Equitable Subordination in Bankruptcy: An Analysis of *In re Yellowstone*

By John C. Murray

Introduction

Section 510(c) of the Bankruptcy Code[1] permits the bankruptcy court to subordinate, on equitable grounds, all or part of a lender's allowed claim or interest, to transfer any lien securing a subordinated claim to the bankruptcy estate, or to disallow the claim entirely in the appropriate circumstances, even if no preferential transfer (under § 547 of the Bankruptcy Code) or fraudulent conveyance (under § 548 of the Bankruptcy Code) has occurred. It is well established that a bankruptcy court has the authority to subordinate a claim on equitable grounds.[2] This article will discuss the scope of equitable subordination under § 510(c), in particular its application to a recent Montana bankruptcy case, *Credit Suisse v. Official Committee of Unsecured Creditors*,[3] where the court ruled that the lender's actions warranted subordination of its secured claim to all other claims (secured and unsecured) in the borrower-debtor's Chapter 11 bankruptcy proceeding.

Scope of the Equitable Subordination Doctrine

In general, the equitable subordination doctrine is limited to reordering priorities, and does not permit total disallowance of a claim.[4] A claim for equitable subordination

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[1] 11 U.S.C. § 510(c). This section provides that:
[A]fter notice and a hearing the court may --
(1) under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest; or
(2) order that any lien securing such a subordinated claim be transferred to the estate.

[2] *See, e.g*., *Pepper v. Linton*, 308 U. S. 295, 305**,** 605 S. Ct. 238, 244 (1939) (ruling that bankruptcy court has exclusive jurisdiction over subordination, allowance, and disallowance of claims, and that court may reject claim in whole or in part according to equities of each case); *In re 80 Nassau Associates*, 169 B.R. 832, 837 (Bankr. S.D.N.Y. 1994) (citing *In re Kansas City Journalism*, 144 F.2d 791, 800 (8th Cir. 1944), court stated that "[t]he power to subordinate a claim derives from the Bankruptcy Court's general equitable power to adjust equities among creditors in relation to the liquidation results"); *In re the O'Day Corp*., 126 B.R. 370, 412 (Bankr. D. Mass. 1991) ("equitable subordination is an equitable remedy available to the [bankruptcy] Trustee"); *In re Poughkeepsie Hotel Assoc. Joint Venture*, 132 B.R. 287, 292 (Bankr. S.D.N.Y. 1991) ("The notion of equitable subordination, as embodied in § 510(c), is peculiar to bankruptcy law and an issue which can only be decided in a bankruptcy setting").

[3] *(In re Yellowstone Mountain Club, LLC*), Case No. 08-6150-11, Adv. 09-00014 (Partial & Interim Order) (Bankr. D. Mont., May 13, 2009) (Docket No. 289) ("Yellowstone Order"). See the discussion of this case at note 10, *infra*, and accompanying text.

[4] *See In re 80 Nassau Associates*, *supra* note 2, 169 B.R. at 837; *Benjamin v. Diamond (In re Mobile Steel Co.)*, 563 F.2d 692, 700 (5th Cir. 1977). However, if the conduct of the creditor is so egregious that it affects the validity of the claim under applicable principles of law, the debtor can ask the court to disallow it in full as part of the claims avoidance process. *See In re Mobile Steel Co.*, *supra*, 563 F. 2d at 699 n. 10; *In re 80 Nassau Associates*, *supra* note 2, 169 B.R. at 837 n. 4; *In re Werth*, 37 B.R. 979, 991 (Bankr. D.

must be brought by an adversary proceeding, and generally may be initiated only by a trustee or debtor in possession, unless a bankruptcy court authorizes another party to initiate such a proceeding.[5]

The bankruptcy court generally invokes the sanctions set forth in § 510(c) of the Bankruptcy Code when the lender has engaged in overreaching or lender control, which occurs when the lender steps beyond the traditional role of a lender and participates in the debtor's business or engages in other egregious conduct that justifies the use of the court's equitable powers. In these situations, the court may decide to subordinate, recharacterize, or even disallow a transaction that would not constitute a preferential transfer or a fraudulent conveyance. The principles of equitable subordination are not set out in the Bankruptcy Code, and are defined by case law. Equitable subordination is an extraordinary remedy and courts generally have strictly construed § 510(c) when determining whether equitable subordination is warranted in a particular situation. For example, in *In re Kreisler*,[6] the Seventh Circuit Court of Appeals stated that:

> Equitable subordination allows the bankruptcy court to reprioritize a claim if it determines that the claimant is guilty of misconduct that injures other creditors and confers an unfair advantage on the claimant [citations omitted]. The result is usually that the claimant receives less money than it otherwise would (or none at all), but that is not the goal. Equitable subordination is remedial, not punitive, and is meant to minimize the effect that the misconduct has on other creditors (citation omitted)).[7]

The courts have developed various standards or "tests" to determine whether or not the conduct (or misconduct) of a particular creditor should result in equitable subordination of the creditor's claim. The Fifth Circuit Court of Appeals, in *In re Mobile Steel Co.*,[8] set forth the standard three-part test for equitable subordination, i.e.:

> (1) The claimant must have engaged in some type of inequitable conduct; (2) The misconduct must have resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant; and (3) equitable subordination of the claim must not be inconsistent with the provisions of the Bankruptcy Act [the predecessor to the Bankruptcy Code].[9]

Colo. 1984) (finding that oral loan agreement existed and that mortgagee had breached agreement; court disallowed mortgagee's claim in full); *aff'd* 54 B.R. 619 (Bankr. D. Colo. 1985).

