ALERTS

Beware the 'Meridian Sunrise' — District Court Rules Investment Funds Are Not 'Financial Institutions' Under Loan Transfer Restrictions

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The U.S. District Court for the Western District of Washington recently construed the terms of a customary loan agreement to preclude certain hedge funds viewed as "acquir[ing] distressed debt and engag[ing] in predatory lending" from voting on a debtor's plan of reorganization. *Meridian Sunrise Village, LLC v. NB Distressed Debt Investment Fund Ltd. (In re Meridian Sunrise Village, LLC)*, 2014 WL 909219 (W.D. Wash. Mar. 7, 2014). According to the court, the hedge funds, which had purchased distressed loans on the secondary market, did not properly constitute "financial institutions" as encompassed within the definition of "Eligible Assignees" in the loan agreement provisions. *Id.* at *3. As a result, the court affirmed the decision of the bankruptcy court, finding that the hedge funds were not eligible to vote on the debtor's plan based on the "plain language of the [loan agreement], the specific text surrounding financial institutions, and the parties' actions." *Id.* Given the court's narrow construction of the loan agreement as well as its deviation from the preference in the distressed debt market for liquidity and free transferability, the decision should be scrutinized closely by borrowers, lenders and distressed investors alike in negotiating and analyzing loan documentation in the future.

Relevance to Distressed Debt Trades

The *Meridian* decision deserves attention given the infrequent court treatment of the term “financial institution” as it appears in the transfer provisions customary within loan trades. Indeed, court analysis of the term is rare, with perhaps the only other federal court decision addressing whether a hedge fund constitutes a financial institution running directly counter to the holding in *Meridian*. *U.S. v. Harris*, 490 F. 3d 589 (7th Cir. 2007) (holding, in the distinguishable context of wire fraud, that hedge fund qualified as “financial institution” for the purpose of sentencing guideline). Still, the precedential value of the *Meridian* decision may be limited given its application of the law of the State of Washington as well as its dependence on fact-driven extrinsic evidence. Furthermore, while the model credit agreements published by the LSTA and LMA include limitations on assignee eligibility, the limitations do not appear to be intended to apply to investment funds.

Specifically, the LSTA’s model prohibits assignments to the borrower, its affiliates, individuals or defaulting lenders,[1] and the LMA models expressly allow for assignments to funds by means of the following language: “another bank or financial institution or to a trust, fund or other entity which is regularly engaged in or established for the purpose of making, purchasing or investing in loans, securities or other financial assets.”[2] In this way, the prevailing LMA form puts forth a definition of “New Lender” that expressly includes funds. Even so, *Meridian* may nonetheless provide leverage to borrowers or other parties seeking to challenge assignments of commercial loans to investment funds in distressed situations, and further serves as a reminder of the importance of negotiating transfer provisions at the drafting stage and scrutinizing them closely at the trading stage.

Facts

Meridian Sunrise Village, LLC (the “Debtor” or “Meridian”) borrowed $75 million from U.S. Bank for the construction of a shopping center pursuant to a negotiated loan agreement in 2008. *Id.* at *1. The loan agreement limited U.S. Bank’s ability to sell, transfer or assign the loan agreement to any entities other than “Eligible Assignees,” which were defined as “any Lender or any Affiliate of a Lender or 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.” *Id.* (citing loan agreement at § 1.1).

According to the court, Meridian had negotiated this limitation specifically to avoid future assignments to entities it described as "predatory investors — investors who purchase distressed loans in the hope of obtaining control of the underlining collateral in order to liquidate it for rapid repayment." *Id.* Soon after the loan agreement was funded, U.S. Bank assigned portions of it to three other commercial banks (collectively, the "Lender Group"), which Meridian did not dispute.

Approximately four years later, the Lender Group declared an event of default based on Meridian's breach of nonmonetary covenants. *Id.* While the Lender Group did not foreclose on the loan agreement or otherwise charge Meridian the default interest rate, U.S. Bank did ask Meridian to amend the loan agreement to excise all Eligible Assignee limitations and thereby allow for free assignability in the marketplace. *Id.*

Nonetheless, Meridian refused to acquiesce to U.S. Bank's demands, arguing that it purposely negotiated the limitations to prevent assignments to "predatory investors." *Id.* at *1-2. Following unsuccessful negotiations to amend the restrictions, U.S. Bank informed Meridian it would immediately begin charging the default interest rate, and shortly thereafter, Meridian filed for bankruptcy protection. *Id.* at *2.

