually refers to a conflict of interest between a company's management and the company's stockholders. The manager, acting as the agent for the shareholders, or principals, is supposed to make decisions that will maximize shareholder wealth even though it is in the manager's best interest to maximize their own wealth.").

[193] *See* de Fontenay, *supra* note 2, at 733–34.

[194] *Id.* at 747.

[195] Scaggs, *supra* note 20; Partnoy, *supra* note 1.

CLO managers to be more precise when optimizing the default correlation of their CLOs.[196]

Despite the benefits that securities laws provide, they are not cost-free. By requiring issuers of securities to disclose certain information, securities laws require private entities to expend time and resources on preparing and distributing that information.[197] This extends to the direct costs of underwriters, accountants, and lawyers, all of whom issuers must retain and pay to make sure that they are adequately complying with securities laws.[198] In addition to these private costs, securities laws require the government to expend resources on regulation and enforcement.[199] Finally, "the indirect costs of mandatory disclosures likely exceed the direct costs."[200]

CONCLUSION

The district court's decision in *Kirschner* illustrated many of the flaws inherent in the *Reves* family resemblance test. In sum, the three-decades-old *Reves* family resemblance test is woefully ill-equipped to analyze the modern-day syndicated loan market and thus, the test must be modified to account for the seismic shifts in syndicated loans in recent years. By modernizing the *Reves* family resemblance test and allowing some syndicated loans to be classified as securities and thus subject to securities laws, courts will be able to inject some much-needed regulation into "the most dynamic and the least visible capital market in the [United States]."[201] We will be able to protect investors, both institutional and individual, that invest in syndicated loans, and to provide safeguards against the dangers posed by the untamed growth of the CLO market. Finally, by modernizing the *Reves* family resemblance test, courts will be better equipped to further Congress's purpose in passing the Securities Act: "to regulate *investments*, in whatever form they are made and by whatever name they are called."[202]

Aidan D. Mulry[†]

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[196] *See* Partnoy, *supra* note 1.

[197] de Fontenay, *supra* note 2, at 734.

[198] *Id.*

[199] *Id.*

[200] *Id.*

[201] *Id.* at 755.

[202] Reves v. Ernst & Young, 494 U.S. 56, 61 (1990).

[†] J.D. Candidate, Brooklyn Law School, 2022; B.A., University of Notre Dame, 2018.
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