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Federal District Court: Distressed Debt Fund Not a "Financial Institution"

A federal district court has ruled that a distressed debt fund is not a "financial institution" for purposes of the assignment provisions of a loan agreement.

Background

In April 2008, Meridian Sunrise Village, LLC ("Meridian") entered into a loan agreement with U.S. Bank providing for a $75 million construction loan to Meridian. Based on prior negative experiences, Meridian negotiated for the assignment provisions of the loan agreement to limit assignments by U.S. Bank and any other lender only to a "commercial bank, insurance company, financial institution or institutional lender"[1] in an attempt to avoid assignments to "predatory investors."[2] After closing, U.S. Bank assigned portions of its interest under the loan agreement to Bank of America, Citizens Business Bank, and Guaranty Bank and Trust Company.

In 2012, though current on its loan payments, Meridian breached a financial covenant in the loan agreement causing it to go into default. The lenders asked Meridian to waive the limiting language on assignments to facilitate sales of interests in the loan, but Meridian refused. The lenders then threatened to charge interest at the default rate (20 percent per annum), as permitted by the loan agreement, if Meridian did not agree to waive the assignment limitations. Despite the threat, Meridian again refused to waive the limitations. In January 2013, the lenders elected to impose the default rate of interest. Unable to carry the increased debt service, Meridian filed for bankruptcy.

Following the bankruptcy filing, Bank of America, despite continued objections by Meridian, assigned its interest to a distressed debt fund, which further assigned its interest to two other similar funds. Meridian petitioned the bankruptcy court to enjoin the funds from voting on Meridian's proposed plan of reorganization. The bankruptcy court granted Meridian's motion. The funds then appealed to the district court, asserting that they each qualified as a "financial institution" and, thus, a permitted assignee under the loan agreement entitled to vote on Meridian's plan or reorganization.

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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) at *1.

2 *Id.*

Reviewing the matter on a de novo basis, the district court agreed with the bankruptcy court's ruling. The district court was not persuaded by the funds' argument that the term "financial institution" should be interpreted consistent with common and legal definitions that would include all institutions that handle and invest funds. The court did little to mask its disdain for the argument, observing that "any individual person could start an LLC online in thirty minutes, and the fly-by-night entity would be a 'financial institution' to which Bank of America could assign the loan."[3]

The bankruptcy court preferred the interpretation advocated by Meridian that the term "financial institution" had to be interpreted in a way that harmonized with the surrounding terms "commercial bank," "insurance company" and "institutional lender."[4] The court observed that these types of entities deal with money lending, so if "financial institution" were read to mean any entity that manages money, it would be out of place in the sequence of terms.

In addition to the wording of the loan agreement, the district court also considered extrinsic evidence, claiming applicable state law permitted doing so when determining the meaning of specific phrases. The court pointed to U.S. Bank's efforts to have Meridian waive the limitation as evidence that the parties intended that the phrase "financial institutions" was to be construed narrowly.[5]

Observations

In retrospect, this case raises a few interesting questions. First, if the court was open to accepting extrinsic evidence to determine the meaning of the phrase "financial institution," why didn't the lenders introduce evidence that many hedge funds do in fact engage in lending activities as part of their business strategy? Second, and more importantly, if Meridian was intent on avoiding assignments to hedge funds, why didn't it negotiate to have unambiguous language (such as "but in no event shall the term Eligible Assignee include hedge funds, distressed debt funds or any other investment fund engaged in predatory lending") included in the loan agreement? This second question points to the real lesson of this case—parties and their legal counsel need to ensure that the plain language of the contract clearly sets forth their intent.

This advisory was written by **Paul Cushing** *and* **Ginger Burton**.

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3 *Id.* at *4 (emphasis omitted).

4 *Id.*

5 *Id.* at *4-*5

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