[5] *See 9281 Shore Rd. Owners Corp v. Seminole Realty Co. (In re 9281 Shore Road Owners Corp*), 187 B.R. 837, 852 (Bankr. E.D.N.Y. 1995).

[6] 546 F.3d 863 (7th Cir. 2008).

[7] *Id.* at 865-66. *See also In re First Alliance Mortg. Co.*, 497 F.3d 977, 1006 (9th Cir. 2006) (holding that when remedy of equitable subordination involves non-insider, non-fiduciary, "the level of pleading and proof is elevated; gross and egregious conduct will be required before a court [can] equitably subordinate a claim"); *Waslow v. MNC Commercial Corp. (In re Paolella & Sons, Inc.),* 161 B.R.107, 119 (Bankr. E.D. Pa. 1993) (noting that equitable subordination is seldom used in a noninsider, non-fiduciary scenario).

[8] *Supra* note 4, 563 F.2d 563 F.2d 692 (5th Cir. 1977).

[9] *Id*. at 700.

Application to Fiduciaries and Insiders

In applying equitable subordination to parties who are deemed to be fiduciaries, the creditor whose claim is sought to be subordinated generally must: (a) have acted in a fiduciary capacity; (b) have breached a fiduciary duty; (c) that breach resulted in detriment to those claimants to whom a duty was owed, or, (d) committed an act of moral turpitude, causing damages to other creditors. Thus, the claims of fiduciaries, as well as those of non-fiduciaries, can be subordinated. Normally, a creditor is not a fiduciary of either the debtor or other creditors of the debtor and owes them no special duty, and would have to exercise virtually complete control over the debtor or its business to be treated as a fiduciary. Where the claimant is an insider,[10] its dealings with the debtor will be subject to closer scrutiny than if the claimant is a non-insider. Where the claimant is a non-insider, egregious conduct must be proven with particularity.[11]

A Case for Equitable Subordination: *In re Yellowstone*

In a recent decision with especially bad facts (for the lender), *Credit Suisse v. Official Committee of Unsecured Creditors*,[12] the bankruptcy court, noting Credit Suisse's "gross and egregious conduct" -- including its lack of due diligence and negligent lending practices and the fact that 94% of the loan proceeds were used for purposes unrelated to the borrower-developer's business purposes -- subordinated the entire $232 million first-priority secured claim of Credit Suisse (which acted as lead arranger for the syndicated loan) to the claims of the debtor-in-possession lender and the unsecured creditors, in the borrower-developer's Chapter 11 bankruptcy proceeding.

This case was a declaratory judgment and avoidance action arising out of a $375 million pre-petition secured loan by Credit Suisse and other prepetition lenders on September 30, 2005, to Yellowstone Mountain Club, LLC, Yellowstone Development, LLC and Big Sky Ridge, LLC (collectively, the "Borrowers," and, together with their affiliate Yellowstone Club Construction Company, LLC , the "Debtors"). After payment

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[10] The term "insider" is defined in § 101(31) of the Bankruptcy Code.

[11] *See, e.g., Fluharty v. Wood Products, Inc. (In re Daugherty Coal Co., Inc.*), 144 B.R. 320, 323 (N.D. W.Va. 1992) (holding that where claimant is a fiduciary of debtor or insider, "the trustee/debtor must only prove unfairness in the transaction; otherwise subordination is proper only in cases of fraud, spoliation or overreaching"); *In re N & D Properties, Inc.*, 799 F.2d 726, 731 (11th Cir. 1986) (same); *In re Missionary Baptist Church Foundation of America, Inc.*, 818 F.2d 1135, 1144 n. 8 (5th Cir. 1987) (same); *In re W.T. Grant Co*., 699 F. 2d 599 (2d Cir. 1983), *cert. denied*, 464 U.S. 822 (1985) (distinguishing between severity of conduct required for equitable subordination of fiduciary claims and non-fiduciary claims); *Capitol Bank. & Trust Co. v. 604 Columbus Avenue Realty Trust (In re 604 Columbus Avenue Realty Trust*), 968 F.2d 1332, 1360 (1st Cir. 1992) ("[w]hether the creditor is an insider or fiduciary of the debtor is fundamentally important to the level of scrutiny that courts apply to allegations of misconduct against a creditor"); *In re Fabricators, Inc.*, 926 F.2d 1458, 1465 (5th Cir. 1991) (ruling that if the claimant is not an insider, "then evidence of more egregious misconduct . . . is necessary"); *In re Beverages International Ltd.*, 50 B.R. 273, 281 (Bankr. D. Mass. 1988) ("[t]he burden is on an insider claimant to show the inherent fairness and good faith of the challenged transaction"); A. DiNatale and P. Abram, *The Doctrine of Equitable Subordination as Applied to Nonmanagement Creditors*, 40 BUS. LAW. 417, 430-45 (1985).

[12] *(In re Yellowstone Mountain Club, LLC*), *supra* note 3, Case No. 08-6150-11, Adv. 09-00014 (Partial & Interim Order) (Bankr. D. Mont., May 13, 2009) (Docket No. 289).

of a pre-existing mortgage indebtedness as well as transaction costs and fees, a total of $342 million was disbursed to the Debtors, of which (according to the credit agreement entered into by the parties on September 5, 2005 ("Credit Agreement")) up to $209 million could be used as "distributions or loans" for purposes unrelated to the Debtors' Yellowstone Club development; and up to another $142 million was authorized by the Credit Agreement to be used for investments into "unrestricted subsidiaries" for purposes that similarly were unrelated to the Yellowstone Club development. Thus, the bulk of the loan proceeds (up to $351 million) were designated to be used for purposes outside of, and unrelated to, the Yellowstone Club or the Debtors' business purposes. Interestingly, in the past the Debtors outstanding debt (pursuant to a revolving line of credit) ranged from approximately $4 million to $5 million on the low end and to approximately $60 million on the high end.

