

June 12, 2009

WEATHERING THE STORM

Look Out Lenders—Collecting Fees For Loaning Money May Be Considered Evil

A Bankruptcy Court in Montana recently equitably subordinated a secured lender's first lien claims to the claims of the debtor-in-possession ("DIP") lender and the unsecured creditors even though the lender did not owe any fiduciary duties to the debtor or any of the debtor's potential creditors. *Credit Suisse v. Official Comm. of Unsecured Creditors (In re Yellowstone Mountain Club, LLC)*, Ch. 11 Case No. 08-61570, Adv. No. 09-00014 (Bankr. D. Mont., May 12, 2009). The Court found that the agent for the syndicated lenders, Credit Suisse, was motivated to earn large fees and encouraged the controlling equity owners of the borrower to cash out of their investments by taking a majority of the proceeds of the loan to the borrower, thus saddling the borrower with so much debt that the borrower was doomed to fail.

The Yellowstone Mountain Decision

Although section 510(c) of the United States Bankruptcy Code permits a court to subordinate a lender's claim based upon inequitable conduct that injured other creditors or conferred an unfair advantage on the lender, it is rare, and difficult, to subordinate claims of creditors that are not fiduciaries or insiders of a debtor. To equitably subordinate a non fiduciary or insider claimant, courts must find gross or egregious misconduct or conduct amounting to fraud.

The *Yellowstone Mountain* Court noted that the loan product marketed to the debtor was marketed to five other residential developers—all of whom filed petitions for bankruptcy—as a product that was “akin to a ‘home equity loan[.]’” The loan expressly permitted the controlling equity holders to take large portions of loan proceeds—in this case, \$209 million of the \$375 million loan—for their own personal use even though Credit Suisse knew that there was a minority shareholder class. The Court also noted that Credit Suisse would have known that if the controlling equity holder took \$209 million of the loan as a distribution, it would have caused the debtor to record negative owners' equity on its books, resulting in a qualification on the debtor's audited financials and non-compliance under the terms of the credit agreement. In order to avoid this result, *Yellowstone* “loaned” \$209 million to the controlling shareholder. The Court focused on the new debt load, which increased “at least six times” as a result of the financing even though the debtor had consistently failed to meet its profitability projections. Additional facts which the Court found to weigh in favor of equitable subordination were Credit Suisse's: (i) lack of due diligence; (ii) failure to request audited financials from the debtor; (iii) exclusive reliance on the projections provided by the debtor; (iv) invention and use of a new form of appraisal methodology, “Total Net Value,” to justify the loan while ignoring a recent prior valuation that suggested a 90% loan to value ratio; and (v) desire to increase fees by loaning more money.

Based on these facts the Court determined that it was appropriate to equitably subordinate Credit Suisse's claim. The court permitted Credit Suisse to credit bid the amount of its secured claim at a sale of the debtor's assets, but only on the condition that it pay off the DIP loan, the administrative fees and costs of the Debtors' bankruptcy estate and unsecured creditors' claims.

Practical Implications

While the facts of the *Yellowstone Mountain* decision are unique, the syndicated loan in *Yellowstone Mountain* is similar to other loans which are currently outstanding. Indeed, many loans have been made to companies where the bulk of the loan proceeds have been distributed to the equity owners. In effect, the court in *Yellowstone*

Mountain concluded that an arms length lender which made a loan to a borrower, knowing that the loan proceeds would be distributed to the equity owners, under all the circumstances described in the decision, has committed egregious conduct warranting equitable subordination. The court apparently felt that a desire to maximize fees and lax underwriting practices are evidence of evil intent. Debtors and junior creditors might refer to the *Yellowstone Mountain* decision in negotiations with senior lenders and lenders to distressed borrowers would be wise to analyze the specific factors that the Bankruptcy Court considered in equitably subordinating Credit Suisse's claim.

It remains to be seen whether other courts will follow the *Yellowstone Mountain* decision or whether it will be treated as an aberration, especially in light of post-decision maneuvers.

Ultimately, Credit Suisse settled the underlying dispute and voted in favor of a third amended plan of reorganization (the "Plan"). The Plan was confirmed on June 2, 2009. A precondition to the Plan's Effective Date is entry of an order vacating or amending the underlying decision. No order has been issued. Either way, the *Yellowstone Mountain* decision is an instructive example of conduct that can lead to equitable subordination.

For more information, please contact:

[Robin Phelan](mailto:robin.phelan@haynesboone.com)
214.651.5612
robin.phelan@haynesboone.com

[Jason Nagi](mailto:jason.nagi@haynesboone.com)
212.659.4989
jason.nagi@haynesboone.com

[Sue Murphy](mailto:sue.murphy@haynesboone.com)
214.651.5602
sue.murphy@haynesboone.com

[Kenric Kattner](mailto:kenric.kattner@haynesboone.com)
713.547.2518
kenric.kattner@haynesboone.com

[Lenard Parkins](mailto:lenard.parkins@haynesboone.com)
212.659.4966
lenard.parkins@haynesboone.com

[Stephen Pezanosky](mailto:stephen.pezanosky@haynesboone.com)
817.347.6601
stephen.pezanosky@haynesboone.com

[Sarah Foster](mailto:sarah.foster@haynesboone.com)
512.867.8412
sarah.foster@haynesboone.com

[Eric Terry](mailto:eric.terry@haynesboone.com)
210.978.7424
eric.terry@haynesboone.com

In order to comply with certain U.S. Treasury regulations, we are informing you that any U.S. federal tax advice that may be contained in this document is not intended or written to be used, and cannot be used, by any person for the purpose of (i) avoiding any tax penalties that may be imposed by the Internal Revenue Service or any other U.S. federal taxing authority or agency or (ii) promoting, marketing, or recommending to another party any transaction or matter addressed herein.