

Client Alert

Current Issues Relevant to Our Clients

May 22, 2014

Distressed Investing – a trade is a trade...but a fund may not be an eligible assignee

There are two recent rulings related to the trading of distressed debt: the first, confirms that a “trade is a trade” and the second puts in doubt the common belief that funds are financial institutions for the purposes of the “Eligible Assignee” definition in credit agreements.

A trade is a trade

Under New York Law, the general rule is that when two parties agree on the material terms of a transaction, subject only to the agreement and execution of definitive documentation, the parties have an enforceable contract and have a duty to negotiate definitive documentation in good faith. Applying the general rule to a standard distressed debt trade, when the parties say “done” on the phone, having agreed on the price, the quantity and the debt to be sold/purchased, the parties have an enforceable trade.

In *Stonehill Capital Management LLC v. Bank of the West*,¹ a New York trial court held that parties entered into an enforceable contract to buy and sell a collection of loans notwithstanding the absence of a final executed sale agreement. The buyer, Stonehill Capital Management LLC and its affiliated funds (“Stonehill”), was deemed the winning bidder at an auction for certain loans held for sale by Bank of the West (the “Bank”) at a purchase price below par. Before executing a final sale agreement, the Bank learned that Stonehill was providing financing to the underlying borrower, the proceeds of which would be used to pay off the loans at par plus accrued interest. Accordingly, the Bank stood to realize a greater recovery if it kept the loans on its books than it would if it sold the loans to Stonehill. The Bank argued that no binding sale agreement existed because the acceptance of Stonehill’s bid was expressly “[s]ubject to the mutual execution of an acceptable Loan Sale Agreement” and the parties failed to execute such definitive documentation.²

The court held that the material terms of the sale were established once the Bank accepted Stonehill’s bid, thus

creating an enforceable contract. The court explained that under New York law, agreeing “subject to” definitive documentation does not preclude the finding of an enforceable contract if the transaction’s material terms are otherwise reasonably certain.³ In addition, the court found that the Bank did not fulfill its obligations to negotiate definitive documentation in good faith. As a result, the court ruled that the Bank breached its agreement to sell the loans to Stonehill.

The court’s holding in *Stonehill* reaffirms the common market principle that “a trade is a trade.” That is, so long as the material terms of a trade are established (e.g., price, quantity, description of debt), orally or otherwise, the parties have entered into an enforceable contract.

But a fund may not be an eligible assignee

Hedge funds have been active participants in the secondary loan trading market for a long time, and although there have been isolated attempts by some borrowers to try to limit activist funds from buying their debt, funds have generally not had much difficulty purchasing loans in the secondary market and becoming lenders by assignment.

But in *Meridian Sunrise Village, LLC v. NB Distressed Debt Investment Fund Ltd.*,⁴ the District Court for the Western District of Washington went against market

3. *Id.* at *4 (“A loan ‘subject to a mutually acceptable’ agreement does not necessarily condition assent on the execution of a definitive agreement as long as ‘[t]he agreement [is] reasonably certain as to material terms.’” (quoting *Emigrant Bank v UBS Real Estate Secs., Inc.*, 49 A.D.3d 382, 383-84 (N.Y. App. Div. 2008))). The *Emigrant Bank* court distinguished “subject to” language from unequivocal reservations of assent which make it clear that parties do not intend to be bound until execution of definitive documentation.

4. 2014 WL 909219 (W.D. Wash. Mar. 7, 2014).

1. 2014 WL 1219093 (N.Y. Sup. Ct. Mar. 24, 2014).

2. *Id.* at *2.

expectations and upheld a bankruptcy court's ruling that hedge funds were not eligible purchasers of the debtor's loans because the funds were not "financial institutions."

Meridian had entered into a loan agreement with U.S. Bank to borrow funds for the construction of a shopping center. The loan agreement limited the sale of the loans only to "Eligible Assignees," which was defined to mean "any commercial bank, insurance company, financial institution or institutional lender" approved by the agent and, unless an event of default had occurred, the borrower. Soon after funding the loan, U.S. Bank assigned portions of the loans to other commercial bank lenders, including Bank of America.