According to a later reported decision in this bankruptcy proceeding:[13]

> Timothy L. Blixseth and his former wife, Edra Blixseth ("Edra"), formed the Debtor corporations on the land that Blixseth acquired through various transactions, and began development in the late 1990s of the world's only private ski and golf community, commonly referred to as the Yellowstone Club. The Yellowstone Club is a membership only master-planned unit development, situated on 13,500 acres of private land in Madison County, Montana near Big Sky, Montana.

The court stated further that:

> Credit Suisse was specifically trying to 'break new ground with a product by doing real estate loans in the corporate bank market.' Through its new syndicated term loans, Credit Suisse was able to offer a loan product the size of which had previously been unavailable to borrowers.[14]

As the court in this case further noted, the borrowing entity would "receive[] a syndicated loan from Credit Suisse's Cayman Islands branch, which allowed the equity holders in said entities to take sizable distributions from all or part of the Credit Suisse loan proceeds."[15] The Yellowstone Order summarized the flaws of this new loan product as follows:

> In 2005, Credit Suisse was offering a new financial product for sale. It was offering the owners of luxury second-home developments the opportunity to take their profits up front by mortgaging their development projects to the hilt. Credit Suisse would loan the money on a non-recourse basis, earn a substantial fee, and sell off most of the credit to loan participants. The development owners would take most of the money out as a profit

[13] *Credit Suisse v. Official Committee of Unsecured Creditors (In re Yellowstone Mountain Club, LLC*), 415 B.R. 769, 783 (Bankr. D. Montana, 2009).
[14] *Id*. at 784.
[15] *Id*.

> dividend, leaving their developments saddled with enormous debt. Credit Suisse and the development owners would benefit, while their developments – and especially the creditors of their developments – bore all the risk of loss. This newly developed syndicated loan product enriched Credit Suisse, its employees and more than one luxury development owner, but it left the developments too thinly capitalized to survive. Numerous entities that received Credit Suisse's syndicated loan product have failed financially.[16]

From the inception of the loan in 2005 through the filing of the Debtors' bankruptcy petition in November 2008, the debtors were continually behind on their accounts payable, and had missed their profitability projections – by a significant amount - for the nine months before the loan from Credit Suisse. Kent Mordy ("Mordy"), a certified public accountant and certified insolvency and reorganization advisor, "concluded that the purported $209 million loan to BGI [Blixeth Group, Inc.] and its affiliates was not in fact a loan under generally accepted accounting principles, but was rather, a distribution and a return of capital to BGI and its then owner, Blixseth . . . In sum, the $209 [*sic*] distribution to BGI left the Debtors highly leveraged and with too little capital with which to fund their financial plans and projections."[17]

The Yellowstone Order also noted, at p. 18, that Credit Suisse was aware that Cushman & Wakefield had previously appraised the mortgaged property in 2004 at a valuation of $420 million and "thus either knew or should have known that the collateral that Blixeth proposed for the Credit Suisse loan had a fair market value of $420 million in 2004. The Court highly doubts that Credit Suisse could have successfully syndicated the Yellowstone club loan if the loan to value ratio was 90 percent."

Credit Suisse nonetheless commissioned Cushman & Wakefield to employ its newly developed valuation methodology based almost entirely on the Debtors' future financial projections, which the Yellowstone Order concluded bore no relation to the Debtors' actual past or current (negative) cash flow from the property. The Yellowstone Order noted that the "Total Net Value" appraisal methodology was first developed by Cushman & Wakefield when Credit Suisse was selling its syndicated-loan product to another resort developer, and that the methodology "does not comply with the Financial Institutions Recovery Reform Act of 1989 ("FIRREA"), but that was not important to Credit Suisse because Credit Suisse was seeking to sell its syndicated loans 'to non-bank institutions.'"[18]

After carefully reviewing all the evidence, the Yellowstone Order stated as follows:

> The only plausible explanation for Credit Suisse's actions is that it was simply driven by the fees it was extracting from the loans it was selling,

[16] Yellowstone Order, at P. 16.
[17] *In re Yellowstone Mountain Club, LLC*, *supra* note 13, 415 B.R. at 788.
[18] Yellowstone Order, at P. 7.

> and letting the chips fall where they may. Unfortunately for Credit Suisse, those chips fell in this Court with respect to the Yellowstone Club loan. The naked greed in this case combined with Credit Suisse's complete disregard for the Debtors or any other person or entity who was subordinated to Credit Suisse's first lien position, shocks the conscience of this Court. While Credit Suisse's new loan product resulted in enormous fees to Credit Suisse in 2005, it resulted in financial ruin for several residential resort communities. Credit Suisse lined its pockets on the backs of the unsecured creditors. The only equitable remedy to compensate for Credit Suisse's overreaching and predatory lending practices in this instance is to subordinate Credit Suisse's first lien position to that of CrossHarbor's superpriority debtor-in-possession financing and to subordinate such lien to that of the allowed claims of unsecured creditors.[19]

In a later decision by the bankruptcy court involving a separate issue in the case, *In re Yellowstone Mountain Club, LLC*,[20] the court noted that "[t]he disputes and resulting litigation in this case between the Debtors, the Official Committee of Unsecured Creditors, Credit Suisse and CrossHarbor was of a magnitude never seen before in this Court."[21] The court further noted that:

