

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

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Introduction

Section 510(c) of the Bankruptcy Code¹ 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

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 Paoletta & 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

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, Blixeth . . . 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

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

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 Chrysler*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*

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 Kreidler*, *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.