BANKRUPTCY COURT EQUITABLY SUBORDINATES CLAIMS ARISING UNDER SECURED CREDIT AGREEMENT

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To Our Clients and Friends:

In a decision handed down last week, the Bankruptcy Court for the District of Montana equitably subordinated a $232 million secured loan made to the Yellowstone Mountain Club, LLC, the developer of an exclusive golf and ski community in Montana, by a lending syndicate led by Credit Suisse. The Court subordinated the secured claim to the claims of Yellowstone's unsecured creditors notwithstanding its determination that the loan was negotiated at arm's length. Despite its questionable reasoning, the decision in *In re Yellowstone Mountain Club, LLC*, Case No. 08-61570 (Bankr. D. Mont. May 13, 2009), may signal greater judicial scrutiny of the actions of secured creditors during the current economic crisis.

Section 510(c) of the Bankruptcy Code permits a court to equitably subordinate all or part of an allowed claim to all or part of another allowed claim for purposes of distribution. If, as was the case in *Yellowstone Mountain Club*, the claim that is subordinated is secured by a lien, the claim becomes unsecured and the property securing the claim becomes part of the debtor's estate. Under established case law, three conditions must be satisfied before a court can equitably subordinate a claim: (i) the claimant must have engaged in some type of inequitable conduct, (ii) the misconduct must have resulted in injury to the other creditors or conferred an unfair advantage on the claimant and (iii) the subordination must not be inconsistent with the provisions of the Bankruptcy Code. Most cases of equitable subordination involve claims held by an insider, such as a controlling shareholder, and in such cases the court will closely scrutinize the conduct of the insider because of the increased opportunity for inequitable conduct. If the claimant is not an insider, evidence of more "egregious conduct" is required, such as fraud, misrepresentation, overreaching or conduct involving moral turpitude.

Although the Bankruptcy Court explicitly found that the syndicated loan was negotiated at arm's length and acknowledged the rarity with which courts equitably subordinate claims of non-insiders, it nonetheless held that the loan was to be equitably subordinated because Credit Suisse's actions "shocked the conscience of the Court." The Court was particularly irked by Credit Suisse's alleged lack of financial due diligence and inattention to Yellowstone's ability to repay the loan. Specifically, the Court found that Credit Suisse had relied on an appraisal of the property that was based on projections of future financial performance that had "no foundation in historical reality." The Bankruptcy Court was also disturbed by the terms of the credit agreement which permitted a substantial portion of the loan proceeds to be used for distributions to Yellowstone's shareholders for purposes unrelated to the development. Finally, the Court noted that several other residential resorts to which Credit Suisse had made similar loans had also failed. Noting the substantial fees that Credit Suisse received in connection with the transaction, the Bankruptcy Court concluded that Credit Suisse's "naked greed" had allowed it to benefit at the expense of Yellowstone's other creditors.

One important issue which the Bankruptcy Court failed to address is whether the claims of the entire lending syndicate should be equitably subordinated based on Credit Suisse's actions. Ironically, if the Court's findings with respect to Credit Suisse's diligence are correct, the other members of the syndicate would appear to have also been victims of the bank's conduct.

Reportedly, Yellowstone, Credit Suisse and other interested parties have now reached a settlement that resolves all litigation in the bankruptcy case, suggesting that the Bankruptcy Court's decision will not be appealed.

Please feel free to contact us with any questions.

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