> [A]fter a lengthy trial and following an incredible number of hearings, many held on an emergency basis, the Debtors, the Official Committee of Unsecured Creditors, Credit Suisse and CrossHarbor, during the eleventh hour of the auction of the Debtors' assets, [in which Credit Suisse participated for the sole purpose of protecting its claim] reached a global resolution of their disputes. That global resolution is reflected in the Debtors' Third Amended Chapter 11 Plan, which Plan was confirmed by Order entered June 2, 2009.[22]

However, the "global" settlement did not deal with or decide the issue of whether all the lenders that participated in the syndicated loan should be held accountable for the actions of the lead arranger, Credit Suisse, in connection with confirmation of the Debtors' reorganization plan. But the court did vacate its previous equitable-subordination order -- thereby negating any chance of appeal or use of this decision, or the Yellowstone Order, as persuasive authority. But the *Yellowstone* case, even though it has extremely bad facts and will not be a reported decision, certainly remains a cautionary tale for secured lenders in terms of lender-liability risk and the ability to demonstrate proper due diligence.[23]

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[19] *Id*. at P. 19.
[20] 2009 WL 2163528 (Bankr. D. Mont, July 16, 2009).
[21] *Id*. at *1.
[22] *Id*. at *2.
[23] *See* Jo Ann Brighton and Felton E. Parrish, *Yellowstone: New Standards for Lender Liability in Today's Economic Climate*, 28-SEP AM. BANKR. INST. J. 28 (2009) (arguing that *Yellowstone* decision is "disturbing" because loan was a "fairly standard syndicated loan transaction" that had been negotiated at arms length, and creditor does not have fiduciary duty to borrower and may act in its own self interest). *Cf.* J. Thomas

On January 3, 2009, property owners in four luxury and golf resorts, including the Yellowstone Club, filed a lawsuit against Credit Suisse and Cushman & Wakefield, Inc., seeking $24 billion in damages ($8 billion of actual damages and $16 billion of punitive damages) and seeking class-action status for more than 3000 investors who bought land or homes at the resorts. The lawsuit claims that Credit Suisse violated federal racketeering laws, overinflated the value of the properties, and knowingly burdened the properties with too much debt.[24]

Other Court Decisions Finding Equitable Subordination

Several other courts have found a significant level of inequitable conduct by a secured creditor to justify the subordination of all or a portion of such creditor's claim to the claims of unsecured creditors (or even, in rare circumstances, disallowance of the secured creditor's claim). *See*, *e.g.*, *In re Herby's Foods, Inc.*[25] (finding sufficient evidence of inequitable conduct when an insider with full knowledge that debtor was undercapitalized and insolvent advanced funds to debtor in form of loans when no other third party lender would have done so); *In re the O'Day Corp*.[26] (holding that creditor's conduct was tantamount to overreaching and therefore constituted sufficient grounds to subordinate creditor's claim pursuant to § 510 of Bankruptcy Code); *In re Ambassador Riverside Inv. Group*[27] (subordinating mortgagee's $4 million first mortgage on equitable principles because mortgagee's agent misrepresented availability of construction loan and take-out loan); *In re Osborne*[28] (holding that mortgagee's secured claims were subordinate to unsecured claims of trade creditor as result of mortgagee's misrepresentations regarding debtor's ability to pay trade creditor; court noted that degree of misconduct that plaintiff must show in case of non-insider must be tantamount to fraud, misrepresentation, overreaching or spoliation to detriment of others); *In re Werth*, *supra*[29] (finding that that mortgagee had breached oral loan agreement; court disallowed mortgagee's claim in full); *In re American Lumber Co.*[30] (ruling that because of mortgagee's control of mortgagor's plant and cash disbursements, mortgagee had

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Beckett, *A Rogue Loan, Not a Rogue Decision*: *A Response to a Recent Analysis of Yellowstone*, 28-NOV AM. BANKR. INST. J. 22 (2009) (disputing conclusions of Ms. Brighton and Mr. Parrish, *supra*, and arguing that in fact *Yellowstone* decision was correct and lender was properly chastised by court -- which concluded that lead arranger's due diligence was "all but non-existent" -- and also arguing that "[l]ending other people's money, Credit Suisse sold a colossal and unnecessary loan to the owner of the Yellowstone Club, a loan that Yellowstone could not possibly repay" and that "[t]he purpose of the loan was not to benefit the club but to take money out of the club for the exclusive enjoyment of its owner"). [Note: Mr. Beckett and his law firm represented the creditors' committee in the *Yellowstone* litigation and the underlying bankruptcy case; Ms. Brighton and Mr. Parrish's law firm represented Timothy Blixseth, a defendant in the *Yellowstone* litigation, in the underlying bankruptcy case.]

[24] *See Gibson et al v. Credit Suisse AG et al*, U.S. District Court (D. Idaho), No. 10-00001 (Jan. 3, 2009). For a discussion of this filing, see Jonathon Stempel, *Credit Suisse Sued Over Resorts, $24 Billion Sought*, REUTERS BUSINESS & FINANCIAL NEWS, Jan. 4, 2009, available at http://www.reuters.com/assets/print?aid.

[25] 2 F3d 128, 132-134 (5th Cir. 1993).

[26] *Supra* note 2, 126 B.R. at 412.

[27] 62 B.R. 147 (Bankr. M.D. La. 1986).

[28] 42 B.R. 988, 996 (Bankr. W.D. Wis. 1984.

[29] 37 B.R. at 991.

[30] 5 B.R. 470 (Bankr. D. Minn. 1980).

received voidable preference; court entered judgment against mortgagee, subordinating mortgagee's claim to other creditors).