After the petition date, a member of the Lender Group assigned its interest in the loan agreement over the objections of Meridian to an investment fund, which further transferred a portion of its interest to two other investment funds (together, the "Funds"). On May 23, 2013, Meridian sought relief from the bankruptcy court to enjoin the Funds from exercising any rights that Eligible Assignees would have under the loan agreement, including the right to vote on Meridian's proposed Chapter 11 plan of reorganization.

The Bankruptcy Court

The bankruptcy court granted Meridian's request for an injunction. *Meridian Sunrise Village LLC v. N.B. Distressed Debt Inv. Fund Ltd. et al.*, No.13-04225-BDL (Bankr. W.D. Wash. June 18, 2013), ECF No. 39 ("Preliminary Injunction Order"). As a result, the Funds appealed to the district court, seeking to stay the injunction. As the district court refused to stay the injunction, the Funds were not allowed to vote on the Chapter 11 plan, and the plan was confirmed by the bankruptcy court as of September 2013. *In re Meridian Sunrise Village LLC*, No. 13-40342-BDL

(Bankr. W.D. Wash. August 16, 2013), ECF No. 205 ("Memorandum on Confirmation"). The Funds subsequently appealed the bankruptcy court's preliminary injunction and confirmation orders, arguing that the term "financial institutions" was wrongly interpreted and that the bankruptcy court erred in prohibiting the Funds from voting on the plan by ruling that they did not constitute financial institutions.

The Reasoning of the District Court

On appeal, the Funds argued that the term "financial institutions" included "any and all institutions that handle and invest funds" under both common and legal dictionaries, and that the court did not need to look to any extrinsic evidence to rule in their favor. *Id.* at *4 (citing *Webster's* and *Black's Law Dictionary*).

The court, however, found the Funds' interpretation too broad, reasoning that such a definition would render the transfer restriction moot by allowing for assignments to "virtually any entity that has some remote connection to the management of money — up to and including a pawnbroker." *Id.* Furthermore, the court looked to a canon of contractual interpretation to construe the term's meaning from its context, and in doing so found that the Funds' preferred construction of the term would render other phrases in the definition of "Eligible Assignee" redundant and "nonsensical." *Id.* Instead, according to the court, "financial institution" could only be harmonized with "commercial bank," "insurance company" and "institutional lender" when interpreted to mean "entities that make loans." *Id.*

The court found it proper to further consider extrinsic evidence under Washington state law to interpret the meaning of "financial institutions." *Id.* According to the court, evidence about Meridian's negotiation of the loan agreement as well as U.S. Bank's attempt to remove the "Eligible Assignee" limitations when a default first occurred constituted "powerful evidence" that the definition limited transfers, especially to "distressed asset hedge funds who candidly admit[ted] they [sought] to 'obtain outright control' of assets." *Id.* at *5.

As the loan agreement plainly permitted only "Eligible Assignees" to vote on the plan, and the Funds were not Eligible Assignees, the court therefore concluded that the bankruptcy court appropriately precluded the Funds from voting on the plan. *Id.*

Comment

Though the precedential value of the *Meridian* decision may be limited given its application of the law of the State of Washington as well as its dependence on unique extrinsic evidence, the case may confer negotiating power on borrowers or other parties seeking to challenge assignments of commercial loans to investment funds in distressed situations. Additionally, the case highlights the importance of negotiating loan transfer provisions carefully at the drafting stage, both for the lender seeking to ensure free transferability in the marketplace, and the borrower looking to limit assignment rights at a later date. Furthermore, the case underscores the importance of close analysis of assignment provisions in loan documents by distressed investors in advance of entering into a trade so as to protect themselves from subsequent denial of participation and voting in the Chapter 11 process.

Authored by David J. Karp , Jonathan D. Kurland and Neil S. Begley .

If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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[1] *See* LSTA Model Credit Agreement Provisions, Section [Successors and Assigns](b)(v) and (vi).

[2] *See, e.g.*, LMA Multicurrency Term and Revolving Facilities Agreement, Clause 24.1.

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David Karp

Partner

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Neil Begley

Special Counsel

New York

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