Finance

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U.S. District Court Reaffirms Distressed Debt Funds Not Eligible Assignees under Loan Agreement

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A recent decision by the U.S. District Court for the Western District of Washington found that certain distressed debt funds were not "financial institutions" under the definition of "Eligible Assignee" in the applicable loan agreement and thus were not entitled to vote on the debtor's chapter 11 plan of reorganization. The District Court decision affirmed a bankruptcy court decision enjoining loan assignments to the funds and recently denied the funds' motion to vacate the decision."[1]

Although the decisions in *Meridian* may have been driven by the particular facts, the case nevertheless serves as a cautionary tale for distressed debt investors and more generally as a reminder for parties drafting and negotiating loan documents.

Background

In April 2008, Meridian Sunrise Village, LLC ("Meridian") borrowed $75,000,000 (the "Loan") from U.S. Bank National Association ("US Bank"), acting as initial lender and administrative agent (in such capacity, "Agent"), for construction of a shopping center. The loan agreement permitted the lenders to assign a portion of the Loan, but only to an "Eligible Assignee"—defined in relevant part as "any commercial bank, insurance company, financial institution or institutional lender approved by Agent in writing and, so long as there exists no Event of Default, approved by Borrower in writing, which approval shall not be unreasonably withheld."[2] US Bank subsequently assigned portions of the Loan to Bank of America, N.A. ("BofA") and two other banks (collectively the "Bank Group").

[1] *Meridian Sunrise Village, LLC v. NB Distressed Debt Investment Fund Ltd.* (In re Meridian Sunrise Village, LLC), No. 13-5503 (W.D. Wash. Filed Mar. 6, 2014)

[2] *Id*. at 2 (citing the Loan Agreement at Sections 1.1 and 13.2).

In early 2012, the Loan was declared in default due to a financial covenant breach. However, the Bank Group did not begin charging default rate interest on the Loan. Instead, Meridian continued to accrue and pay interest at the original loan agreement rate while the Agent attempted to have Meridian waive and amend the "Eligible Assignee" definition in the loan agreement in order to facilitate sales of the Loan to "any person other than borrower or any affiliate of borrower."[3] After negotiations lasting over a month, Meridian refused to waive or amend the Eligible Assignee definition.

Subsequent to Meridian's refusal to amend the "Eligible Assignee" definition, the Agent on behalf of the Bank Group began charging default interest. In January 2013, Meridian, unable to pay the additional default rate interest, filed a bankruptcy petition under chapter 11 in the United States Bankruptcy Court for the Western District of Washington (the "Bankruptcy Court").

In March 2013, Meridian filed a plan of reorganization designating the Bank Group as a specific class for voting purposes. Each of the four Banks in the Bank Group was granted a single vote.

BofA thereafter assigned its interest in the Loan to NB Distressed Debt Limited Fund ("NB"), and NB in turn assigned a portion thereof to two other distressed debt funds (collectively the "Funds"). Meridian objected to these assignments, arguing that the Funds were not "Eligible Assignees" under the loan agreement.

In May 2013 Meridian filed a motion with the Bankruptcy Court seeking to enjoin (i) the Funds from exercising any of the rights of an "Eligible Assignee" under the loan agreement, including voting on Meridian's plan of reorganization, and (ii) the Agent from recognizing and/or dealing with the Funds as "Eligible Assignees."[4]

Court Decisions

The Bankruptcy Court granted Meridian's request for an injunction, finding that none of the Funds was an "Eligible Assignee" as defined in the loan agreement. Consequently, the Funds were not eligible to vote on Meridian's plan of reorganization.

The Funds appealed to the U.S. District Court for the Western District of Washington (the "District Court") and sought to stay the injunction granted by the Bankruptcy Court. The District Court did not stay the Bankruptcy Court decision, and thereafter the Bank Group approved the plan of reorganization.

The Funds subsequently moved to vacate the District Court's decision, arguing that they had discovered new facts that would undermine the factual basis for the initial District Court decision. On April 30, 2014, the District Court ruled that it would not vacate its prior decision and thus denied the Funds' motion.[5]

Each of the Funds and BofA has filed an appeal, and the Agent has filed an appeal from a portion, of the initial District Court decision not to stay the original Bankruptcy Court preliminary injunction and confirmation of Meridian's plan of reorganization. These appeals have been made to the United States

[3] *Meridian Sunrise Village, LLC v. NB Distressed Debt Investment Fund Ltd.* (In re Meridian Sunrise Village, LLC), No. 13-04225 (Bankr. W.D. Wash. June 25, 2013), at *8.

[4] Paradoxically, even while determining that the Funds were not "Eligible Assignees" under the loan agreement, the Bankruptcy Court did say that the Funds would still be entitled to receive their proportionate distributions, and retain their other rights, under the loan agreement. *Id.* at *20. It is not clear whether this seeming inconsistency is a consequence of the oral ruling that the Bankruptcy Court made—there was no written opinion—or if the Funds' rights are best understood in context as being those of participants derived contractually from their grantors (who, as the lenders of record, would have the direct rights under the loan agreement).