Cases Not Finding Conduct Justifying Equitable Subordination

Other courts have found an insufficient showing of inequitable conduct to justify invoking the remedy of equitable subordination. *See*, e.g., *United States v. Noland* [31] (reversing and remanding decision by Sixth Circuit that IRS penalty claim was subject to equitable subordination under § 510(c) notwithstanding absence of misconduct by IRS, and holding that bankruptcy court may not equitably subordinate claims on a categorical basis in derogation of Congress's scheme of priorities); *In re After Six, Inc*.[32] (holding that fact that lender sought to advance its own legitimate interests contrary to those of other creditors did not render lender's actions unconscionable; court noted that Uniform Commercial Code prohibition against commercially unreasonable disposition of collateral does not apply to "the creation or transfer of an interest in real estate"); *In re Dry Wall Supply, Inc.*[33] (rejecting equitable subordination based on allegations that creditor knew that loan transaction would render borrower insolvent); *In re WCC Holding Corp.*[34] (finding that lender's claim cannot be subordinated on basis of debtor's undercapitalization or because lender should have known that company would fail); *In re Anchor Resolution Corp.*[35] (ruling that plaintiffs had not shown grounds for equitable subordination and stating that "disparate treatment of unsecured creditors obviously is not the test for [equitable] subordination"); *First National Bank of Barnesville v. Rafoth (In re Baker & Getty Financial Services, Inc., supra*[36] (rejecting claim of equitable subordination where bank's alleged inequitable conduct "occurred before bankruptcy proceedings and was not specifically directed toward injury of the debtor or other creditors or for gaining an unfair advantage over other creditors"); *Boyajian v. DeFusco*,[37] (concluding that equitable subordination or disallowance of claim was inappropriate absent showing of any particular inequity with respect to other creditors); *United States v. Reorganized CF & I Fabricators of Utah, Inc.*[38] (holding that insider loans may not be equitably subordinated simply because they were made by insiders); *In re Hartland Chems.*[39](lender did not exercise sufficient control over management of debtor to cause it to be fiduciary of debtor or justify equitable subordination); *In re Kreisler*[40] ("Even accepting that [the debtors] committed misconduct within the contemplation of this equitable doctrine, misconduct alone doesn't justify subordination of this claim. Only misconduct that harms other creditors will suffice, and there is no evidence that [the debtors'] scheme harmed any of their creditors"); *In re Automotive*

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[31] 517 U.S. 535, 116 S. Ct. 1524, 1526 (1996).
[32] 177 B.R. 219, 227, 232 (Bankr. E.D. Pa. 1995).
[33] 111 B.R. 933, 937-939 (Bankr. D. Colo. 1990).
[34] 171 B.R. 972, 988 (Bankr. N.D. Tex. 1994).
[35] 221 B.R 330, 342 (Bankr. D. Del. 1998).
[36] 974 F.2d at 718-19.
[37] *(In re Giorgio)*, 862 F.2d 933, 939 (C.A.1 (R.I.) (1988)).
[38] 518 U.S. 213, 227, 116 S. Ct. 2106, 2115 (1996).
[39] 136 B.R. 503, 518 (Bankr. C.D. Ill. 1992).
[40] *Supra* note 6, 546 F.3d at 866-67.

Professionals, Inc.,)[41] (holding that "unclean hands" defense did not apply to trustee's equitable subordination claim; and stating that "[t]his focus on the actions of the creditor to be subordinated, not the debtor, makes sense because the debtor does not stand to gain or lose from equitable subordination--it simply rearranges the order in which creditors will be paid from the estate").

Summary

As noted earlier, the *Yellowstone* case has extremely bad facts. But the *Yellowstone* case (and the Yellowstone Order) illustrate clearly that, at least in this case, Credit Suisse likely would not have been able to successfully syndicate the mortgage loan if it had been structured as a typical (and traditional) mortgage loan based on 1) a true current loan-to-value ratio of the project; 2) projected revenue based on past history (and not on the Debtors' unjustified revenue projections with no independent verification); 3) a current FIREEA-approved appraisal of the valuation of the real property. Even though the that "nothing in the record suggests that the loan between Credit Suisse and Blixeth was not at arms length,'[42] the court found that the true purpose of the loan was to earn large fees for Credit Suisse that were not commensurate with the risk involved or the anticipated ability of the borrower to service the loan in the future. The *Yellowstone* court decisions, somewhat surprisingly, totally ignored the standard "fraudulent transfer" analysis that would normally apply, i.e., whether the Debtors were solvent when the loan was made and whether adequate consideration was exchanged -- instead finding that Credit Suisse's actions were so egregious and overreaching in and of themselves that equitable subordination was justified. This is more of a lender-liability analysis by the court than a consideration of the factors normally used to determine if equitable subordination is justified, and it will be interesting to see if other bankruptcy courts follow this line of reasoning.

Certainly mortgage lenders now would be well advised to reconsider their due-diligence efforts in connection with one-off mortgages as well as syndicated and participated loans, and perform a thorough financial analysis of the borrowing entity as well as the income likely to be generated by the property in the future, bolstered by a current appraisal by a certified appraiser using standard commercial appraisal protocols and standards. (It remains unclear whether higher standards will be imposed where the loan is syndicated as opposed to remaining on the lender's own books.) Also, lenders would be well advised to avoid situations where a large portion of the loan proceeds is being diverted (with the lender's knowledge and acceptance) to equity participants for purposes unrelated to the financed project or the borrower's stated business purposes. Finally, the *Yellowstone* court may have been influenced by the fact that if Credit Suisse maintained its first-priority mortgage position with respect to collateral insufficient to cover even its own loan, the other creditors (CrossHarbor, which supplied the debtor-in-possession financing, and the allowed claims of unsecured creditors, as well as the parties

[41] 398 B.R. 256, 260 (Bankr. N.D. Ill. 2008.

