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District Court Holds Hedge Funds Not Eligible Assignees Under Loan Agreement And Thus Not Entitled To Vote On Plan

Overview

The District Court for the Western District of Washington recently concluded that certain hedge funds were not "Eligible Assignees" of loan obligations under a debtor's prepetition loan agreement.[1] Although the definition of "Eligible Assignees" in the loan agreement included "financial institutions," the court ruled that the clear meaning of that term, the surrounding language and the parties' actions excluded from its scope entities like the hedge funds that did not "make loans" but rather purchased distressed debt in the hope of obtaining control of the underlying collateral. As a consequence, the court upheld the bankruptcy court's decision to prohibit the hedge funds from voting on the debtor's plan.

Background

In April 2008, Meridian Sunrise Village LLC ("Meridian") borrowed $75 million from U.S. Bank for the construction of a shopping center. The parties negotiated a loan agreement which, among other terms, only permitted U.S. Bank to assign the loan to an "Eligible Assignee." The definition of "Eligible Assignee" included "any commercial bank, insurance company, financial institution or institutional lender" approved by the Agent and, provided there was no event of default, Meridian.[2] U.S. Bank then assigned portions of the loan to Bank of America, Citizens Bank and Guaranty Bank and Trust.

In 2012, the lenders declared a non-monetary event of default based on Meridian's breach of certain debt coverage covenants in the loan agreement. Instead of charging Meridian default interest, U.S. Bank requested that Meridian waive the "Eligible Assignee" limitations so U.S. Bank could sell the loan. Meridian declined and, after U.S. Bank declared that it would begin charging default interest, Meridian filed for bankruptcy. After the bankruptcy filing, Bank of America assigned its interests in the loan to BN Distressed Debt Limited Fund, which subsequently assigned half of the interests to two additional hedge funds (collectively, the "Funds").

Meridian objected to the Funds' acquisition of the loans, and argued that they did not qualify as "Eligible Assignees" under the loan agreement. It sought an injunction from the bankruptcy court to prevent the

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[1] *Meridian Sunrise Village, LLC* v. *NB Distressed Debt Investment Fund Ltd., et al.,* 2014 WL 909219 (W.D. Wash. Mar. 7, 2014).

[2] *Id.* at *1.

Funds from voting on Meridian's plan of reorganization. After the bankruptcy court granted the injunction, the Funds appealed to the district court.

Analysis

The district court affirmed, finding that the term "financial institution" did not contemplate hedge funds. The Funds argued that the court should look only to the dictionary definition of "financial institution" and not consider any extrinsic evidence. They pointed to definitions in Webster's and Black's Law Dictionary that defined the term as any institution that handles and invests funds.[3]

The court found the Funds' interpretation too broad, noting that such a definition would have "no limiting effect at all," and could include a pawnbroker or an individual who created an online LLC "in thirty minutes."[4] Resort to the Funds' interpretation of "financial institutions" would also render superfluous other phrases in the definition of "Eligible Assignee" (*i.e.*, commercial bank, insurance company and institutional lender). The court noted that "financial institution" should be interpreted in a manner that harmonizes with the other phrases in the definition. Applying the principle of statutory construction, *noscitur a sociis*,[5] the court held that the other words in the "Eligible Assignee" definition demonstrated that the term "financial institution" should mean "entities that make loans."[6]

Applying Washington state law, the court found proper considering extrinsic evidence to decipher the meaning of "financial institutions." It noted that U.S. Bank's attempt to remove the "Eligible Assignee" limitations when a default first occurred served as "powerful evidence that the parties to the agreement meant to (and did) limit the list to lenders, and to exclude assignment to distressed asset hedge funds… ."[7]

Because the loan agreement permitted only "Eligible Assignees" to vote on the plan, the court concluded that the bankruptcy court properly barred the Funds from voting.[8]

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3 *Id.* at *4.

4 *Id.*

5 Latin for "it is known by its associates." This cannon of interpretation provides that the meaning of an uncertain word or phrase should be informed by its surrounding words or phrases.

6 *Id.*

7 *Id.* at *5.

8 The court also found that, even were the Funds entitled to vote, their votes against the plan would not have prevented confirmation of the plan. In reaching this conclusion, the court held that the Funds would have only been entitled to a single vote, not one vote for each of the three Funds. "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. If the Funds' reading was correct, any voter could veto the Plan by assigning its claim to enough assignees." *Id.* at *5.

Conclusion

The district court's decision in *Meridian* highlights that courts may consider extrinsic evidence, including a lender's conduct years after the execution of a loan agreement, when construing "eligible assignee" provisions. Borrowers seeking to limit assignment rights should be precise and explicit in drafting eligible assignee provisions; lenders seeking to preserve broad assignment rights should ensure that their conduct comports with their proposed construction of such provisions.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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