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District Court Denies Distressed Funds the Right to Vote on Bankruptcy Plan

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The US District Court for the Western District of Washington (the "District Court") recently affirmed a bankruptcy court decision that prohibited a transferee of a secured lender's interest in a loan from voting on a debtor's plan of reorganization on the grounds that such transferee, a distressed debt investor, was not an Eligible Assignee under the applicable loan agreement. *Meridian Sunrise Village, LLC v. NB Distressed Debt Investment Fund Ltd., et al.*, No. 13-5503 (W.D. Wash. March 6, 2014) (*In re Meridian Sunrise Village, LLC*).

Background

In 2008, Meridian Sunrise Village, LLC (Meridian) borrowed $75 million from U.S. Bank (the "Agent") to finance the construction of a shopping center. The Agent syndicated the loan, assigning portions to Bank of America, Citizens Business Bank, and Guaranty Bank and Trust Company (each a "Lender" and, collectively with the Agent, the "Lender Group"). Section 13.2 of the loan agreement among the parties (the "Loan Agreement") included the following limitation on subsequent transfers:

> No Lender shall at any time sell, transfer or assign any portion of the Loan (each such interest so disposed of being herein called a "Transferred Interest") to any Person other than an Eligible Assignee (hereinafter called a "Transferee").

In relevant part, the definition of "Eligible Assignee" in Section 1.1 of the Loan Agreement limited potential assignees to affiliates of existing Lenders or to "any commercial bank, insurance company, financial institution or institutional lender" approved in writing by the Agent and Meridian, so long as Meridian was then not in default.

In late 2012, while Meridian was operating under a nonmonetary covenant default under the Loan Agreement, the Agent—desiring to facilitate transfer of the loan—requested that Meridian agree to waive the Eligible Assignee limitations on transferability. Meridian declined to do so. In January 2013, Meridian again refused to waive its consent requirement, and accordingly, the Agent began charging the default rate of interest, causing Meridian to file its Chapter 11 petition in the Western District of Washington (the "Bankruptcy Court").

On March 27, 2013, Meridian filed a plan of reorganization (as amended, the "Plan") that categorized the Lender Group as a specific class of creditors for the purpose of voting on the Plan, and allocated one vote to each of the four Lenders. Prior to the scheduled vote, but after the proposal of the Plan, Bank of America transferred its interest in the loan to NB Distressed Debt Limited Fund (NB). Meridian immediately and repeatedly objected to the transfer, arguing that NB was not an Eligible Assignee under the Loan Agreement. NB subsequently assigned portions of its acquired interest to two affiliate funds (collectively with NB, the "Funds").

On May 23, 2013, Meridian moved the Bankruptcy Court to enjoin the Funds from exercising rights otherwise afforded to Eligible Assignees, including the right to vote on the Plan. It is interesting to note that the Bankruptcy Court was not asked by Meridian to avoid the sale transaction altogether, and did not rule on this issue.

On June 17, the Bankruptcy Court granted the injunction, holding that the Funds were not "financial institutions" and, accordingly, were not Eligible Assignees under the Loan Agreement. Interestingly, the Bankruptcy Court decided that the Funds were still entitled to receive their proportionate distributions under the Plan pursuant to their interests in the Loan Agreement, and that they would retain all other rights, benefits and privileges under the Loan Agreement. In deciding such, the Bankruptcy Court reasoned that the Funds' interest in the loan, at least insofar as such interest tracked that of the other Lenders, would be protected by the remaining eligible Lenders. *In re Meridian Sunshine Village, LLC*, No. 13-40342 (Bankr. W.D. Wash. June 17, 2013) (BDL).

The Funds appealed the Bankruptcy Court's ruling and sought a stay of the preliminary injunction. The District Court granted the Funds' appeal but denied the stay motion. Summarily, the other members of the Lender Group supported and voted for the Plan. In September 2013, the Bankruptcy Court confirmed the Plan.

Discussion

On *de novo* review of the Bankruptcy Court's interpretation of the term "financial institution," the District Court accepted Meridian's arguments that the plain language of the Loan Agreement, the specific text surrounding the term, and the parties' actions all proved that the parties intended to exclude entities such as the Funds from becoming an Eligible Assignee. The District Court opined that to hold otherwise would deprive the negotiated limitation of any meaning and render it nonsensical. The District Court concluded that Meridian's refusal to waive the Eligible Assignee limitations—even after the Agent imposed the default rate of interest—clearly indicated that such limitation was a material condition of the underlying loan. Accordingly, the court held that the Funds were not "financial institutions" under the Loan Agreement, and, thus, not Eligible Assignees. Because the Loan Agreement permitted only Eligible Assignees the right to vote on the Plan, the Funds were rightfully precluded from voting on it.

The Funds also argued that if granted the right to vote on the Plan, they should be entitled to three votes instead of one, as three separate entities held portions of the loan. Section 1126(c) of the Bankruptcy Code deems a class to have accepted a plan of reorganization when more than 50 percent of class member votes and at least two-thirds of the claimed dollar amount held by the class votes to accept such plan. Assuming the Funds' rationale had been upheld, then the Funds could have prevented acceptance of the Plan by the class through artificially manufacturing a voting-block through division of their claim. Accordingly, the District Court appropriately held that even if the Funds had the right to vote, they would only be entitled to one vote. The court's decision reaffirmed the precept that "a creditor does not have the right to split up a claim in such a way that artificially creates voting rights that the original assignor never had." *Id.* at 9.

Conclusion

The strict enforcement by the courts of the Loan Agreement even in the bankruptcy context is not particularly surprising. But the District Court's decision is nonetheless exceedingly important for commercial lenders and distressed debt investors, as it reaffirms the importance of drafting and contract interpretation for parties that may become creditors in distressed and bankruptcy situations. Initial lenders must be diligent in negotiating and drafting assignment provisions in order to ensure that the sale restrictions contained in credit agreements match the intentions of the parties. Equally important, syndicated lenders and distressed debt investors must be diligent in reviewing and interpreting credit agreements in order to ensure that they are cognizant of all relevant terms, conditions and restrictions on the opportunity they intend to pursue.

The same incentives that motivated Meridian in this case to negotiate a term that would protect it from opportunistic investors often guide syndicated lending groups to demand similar terms to likewise protect their interests in the event of a financial restructuring. As always, activist investors participating or interested in purchasing credit positions in order to actively participate in bankruptcy proceedings should consult with counsel to ensure well-reasoned interpretation of the governing agreements to ensure the legal capability to fulfill their investment objective as they intend.

If you have any questions, please contact your Katten Muchin Rosenman LLP attorney or:

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