[42] Yellowstone Order, at P. 9. The Yellowstone Order noted that the loan transaction fee was actually negotiated downward by Blixeth from three percent to two percent. *Id.*

entitled to the approved administrative fees of and costs of the bankruptcy estate) would receive virtually nothing.[43]

[43] *See, e.g., In re Kreisler, supra* note 6, 546 F.3d at 866-67 ("Even accepting that [the debtors] committed misconduct within the contemplation of this equitable doctrine, misconduct alone doesn't justify subordination of this claim. *Only misconduct that harms other creditors will suffice*" (emphasis added)); *Boyajian v. DeFusco (In re Giorgio), supra* note 37, 862 F.2d at 939, in which the court held that equitable subordination or disallowance of a claim was inappropriate absent a showing of any particular inequity with respect to other creditors, and stating that:

> In this case, the record reveals no particular inequity vis-à-vis other creditors. The loans in question took place several years before bankruptcy. They were apparently made without other creditors in mind; indeed, the record does not reveal who the other creditors are, and how, if at all, [the lender's] conduct might have been unfair to them.

REVISIONS TO THE 2007 MARYLAND OPINION REPORT

By Edward J. Levin*

January 26, 2010

The Special Joint Committee (the "Committee") of the Section of Business Law and the Section of Real Property, Planning and Zoning of the Maryland State Bar Association, Inc. ("MSBA") recently revised its 2007 Report on Lawyers' Opinions in Business Transactions (the "2007 Report"), and the revisions were approved by the Section Councils of each of the sponsoring sections. The 2007 Report and the 2009 revisions to it are posted at http://msba.org/docs/opinionmatters.asp.[1]

The 2007 Report, which is more than 260 pages long, includes an illustrative certificate from a company officer to the opinion giver and four illustrative opinions – a business transaction opinion, a "long form" real estate loan opinion, a "short form" real estate loan opinion which does not include a number of implicit assumptions and qualifications, and a share issuance opinion. The 2007 Report updated, revised, and added to the Maryland Opinion Report that was written in 1989 and published at 45 Bus. Law. 705 (1990) (the "1989 Report"). As the law and practice have changed since the 1989 Report was issued, limited liability companies, business trusts, and REITs have come into existence or become more popular. The 2007 Report addressed opinion related issues concerning those entities, as well as evolving issues relating to partnerships and corporations. The adoption by Maryland and every other state of revisions to Article 9 of the Uniform Commercial Code made changes in the way in which security interests in personal property are created and perfected, and the 2007 Report discusses how these changes affect opinion practice. Additionally, the 2007 Report includes a section on equity issuances, which was not part of the 1989 Report.

The 1989 Report and its illustrative opinions were widely used by opinion givers and opinion recipients in Maryland because of the Report's balanced approach, and the 2007 Report has gained the same broad acceptance during the past two and one-half years. The illustrative opinion letters in the 2007 Report are particularly user-friendly because they note to which of the specific opinions the assumptions and qualifications relate, and they include footnotes that provide guidance to and alternatives for opinion givers. Maryland lawyers frequently used the 1989 Report as a reference source, and they now employ the 2007 Report in the same way because of the Reports' discussions regarding the due diligence that is necessary to render the various opinions that are addressed in them.

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[1] This site also includes separate postings of the four illustrative opinions and the illustrative certificate from the 2007 Report as revised in 2009 that are referenced herein. The 1989 Report referenced herein is also posted at this site.

For preparing the 2007 Report, the Sections of Business Law and Real Property, Planning and Zoning received the Presidential Best Section Project Award from the MSBA in June 2007. Further, the 2007 Report has been widely acclaimed by various opinion-related groups nationally, including the American College of Real Estate Lawyers (ACREL) and the Legal Opinions in Real Estate Transactions Committee of the Section of Real Property, Estates and Trust Law of the American Bar Association.

Last year Donald Glazer, one of the authors of Glazer and FitzGibbon on Legal Opinions, reviewed the 2007 Report in connection with a forthcoming supplement to his treatise. Although he praised the 2007 Report generally, he suggested that it should be changed in several ways. Mr. Glazer expressed a concern about the 2007 Report's position that all opinion letters rendered under Maryland law should be interpreted in accordance with the provisions of the 2007 Report, regardless of whether the opinion letters specifically incorporate the 2007 Report by reference.[2] Also, he recommended that this concept be addressed in a more conspicuous part of the 2007 Report.

The issue regarding the relationship of bar association reports with opinion letters rendered under the law of the states of those reports needs to be understood in context. After the issuance of the 2007 Report, 28 bar association groups, committees, and associations approved the "Statement on the Role of Customary Practice in the Preparation and Understanding of Third-Party Legal Opinions," which was published at 63 Bus. Law. 1277 (2008) (the "Statement"). The ABA Section of Business Law sponsored the Statement, and the signatories to it included the ABA Section of Real Property, Trust and Estate Law, the MSBA Section of Business Law, and the MSBA Section of Real Property, Planning and Zoning. The Statement explains the role of customary practice in the interpretation of opinion letters as follows: "Customary practice permits an opinion giver and an opinion recipient . . . to have common understandings about an opinion without spelling them out." The Statement concludes with the following language:

> The *Restatement* [referring to Sections 51, 52 and 95 of the American Law Institute's *Restatement (Third) of the Law Governing Lawyers*] treats bar association reports on opinion practice as valuable sources of guidance on customary practice. Customary practice evolves to reflect changes in law and practice.
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> Some closing opinions refer to the application of customary practice. Others do not. Either way, customary practice applies. 63 Bus. Law at 1278.