Following an event of default, U.S. Bank requested that Meridian waive the Eligible Assignee limitations so as to facilitate sales of the loans by the lenders. Meridian, however, declined to waive the limitations. U.S. Bank then informed Meridian that it would begin charging the default rate of interest if Meridian did not agree to eliminate the Eligible Assignee restrictions, which in turn prompted Meridian to file for protection under chapter 11 of the Bankruptcy Code. During the pendency of the bankruptcy proceeding, Bank of America sold its interest in the loans to a hedge fund, which then further assigned portions of its interests to two affiliated funds (collectively, the "Funds"). The Funds opposed confirmation of Meridian's proposed plan of reorganization.

Meridian objected to the transfer of the loans to the Funds and sought to enjoin the Funds from exercising their rights as Eligible Assignees, including the right to vote on the proposed plan. The bankruptcy court granted the injunction and subsequently confirmed the plan without taking into account the vote of the Funds. The Funds appealed both the injunction and the confirmation of the plan.

On appeal, the Funds argued that the term "financial institutions" should be interpreted broadly, based upon definitions found in common and legal dictionaries, to include any entity that handles the investment of funds. The District Court, however, stated that the loan agreement's limitations on assignments would have no limiting effect at all if lenders were free to assign the loans to "virtually any entity that had some remote connection to the management of money - up to and including a pawnbroker."⁵ In addition, the District Court determined that when the term "financial institution" was read in the context of the other phrases in the "Eligible Assignee" definition in the loan agreement (*i.e.*, "commercial bank," "insurance company" and "institutional lender"), it could only mean entities that made loans; otherwise, the surrounding phrases and the term "financial institution" itself would all become nonsensical.⁶

Finally, the District Court looked at U.S. Bank's previously unsuccessful attempts to eliminate the restrictions regarding who could be an Eligible Assignee as further evidence that the parties intended "financial institutions" to exclude entities like the Funds. The District Court went on to conclude that even if the Funds had been permitted to vote on the plan, their vote would not have changed the outcome because they would effectively have had only one vote (not the three that the Funds asserted), because they had artificially increased their voting power by splitting their claims among affiliate funds.

As funds have come to play a larger role in the primary and secondary loan markets, concerns that may have initially existed regarding their status as eligible assignees have largely fallen away. There has also been a move away from listing various types of entities as "Eligible Assignees," and many credit agreements now permit borrowers (absent an event of default) to consent to assignments on an case by case basis, which consent cannot be unreasonably withheld. This is the approach taken by the LSTA under the terms of its Model Credit Agreement.

The ruling in *Meridian Sunrise*, although it is fact specific and resulted from the application of Washington law, reminds us again that normal expectations and standard practices are often challenged in bankruptcy proceedings and that courts of equity may sometimes upend market expectations and conventions. The case highlights the importance of precise drafting and the need for purchasers of loans to continue to carefully review the assignment and transfer provisions in loan agreements to minimize the possibility of unpleasant surprises.

For More Information

For more information, please contact Larry G. Halperin (212.655.2517), Joon P. Hong (212.655.2537), Andrew Wool (312.845.3730) or your primary Chapman attorney, or visit us online at chapman.com.

This document has been prepared by Chapman and Cutler LLP attorneys for informational purposes only. It is general in nature and based on authorities that are subject to change. It is not intended as legal advice. Accordingly, readers should consult with, and seek the advice of, their own counsel with respect to any individual situation that involves the material contained in this document, the application of such material to their specific circumstances, or any questions relating to their own affairs that may be raised by such material.

To the extent that any part of this summary is interpreted to provide tax advice, (i) no taxpayer may rely upon this summary for the purposes of avoiding penalties, (ii) this summary may be interpreted for tax purposes as being prepared in connection with the promotion of the transactions described, and (iii) taxpayers should consult independent tax advisors.

© 2014 Chapman and Cutler LLP. All rights reserved.

Attorney Advertising Material.

5. *Id.* at *4.

6. *Id.*