NASHVILLE NOTES

# Leveraged loans quack like a security duck

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Hardly a day goes by that the financial media does not have a story about the dangers of the leveraged loan market. One day the market will have its comeuppance; hopefully when it comes regulators and other non-market forces will not try to prevent it because markets must clear, sometimes violently.

Perhaps a new risk is emerging — securities fraud when a loan goes sour.

I am somewhat surprised it has taken this long, but Bloomberg recently ran a story about a lawsuit brought by Marc Kirschner against the commercial banking and securities units of JPMorgan Chase & Co., Citigroup Inc., SunTrust Banks Inc. and Bank of Montreal. At issue, obviously, is money. Kirschner, or entities he represents, lost money by investing in (or lending to) a $1.8 billion leveraged loan arranged for Millennium Health LLC.

The subplot is one I have raised repeatedly in this blog over the last several years. Loans are not securities, but the leveraged loan market functions like the corporate bond market in which loans are underwritten, distributed via a syndicate to other banks and institutional investors and then traded in a secondary market. The market seemed to gel in the mid-1990s, but it has been around since the 1980s when Jimmy Lee pioneered the market. It has grown enormously in the years since the financial crisis.

Kirschner argues that securities fraud occurred because the underwriters (i.e., lenders) did not disclose a federal investigation into the company's billing practices (presumably Medicare-related). JPMorgan knew of the investigation, but apparently did not disclose it in the marketing material because the company indicated it was not then material. Within a matter of months the issue became material, and Millennium later filed for bankruptcy.

Kirschner raises an interesting point. Had the loans been deemed a security from a legal perspective, the offering memorandum or registration statement if public presumably would have listed the investigation as a potential risk even though management then viewed it as immaterial. I say 'presumably' because every registration statement I see has a list of risks that seems to get longer every year as attorneys add language for ever more risk factors regardless of how remote they may be.

The argument, while clever, begs the point that had JPMorgan thought the issue was material as part of its due diligence it would never have underwritten the loan even if it sold its entire position. The same applies to JPMorgan's co-defendants. A cynic, however, might argue that I am giving the underwriters too much credit if they could unload all of the loans on sophisticated investors such as Kirschner and CLO managers as significant investors in leveraged loans.

As an aside, my experience over my career is any business model such as healthcare that is dependent upon reimbursement from the government is inherently risky. The state has a propensity to challenge reimbursement claims, and sometimes the government alleges fraud.

The Bloomberg article goes on to speculate that if the plaintiffs prevail, the leveraged loan market will be in a world of hurt if federal (and state) securities laws apply to the market. It seems unlikely Kirschner will prevail. Historical precedent is not on his side. As best as I can tell, loans have not been viewed as securities in a legal sense since the enactment of landmark federal securities legislation in the 1930s.

Even if Kirschner wins, the market will survive because it is highly efficient at pricing and distributing risk. While price signals can become skewed by the ebb and flow of liquidity, markets provide real time feedback on asset prices, including credit. The traditional commercial bank model of "originate and mark" at par unless something bad happens does not do this.

The rise of the leveraged loan market occurred because it was a more efficient model and because leveraged loans evolved into a stand-alone asset class for investors.

Lenders can manage risk by choosing what to retain and what to sell based upon market dynamics and their risk tolerance. Issuers can toggle between the high-yield bond and leveraged loan markets based upon relative costs, capital structure constraints and other economic factors. For investors, leveraged loans are an alternative that are senior in the capital structure to high yield bonds and therefore have a higher recovery rate in the event of default. Plus, fixed-income investors can manage duration because the borrower pays a floating rate tied to LIBOR compared to a fixed-rate high yield bond.

Leveraged loans exist because there is a market for them that works for underwriter, borrower and investor (lender). That will still be the case even in the unlikely event that the courts ultimately redefine leveraged loans to be securities.

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