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[2] The last three sentences of the third paragraph on page 173, Section D.17, "Assumptions, Qualifications, and Other Limitations" provided:

> It is intended that, by using the sample language for assumptions and qualifications set forth in this Report, those assumptions and qualifications will have the meanings and be interpreted as discussed in this Report. In order to further this goal, the Committee has specified that, unless stated otherwise in an opinion letter, it is implicit in every opinion, which indicates in the opinion letter that it is given as to the laws of the State of Maryland, that the opinion is to be interpreted in accordance with this Report. Accordingly, to the extent any opinion letter given under Maryland law uses sample language from this Report to express an assumption, qualification or limitation, that sample language should be interpreted in accordance with the discussion set forth in this Report.

In light of the view of Mr. Glazer and the language of the Statement, the Committee deleted the language on page 173 of the 2007 Report that all opinions under Maryland law incorporate the 2007 Report by reference, whether or not they so specify, and it added a paragraph to Section B, "Statement of Policy" on page 6 of the 2007 Report. The new paragraph states that it is the Committee's belief that the 2007 Report reflects customary opinion practice in Maryland. It also states that, to the extent an opinion letter under Maryland law uses language from the 2007 Report to express an opinion, assumption, qualification, or limitation, such language should be interpreted as set forth in the 2007 Report. However, the language added to the Statement of Policy does not provide that all opinions under Maryland law incorporate the 2007 Report by reference.[3]

In reviewing the 2007 Report to update his treatise, Mr. Glazer made a number of other suggestions for changes to the 2007 Report, some of which were based on positions taken by other bar association opinion reports. The Committee considered all of Mr. Glazer's comments and agreed that some of them merited changes to the 2007 Report while others did not. As to the changes that the Committee did not make, it believed that certain of Mr. Glazer's recommendations were not consistent with Maryland law or practice, and the Committee decided to take a different position from Mr. Glazer on other points.

The additional changes that the Committee did make to the 2007 Report are as follows:

1. Pages 21 and 22, Section C.3.k. "Procedures / Foreign Law." In connection with the discussion about rendering an opinion when the law governing the transaction documents is other than Maryland law (and the opinion giver is not admitted to practice in the jurisdiction of the governing law), the Committee added as an option that the opinion giver may be permitted to render an "enforceability" opinion with the assumption that the documents in question are governed by the law of Maryland (in addition to the assumption that the laws of the state chosen to govern the transaction are identical to the laws of Maryland). The Committee also revised the illustrative share issuance opinion of the 2007 Report to reflect this change.

2. Page 51, Section D.4. "Authorization, Execution, Validity and Enforceability." The Committee revised the language of the "authorization" opinion to make it clear that this opinion means that all action has been taken at the entity level to authorize the company's execution, delivery, and performance of the transaction documents (as opposed to action that may have been taken by any other person, agency, or authority). The Committee also revised the four illustrative opinions of the 2007 Report to reflect this change.

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3 The new language in Section B, "Statement of Policy," is:

> The Committee's view is that this Report reflects customary practice in Maryland with respect to issuing and receiving opinions on the matters addressed by this Report. Since the issuance of this Report on June 14, 2007, the Sections of Business Law and Real Property, Planning and Zoning, along with many other organizations and associations, adopted the Statement on the Role of Customary Practice in the Preparation and Understanding of Third-Party Legal Opinions dated August 1, 2008 (the "Statement of Customary Practice"). [63 Bus. Law. 1278 (2008)] The Statement of Customary Practice specifies that customary practice applies in determining the meaning of an opinion letter and that bar association reports, such as this Report, are valuable sources of guidance on customary practice. Accordingly, the Committee believes that to the extent any opinion letter given under Maryland law uses language from this Report to express an opinion, assumption, qualification, or limitation, that language should be interpreted in accordance with the meaning and discussion set forth in this Report.

3. Pages 52 and 53, Section D.4. “Authorization, Execution, Validity and Enforceability.” The Committee changed the word “persons” to “individuals” in the commentary about the “execution” opinion to make it clear that opinion givers may assume that natural persons have the legal capacity to sign documents, but opinion givers may not make the same assumption about entities.

4. Page 65, Section D.5.1 “Equity Issuances / Corporation.” The 2007 Report stated that an opinion that shares of a corporation have been “duly issued” could be rendered without regard to whether the shares were issued in violation of preemptive rights of existing stockholders. The Committee changed the discussion on this matter to provide that preemptive rights may be covered by “validly issued” opinions. The Committee provided that if a corporation’s charter or bylaws restrict the issuance of stock that violates preemptive rights, a “validly issued” opinion cannot be rendered.

5. Page 145, Section D.9, “No Violations of Law.” In the 2007 Report, the Committee strongly discouraged the requesting and giving of “no violations of law” opinions. The Committee revised the commentary about “no violations of law” opinions to indicate that such opinions may be given if the opinion letters contain substantial limitations and appropriate qualifications.