[5] *Meridian Sunrise Village, LLC v. NB Distressed Debt Investment Fund Limited, et al.* (In re Meridian Sunrise Village, LLC), 2014 WL 1744166 (W.D.Wash. April 30, 2014) (hereinafter "District Court Vacate Order")

Court of Appeals for the Ninth Circuit (the "Circuit Court"). On May 7, 2014, the Circuit Court granted the stipulated motion to consolidate the appeals by the Funds, BofA and Agent for briefing and oral argument.[6]

Parties' Arguments

Meridian had three broad arguments as to why the Funds were not "Eligible Assignees" under the loan agreement: the plain meaning of the loan agreement definition; the specific text surrounding "financial institutions" in the "Eligible Assignee" definition; and the parties' course of conduct.

According to the District Court, Meridian asserted that it had had prior bad experiences with distressed debt funds, and consequently negotiated the limitation to loan assignments so as to avoid assignments to "predatory investors" that merely sought to seize and sell collateral for rapid repayment.[7] Meridian's other loans—under other agreements—with the Initial Lender (in which it is the sole lender) do not contain similar loan assignment restrictions, and, based on its relationship with the Initial Lender, Meridian believed that such other loans would not be assigned. In contrast, however, Meridian understood from inception that the Initial Lender intended to assign portions of the Loans to third parties with whom Meridian might not have a lending relationship. Meridian said that, accordingly, it intentionally negotiated the loan assignment restrictions reflected in the definition of "Eligible Assignee" above.[8]

It should be noted that, as detailed in the District Court Vacate Order, the Funds claimed that post judgment discovery demonstrated that Meridian did not actually negotiate the "Eligible Assignee" definition and that the negative experience one officer of Meridian had purportedly had did not involve the assignment of a loan to a non-institutional lender.[9] However Meridian argued, and the District Court judge agreed, that, regardless of the motivation, Meridian simply did not want the Loans to be assigned to entities such as the Funds.[10]

Meridian further argued that financial institutions are entities that make loans. In support, Meridian pointed in particular to the definitional context of "financial institution" and where it appears in the "Eligible Assignee" definition. In essence, Meridian felt that it was axiomatic that commercial banks, insurance companies and institutional lenders—the other listed entities—made loans, whereas it believed distressed debt funds were different.

Meridian also argued that the parties' conduct (including the Agent's request that Meridian agree to change the definition of "Eligible Assignee") demonstrated that distressed debt funds in particular were never understood by the parties to be possible members of the Bank Group. In this regard, the mere request by the Agent to amend the definition bolstered Meridian's belief that the Agent and Bank Group recognized that distressed debt funds were not Eligible Assignees.

Finally, Meridian argued (and here the Agent agreed) that, even if the Funds were Eligible Assignees, they should be entitled to only a single plan vote among all of them.

By contrast, the Funds argued that "financial institutions" should be interpreted broadly to include any entities specializing in the handling and investment of funds, pointing in particular to common (Webster's) and legal (Black's) dictionary definitions of the term.[11] The Funds also argued that each Fund was entitled to its own vote on the plan, i.e. three in total rather than just a single vote.

[6] NB Distressed Debt Investment Fund Limited; NB Distressed Master Fund LP; Strategic Value Special Situations Master Fund II LP; Bank of America National Association; US Bank National Association, appellants, vs. Meridian Sunrise Village LLC, appellee (In the Matter of: Meridian Sunrise Village LLC, debtor)—docket # 65 in District Court docket, entered May 8, 2014

[7] *Meridian* at 3.

[8] Evergreen Capital Trust's Opposition to Funds' Request for a Stay Pending Appeal at 3, *Meridian*.

[9] District Court Vacate Order, at *1

[10] *Id.*

[11] *Meridian* at 5-6.

District Court Ruling

The District Court concluded that the Funds were not financial institutions; therefore, they were not Eligible Assignees and, consequently, were not entitled to vote on Meridian's plan of reorganization. The District Court agreed with Meridian that the plain meaning of the term "financial institution," the specific text in the definition of "Eligible Assignee" surrounding the term "financial institution," and the parties' actions, all proved "that the parties intended financial institutions to exclude entities like the Funds."[12] In the view of the District Court, the broader interpretation of "financial institution" supported by the Funds effectively would drain all meaning from the purported limitation.[13] The District Court determined that the term "financial institution" harmonizes with the other components of "Eligible Assignee" when interpreted to mean "entities that make loans."[14]

In denying plan voting rights to the Funds, the District Court expressed its concern that creditors not be able to "manipulate" plan confirmation procedures—in particular that creditors not split up claims by assigning to multiple assignees, thereby "artificially creat[ing] voting rights that the original assignor never had."[15] The District Court concluded that, even if the Funds had been entitled to vote on the plan, they would have collectively held only a single vote in respect of their purchased loans, in turn meaning that the overall acceptance of the plan by the Bank Group would not have changed.[16]

