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Distressed Debt

Is a Hedge Fund a "Financial Institution" Under a Clause Restricting the Assignability of Debt?

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In 2013, hedge fund NB Distressed Debt Investment Fund Limited (NB Distressed) and affiliates purchased an interest in a defaulted loan to a bankrupt borrower. Distressed debt investing can present a host of complexities, especially when the borrower is in bankruptcy. See "ALM's 7th Annual Hedge Fund General Counsel Summit Addresses Distressed Debt Investing (Part Two of Three)," Hedge Fund Law Report, Vol. 6, No. 46 (Dec. 5, 2013). Those issues may involve credit bidding, equitable subordination, disallowance risks, insider trading and recharacterization of debt as equity. In the case of NB Distressed, the loan documents provided that the lender could only transfer the loan to "Eligible Assignees," a term that included banks, insurance companies and "financial institutions." The bankruptcy court ruled that the funds were not financial institutions and therefore not entitled to vote on the borrower's reorganization plan. In a recent decision, the U.S. District Court for the Western District of Washington (Court) agreed, concluding that the funds that had purchased interests in that distressed debt were not financial institutions, and therefore not Eligible Assignees of that debt.

Factual and Procedural Background

In 2008, Meridian Sunrise Village, LLC (Meridian) borrowed $75 million from U.S. Bank (Loan). The Loan documents prohibited the lender from assigning all or any portion of the Loan to any person other than an Eligible Assignee, a term defined as follows:

"Eligible Assignee" means 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.

U.S. Bank eventually assigned portions of the Loan to Bank of America and two other banks (collectively, the Lenders). In 2012, based on Meridian's breach of certain financial covenants, the Lenders declared Meridian to be in default, but elected not to impose the default rate of interest, which would have exacerbated Meridian's financial problems. To facilitate a sale of the Loan, however, the Lenders asked Meridian to waive the Eligible Assignee requirement. When Meridian refused, the Lenders threatened to impose the default rate of interest, and Meridian filed for Chapter 11 bankruptcy protection in the U.S. Bankruptcy Court for the Western District of Washington (Bankruptcy Court).

During the bankruptcy, over Meridian's objections, Bank of America assigned a portion of the Loan to hedge fund NB Distressed, which subsequently assigned a portion of the interest to Strategic Value Special Situations Master Fund II, L.P., and NB Distressed Debt Master Fund LP (together, the Funds). Meridian then sought, and was granted, an injunction preventing the Funds from acting as Eligible Assignees of the Loan. The Bankruptcy Court determined that the Funds were not financial institutions for purposes of the definition of Eligible Assignee. The effect of the injunction was that the Funds were not permitted to vote on Meridian's proposed reorganization plan. The Lenders voted to approve that plan in September 2013.

The Funds appealed the Bankruptcy Court's decision to the Court. For the reasons discussed below, the Court upheld that decision, ruling that the Bankruptcy Court had correctly determined that the Funds were not financial institutions and, therefore, not Eligible Assignees.

Legal Analysis

The Court's decision turned on the meaning of the term "financial institution." The Court explained that, in Washington, a court may consider "extrinsic" evidence of the meaning of a contract term even if the term is not ambiguous. Such evidence may include "(1) the subject matter and objective of the contract, (2) all the circumstances surrounding the making of a contract, (3) the subsequent acts and conduct of the parties, and (4) the reasonableness of respective interpretations urged by the parties." A court must "harmoniz[e] the interpreted word with the surrounding context." (Citations omitted.)

Plain Meaning of "Financial Institution"

The Funds had argued that the plain meaning of the term "financial institution," as defined by both ordinary and legal dictionaries, meant "any and all enterprises that specialize in the handling and investment of funds" and was therefore broad enough to encompass hedge funds. The Court disagreed, holding that the term should be limited to "entities that make loans."

First, the Court reasoned that the Funds' interpretation would "drain any force from the limitation [on assignment]" intended by the parties to the Loan. According to the Court, under the Funds' erroneous interpretation, a lender would be "free to assign the loan to virtually any entity that has some remote connection to the management of money – up to and including a pawnbroker." Second, a broad interpretation of the term financial institution would render the other terms in the definition – commercial bank, insurance company and institutional lender – superfluous, because they would be encompassed by the term financial institution.

Extrinsic Evidence

The Court also explained that its restrictive interpretation of the term financial institution was bolstered by the context of Meridian's negotiations with the Lenders: The Court viewed U.S. Bank's request that Meridian waive the Eligible Assignee provision as evidence that the parties had intended to prohibit assignment to entities such as hedge funds that invest in distressed debt. This evidence was strengthened by the fact that Meridian filed for bankruptcy protection rather than accede to U.S. Bank's demand to loosen the restriction.

The Court also suggested that Meridian, and perhaps U.S. Bank, had distressed debt investors in mind when drafting the Loan documents: "Based on prior negative experiences, Meridian specifically limited 'Eligible Assignees' to commercial banks, financial institutions, or institutional

lenders to avoid future assignments to 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." In that regard, the Court noted: "NB Distressed boasted that it 'provide[d] investors with attractive risk-adjusted returns through long-biased, opportunistic stressed, distressed and special situation credit-related investments while seeking to limit downside to risk.'"

Funds Entitled to Only One Vote

The Court also noted that, even if the Funds were Eligible Assignees, their ability to vote would not have changed the outcome. The Funds, collectively, would have been entitled to only one vote on the confirmation of the plan: "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." The Funds' single vote would not have changed the outcome.

Implications of the Decision

At first blush, the decision appears to deal a severe blow to hedge funds that invest in distressed debt. However, an insightful April 16, 2014 memorandum issued by Richards Kibbe & Orbe LLP suggests that the impact of the decision may be limited:

- Washington is more permissive than other states in considering extrinsic evidence. Most states would first require a showing that a contract is, in fact, ambiguous. Consequently, the parties' negotiations surrounding the Eligible Assignee clause might not have been considered in other states.
- Some states, such as New York, permit only "express limitations on assignability" or look with disfavor on clauses that restrict a lender's ability to transfer a loan.
- The Court failed to recognize the role that hedge funds now play in capital markets. The authors note: "In fact, investment funds are far more active as original lenders than are insurance companies, which the Court accepted as financial institutions without question."
- Finally, the concept of eligible assignee in general, and the term financial institution in particular, are now used less frequently in loan transfer clauses.

The authors also note that the Court's decision is a reminder of the importance of careful review of transferability restrictions in loan documents. See also "Tribune Bankruptcy Highlights the Importance of Close Reading of Indenture Agreements by Hedge Funds That Trade Bankruptcy Claims or Distressed Debt," Hedge Fund Law Report, Vol. 5, No. 43 (Nov. 15, 2012).

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