6. Pages 155 and 156, Section D.12, “No Litigation.” The commentary to the 2007 Report stated that arbitrations and mediations were intended to be covered by “no litigation” opinions, but the form of “no litigation” opinion in the 2007 Report did not specifically refer to arbitrations or mediations. The Committee became concerned that opinion givers may inadvertently render “no litigation” opinions that implicitly include reference to arbitrations and mediations. Therefore, the Committee amended the form of “no litigation” opinion to explicitly refer to proceedings before arbitrators and mediators so that those who render “no litigation” opinions will be aware of the need to consider arbitrations and mediations. The Committee also revised the four illustrative opinions of the 2007 Report to reflect this change.

7. Pages 174 to 176, Section D.17, “Assumptions, Qualifications and Other Limitations.” The lead-in language to the “assumption” section of the illustrative opinion letters that previously appeared in the 2007 Report provided: “In reaching the opinions set forth below, we have assumed, <u>and to our knowledge there are no facts inconsistent with</u>, the following: . . . .” (Underscore added.) The effect of the underscored language was to provide the opinion recipient with an implied negative assurance about the matters that were being assumed, which include the representations and warranties in the loan documents. This language could be a problem because the term “our knowledge” is defined in the illustrative opinions that are part of the 2007 Report to include the knowledge of specified lawyers in the firm of the opinion giver; however, it may be that not all of those lawyers will have reviewed the loan documents. If a lawyer who is included within the group whose knowledge is encompassed by the term “our knowledge” knows of a misstatement in the representations and warranties in the loan agreement, but that lawyer does not review the loan documents, the lawyer would not be aware of the need to call out the misstatement. In such a case, the opining firm would not want to render an opinion that it does not have knowledge of facts inconsistent with the loan documents. Therefore, the Committee deleted the underscored words. The Committee also revised the four illustrative opinions of the 2007 Report to reflect this change.

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“Failure to Mediate Leads to Remediation of Moldy Delusional Dispute”
by Paul Fisher, click here for bio.

This case contains two new twists on two old rules, all of which is a powerful warning to attorneys.

Plaintiff brought suit against Newport Crest Homeowners Association (the “HOA”) and others claiming biological, mold and other contamination to her residential unit. The dispute was resolved at a mediation. A settlement agreement was signed that provided for: (i) the HOA to pay $500,000 to plaintiff, (ii) the HOA to conduct remediation, and (iii) in the event of future conflict, the parties must first mediate before seeking judicial relief. The HOA paid the $500,000. Subsequently, plaintiff filed a petition to enforce the settlement agreement pursuant to Code of Civil Procedure Section 664.6 contending that the HOA failed to remediate the biological and mold conditions. The HOA filed an opposition motion and filed its own petition to enforce the settlement agreement pursuant to Code of Civ. Pro §664.6 contending that plaintiff had failed to mediate the dispute which arose subsequent to the settlement. The trial court, on its own motion, set an order to show cause for dismissal, and after hearing, ordered plaintiff’s case dismissed.

The court of appeal (the “Court”) found that the parties had signed a binding settlement agreement, which had been approved by their counsel at the mediation, and that all parties wanted the settlement agreement to be enforced, except plaintiff wanted the mediation provision “excised”. After plaintiff had substituted herself in as attorney of record, defense counsel repeatedly and unsuccessfully attempted to serve her with proposed dates for a mediation to resolve the then current conflict. She was finally served by process server when she appeared in court on another matter. The Court also found that the settlement agreement had been fully performed in that the HOA had paid the $500,000 plus other payments and had done the remediation allowed by plaintiff.

Plaintiff argued a seemingly endless list of issues including that the mediation provision in the settlement agreement applied only to disagreements as to interpretation of the terms of the agreement and not to the performance of the agreement. The Court observed that plaintiff sought to enforce the settlement agreement terms which she believed benefitted her and not to enforce the mandatory mediation provision, or alternately, that use of a mediator was an option. The Court concluded that the entire settlement agreement was enforceable, including the mediation provision, and that plaintiff had failed to first mediate before bringing her petition to enforce the settlement agreement.

There is a subtle undertone to the language used by the Court in this opinion. This undertone suggests that although the Court rendered its decision completely impartially (which I believe it did) it was none the less more than a little put off by the plaintiff’s tactics, particularly the plaintiff’s tactics when acting as attorney in pro per (pro se).

Two new twists on two old rules

First old rule and new twist: the court will enforce mandatory mediation provisions, here a mediation provision in a settlement agreement reached during mediation. Second old rule and new twist: an attorney who represents him or herself has a fool for a client, especially when the attorney in pro per has already fired three prior counsel, has failed to mediate when required to do so pursuant to a previously signed settlement agreement and has offended the trial and appellate court. Beware: This case appears to indicate that an attorney in pro per can become infected with a virus of self delusion and be incapable of knowing the danger he or she is in.

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Paul Fisher has resolved many hundreds of disputes as Mediator since 1986, and has heard hundreds of cases as Arbitrator since 1978. Paul has been a full time mediator since 1991. From 1971 until 1991, he was in a litigation practice specializing in complex real estate, business and construction disputes.

He is an adjunct professor of law at the Straus Institute for Dispute Resolution, Pepperdine University. In 2001, Paul was named to the Distinguished Panel of Neutrals of New York's CPR International Institute for Conflict Prevention & Resolution. In 2002, he received the Los Angeles County Board of Supervisors Award for Case of the Year. In 2006, Paul was a discussion leader at the Harvard - International Academy of Mediators conference.

Paul is a nationally published author, and frequent speaker. He is Co-Chair of the ABA Committee on Emotional and Psychological Issues in Estate Planning. He has been selected as a 2007, 2008, 2009 and 2010 Southern California Super Lawyer in the area of dispute resolution. The majority of his mediation practice today involves trusts, estates, elder financial abuse, probate and conservatorship disputes.