Furthermore, the District Court Vacate Order emphasized that the language in the loan agreement was sufficient for the District Court to determine that assignments to entities such as the Funds was not permitted.[17] Thus the District Court was indifferent to, and in reaching its initial ruling had not relied upon, how the definition of "Eligible Assignee" became part of the loan agreement or why Meridian did not want distressed debt funds to be "Eligible Assignees" under the loan agreement.[18]

Practical Considerations

The Meridian Bankruptcy Court and District Court decisions may have limited precedential effect. The loan documents were governed by the law of the State of Washington, and the court decisions interpreted Washington law. Consequently, similar facts in other jurisdictions, or interpreted under other law, could yield a different result than *Meridian*. Nevertheless, *Meridian* serves as a useful reminder in a number of different ways:

First, when drafting loan documents, all parties should say exactly what they mean and use clear and precise language to accurately reflect their intent. Language that is—or can be argued to be—ambiguous, or jargon having a meaning that may not be readily apparent to a judge or fact-finder can lead to unanticipated, and potentially disappointing, results.

Meridian might have avoided all ambiguity, and the attendant litigation risks and uncertainties, by expressly excluding from the definition of "Eligible Assignee" hedge funds, distressed debt funds and other entities

[12] *Id.* at 5.

[13] *Id.* at 7.

[14] *Id.* There was apparently no dispute that these particular Funds did not in fact make loans. However there are countless hedge funds and private equity funds that do engage in lending activities. In light of the courts' willingness to consider extrinsic evidence, it is unclear why the Funds did not submit evidence that there are funds that do make loans. In all likelihood, though, given the broad conclusions of the District Court, one suspects that the result—i.e. the Funds are not financial institutions and therefore are not "Eligible Assignees"—might not have been any different.

[15] *Id.* at 9.

[16] Bankruptcy Code Section 1126(c) provides generally that a class of creditors has accepted a plan of reorganization if at least two-thirds in amount of allowed claims and at least one-half in number of allowed claims vote in favor of such plan. 11 U.S.C. 1126(c).

[17] District Court Vacate Order, at *2

[18] *Id.*

that Meridian did not want to deal with. Although Meridian has prevailed in both the Bankruptcy Court and the District Court, the lack of precision in the definition might have yielded a different result under other circumstances or jurisdictions.

On the other hand, lenders generally want to be able to sell their loans to the broadest possible range of investors, including hedge funds and private equity funds. Consequently, liquidity of the loans, and possible exits from the credit, will always be a consideration for any lender from the time the loan agreement is first being negotiated. The record in *Meridian* suggests that a broader definition of "Eligible Assignee" would never have been agreed by the borrower. However, under other circumstances, even if the loan agreement must include some limitation on the kinds of entities that can be new lenders, lenders may prefer there be an explicit reference to funds and other entities that make, invest in or hold loans or similar assets.

Second, buyers and sellers of loans in the secondary markets must carefully review, and develop their own views about, the assignment provisions and restrictions in loan documents. In *Meridian*, the borrower had no right to consent to an assignment following an event of default. However, Meridian was still able to object to, and ultimately prevent, the assignment to the Funds by way of available contractual arguments.

Furthermore, secondary market investors need to consider how the relevant governing law, and in particular who may become a new lender under a loan agreement interpreted under such governing law, may impact their investment strategies. When distressed investors purchase loans governed by the laws of jurisdictions other than New York and Delaware (and more generally outside the United States), *Meridian* suggests that different rules may apply and unanticipated outcomes may result.[19]

Third, *Meridian* reminds that conduct and context matter. As a general matter, loan documents (at least those between sophisticated parties) arise out of a negotiated "meeting of the minds" so that the loan documents memorialize the commercial understanding. But if questions or disputes arise about what the documents say, or unanticipated scenarios arise, then courts may look beyond the loan documents to, for example, the parties' conduct and the nature of their relationship, in order to determine what the parties "actually" intended or how to interpret a contractual provision.[20]

[19] Most loan agreements for large syndicated and middle-market loans in the U.S. do now typically permit the assignment of loans to virtually any entity other than to the borrower or its affiliates (see, for example, the Model Credit Agreement Provisions promulgated by The Loan Syndications and Trading Association). For loan agreements governed by non-U.S. law, whether a "fund" may be an eligible assignee can depend in part on local banking laws, in addition to whether such a fund is included in the litany of parties listed as "eligible assignees" in the loan agreement.

[20] It is not unusual, during an event of default, for a lender to request changes to the loan agreement in exchange for concessions requested by the borrower, such as a forbearance. However *Meridian* demonstrates that such a request could in litigation later be viewed through the prism of a lender being aware of contractual limitations or weaknesses in its loan agreement or conduct vis-à-vis the borrower.

For practical advice, please contact any of the attorneys in Pillsbury's Finance Practice.

If you have any questions about the content of this alert, please contact the Pillsbury attorney with whom you regularly work, or the authors below.

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