CLIENT UPDATE

DISTRESSED INVESTORS BEWARE: ASSIGNMENT RESTRICTIONS MAY NOT MEAN WHAT YOU THINK IN CERTAIN JURISDICTIONS

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A recent appellate decision in the Western District of Washington prohibited hedge fund creditors from voting on a debtor's chapter 11 plan on the basis that the funds did not qualify as "financial institutions" for purposes of the definition of "Eligible Assignee" under the applicable loan agreement.[1] While this counter-intuitive result seems driven by the specific facts of that case, this decision serves as a useful reminder of the importance of carefully reviewing assignment restrictions when purchasing loans in the secondary market. This is particularly important where there is a risk that the borrower will seek bankruptcy protection in a jurisdiction where judges are less familiar with the role of distressed funds in restructurings or where the contract at issue is governed by the laws of a foreign jurisdiction or a state other than New York or Delaware.

BACKGROUND

In April 2008, Meridian Sunrise Village, LLC borrowed $75,000,000 under a loan agreement governed by Washington State law from a syndicate of four lenders. After Meridian defaulted on its financial covenants in early 2012, U.S. Bank, as agent, asked Meridian to waive the requirement that loans only be assigned to an "Eligible Assignee" to enable the lenders to freely sell their loans. The loan agreement defined "Eligible Assignee" as:

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[1] *Meridian Sunrise Village, LLC v. NB Distressed Debt Investment Fund Limited*, No. 13-5503RBL, 2014 WL 909219 (W.D. Wash. March 7, 2014).

> 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.

Following Meridian's refusal to grant this waiver and U.S. Bank's indication that it would begin charging default interest based on the financial covenant default, Meridian filed for chapter 11 protection in the Bankruptcy Court for the Western District of Washington. One of the lenders, over Meridian's objections, assigned its loans to a distressed fund, which in turn assigned portions thereof to two other distressed funds. A dispute arose in the Bankruptcy Court over whether those assignments were valid, and thus whether the funds were eligible to exercise rights as creditors for chapter 11 purposes.

DECISION

The principal issue on appeal was whether the distressed fund loan purchasers fit within the definition of "Eligible Assignee" in the loan agreement and were therefore entitled to vote on Meridian's plan. The District Court found that Meridian had specifically negotiated the Eligible Assignee definition with the intent to exclude hedge fund investors, despite the use of the broad terms "financial institution or institutional lender" in the definition.[2] The District Court rejected the argument that those terms should be read — consistent with their plain-English meaning — to include all entities that invest money. The court explained that this reading would expand the universe of Eligible Assignees so much that it would effectively neutralize the concept as a limitation on assignments, and would render the other types of entities listed in the definition redundant.[3]

In addition, the District Court pointed to the parties' actions—U.S. Bank's pre-bankruptcy request for a waiver of the assignment restrictions and Meridian's decision to file a bankruptcy petition following Meridian's refusal to grant the waiver—as evidence that the parties understood that "financial institutions" did not include entities like the funds at issue.[4] Accordingly, the District Court held that the funds were properly enjoined by the Bankruptcy Court from voting their claims and affirmed the confirmation of Meridian's chapter 11 plan over the funds' objection.

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[2] *Id.* at *1.

[3] *Id.* at *4.

[4] *Id.* at *4-5.

PRACTICAL IMPLICATIONS

Meridian involved the interpretation of a contract governed by Washington State law by a judge in Washington State seemingly hostile to distressed investors (which he defined as "hedge funds that acquire distressed debt and engage in predatory lending"[5]). In addition, the parties' course of conduct leading to the disputed assignments was an important element of the court's analysis and did not favor the funds' interpretation of the contract. It is unclear whether a court in a jurisdiction that more routinely deals with distressed investors in chapter 11 cases (or whether the *Meridian* court applying New York or Delaware law instead of Washington law) would have reached a different conclusion. However, this case highlights the need for careful consideration of not only the specific wording of assignment restrictions, but also the likely venue of any bankruptcy case that may be filed by the borrower and the law governing the loan agreement.

The *Meridian* loan agreement involved a relatively uncommon formulation of the "Eligible Assignee" definition. Generally, large syndicated loan agreements freely permit assignments, except to certain "disqualified entities," such as the borrower and its affiliates, natural persons, defaulting lenders and competitors of the borrower. The Loan Syndications and Trading Association (LSTA) 2012 Model Credit Agreement Provisions,[6] a common starting form for middle-market deals, afford the borrower a reasonable consent right over assignments, except after an event of default or where the assignee is affiliated with a current lender. Accordingly, distressed investors would typically be permitted assignees unless they are specifically listed as "disqualified entities" or unless the borrower withholds its consent to the assignment (for assignments prior to a default). *Meridian* makes clear, however, that these provisions can be negotiated and should be closely reviewed before purchasing a loan on the secondary market.

Finally, as distressed U.S. investors become increasingly active in Europe and in other foreign jurisdictions, *Meridian* is a good reminder that it is critical to confirm that such investors indeed qualify as eligible assignees for purposes of the relevant loan agreement under applicable local law. For example, the English Court of Appeal held in 2006[7] that a hedge fund that invested money for clients (including some but not a significant amount of primary lending) and whose business concerned "commercial finance" was a "financial institution" under English law for the purposes of an old-style Loan Market Association (LMA) loan agreement permitting transfers to "a bank or other financial institution." To

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[5] *Id.* at *1.

[6] The 2012 Model Credit Agreement Provisions are currently under revision.

[7] Essar Steel Ltd v. The Argo Fund Ltd, [2006] EWCA (Civ) 241.

put the matter beyond doubt, however, English-law governed loan agreements generally use the current LMA definition of "New Lender" that expressly includes funds. By contrast, under German law, it is unclear that a fund would be covered by the term "financial institution." Although it is not uncommon to see German-law governed loan agreements limiting the definition of "Eligible Assignees" to "banks and financial institutions," loan agreements with more liberal assignment provisions follow (with some variation) the current LMA definition of "New Lender." Following a different approach, bank loans governed by French law are not assignable to non-regulated funds absent express contractual language, resulting in heavily negotiated lists of eligible assignees in credit agreements. As the interpretation of assignment provisions by courts applying the laws of different national and state jurisdictions can differ significantly, similar language in agreements governed by different laws can lead to different results and should be carefully considered before an investment is made.

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Please do not hesitate to contact us with any questions.

April 8, 2014