



Client Alert

Financial Markets Developments

In re Yellowstone Mountain Club LLC—the pitfalls of “equitable subordination” for the unwary lender

The recent ruling by the Bankruptcy Court for the District of Montana in the Chapter 11 case of *In re Yellowstone Mountain Club LLC*¹ (“Yellowstone”), which found that a senior secured lender had engaged in “overreaching and predatory lending practices”, suggests an application of lender liability theory from today’s perspective to a transaction that took place before the credit crisis.

It raises the real possibility that lender underwriting conduct that was previously thought not to give rise to any risk of liability may (if the ruling stands and is followed by other courts) involve certain lender claims being equitably subordinated during bankruptcy proceedings and require lenders to consider the potential impact of proposed new loans on unsecured creditors.

The Yellowstone case involved a secured loan that was made to the Yellowstone Mountain Club (a resort development located in Montana close to the Yellowstone National Park).

Yellowstone was decided on the grounds of “equitable subordination” relying on Article 510 of the US Bankruptcy Code² and goes beyond previous decisions by US courts holding lenders accountable to creditors of a bankrupt estate for their pre-bankruptcy conduct.

In Yellowstone, the Bankruptcy Court:

- limited the amount of the lender’s secured claim to US\$232 million³ for the purposes of an upcoming auction of the debtor’s assets; and
- equitably subordinated the amount of the reduced claim to the allowed claims of all unsecured nonmember creditors in the case,⁴ thereby placing the lender behind all allowed unsecured claims in terms of priority.⁵

1 Case No. 08-61570-11, Adv. Pro. No. 09-00014, Partial & Interim Order, dated May 13, 2009 [Dkt. No. 289]. We note that the decision has not been published and that, according to the Bankruptcy Court, the order entered by the Bankruptcy Court on May 13, 2009 is only a partial and interim ruling and a detailed Memorandum of Decision and Order will be issued subsequently which will decide all matters that the Bankruptcy Court heard at trial.

2 Title 11, U.S.C. § 510 (Subordination)

3 Pursuant to a separate Memorandum of Decision, also dated May 13, 2009, the Bankruptcy Court for the District of Montana adopted a valuation estimate of US\$232 million as the value of the lender’s collateral.

4 But not to “interests”; note that the lender’s secured claims were not subordinated to the “interests” of members of the Debtors but only to “claims” of unsecured parties

5 The Bankruptcy Court permitted the lender to credit bid its US\$232 million secured claim at the upcoming auction of the Debtors’ assets, however, because such claim was equitably subordinated, the Bankruptcy Court required the lender to provide as a component of its credit bid, sufficient funds to repay the debtor-in-possession financing, the administrative fees and costs of the Debtors’ bankruptcy estate and the allowed unsecured claims of the creditors to whom it was subordinated.



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Normally, before a non-insider claim is equitably subordinated, “egregious conduct” must be “proven with particularity,” and is a high standard to meet—it requires proof that the claimant “is guilty of gross misconduct tantamount to fraud, overreaching or spoliation to the detriment of others.”⁶

The Bankruptcy Court based its decision on the behavior of the lender, thereby avoiding the potential *in pari delicto* defense or Wagoner doctrine⁷ that could result from the conclusion that the Yellowstone Mountain Club’s majority shareholder, Timothy Blixseth, and the lender acted together. In criticizing the lender’s behavior, the Bankruptcy Court focused on the following factors:

- nature of the lender’s marketing and credit analysis (which the Bankruptcy Court found were designed to produce an artificial valuation that was beneficial for the purposes of syndication but which failed to take into account any actual historical or current operating performance results as demonstrated by the borrower’s actual financial statements)—in effect the “product” was marketed to Yellowstone Mountain Club (and other similar real estate developments) as equivalent to a “home equity loan” or “leveraged loan” to monetize the expected gains of the equity investors without any justifiable or supportable basis for the projected gains (or the ability of the borrower vehicle to service or repay the debt assumed)—the lender relied solely on borrower projections
- the lender did not intend to retain any portion of the loans on its own books, since it planned to on-sell 100 percent of the loans to third party investors
- the transaction was driven in large part by the desire on the part of the lender to earn large fees disproportionate to the risk being assumed by the lender and in circumstances where the lender would have been unlikely to successfully syndicate the loan if it had been structured as a traditional real estate loan based on a loan to value ratio

- the loans, once advanced, could be used for purposes unrelated to the corporate and development purposes of the real estate development borrower (the Yellowstone Mountain Club) and were in fact used to finance distributions to the equity investor (although in this case, the proceeds ended up being advanced to the equity investor as a loan for other structuring reasons)
- the lender failed to properly disclose in its marketing materials that the property owners and other unsecured creditors of the resort development would effectively assume all of the risk of servicing and repayment of the debt

The Bankruptcy Court also criticized the lender for earning fees by persuading owners of resort developments such as the Yellowstone Mountain Club to take out what the Bankruptcy Court described as “unnecessary” loans and noted that the lender had made similar loans to a number of other luxury developments all of which subsequently failed financially due to the high debt burden assumed by them.

The Bankruptcy Court’s decision was influenced by the fact that the lender’s actions in devising and marketing its particular loan product “were so far overreaching and self serving that they shocked the conscience of the Court.”

While the impact of this decision, and its precedential value, cannot be fully determined yet, the Bankruptcy Court’s forceful criticism of the lender’s conduct in this case may reflect a hardening in judicial attitude towards transactions that were entered into during the “credit bubble” and suggests that lenders may have to meet a higher standard of conduct than was previously thought to apply in order to avoid the risk of having their claims equitably subordinated.

For the moment at least, lenders’ counsel, credit committees and risk management will need to re-evaluate lending policies and processes for internal “product approval” in light of this decision.

⁶ *In re First Alliance Mortg. Co.*, 497 F.3d 977, 1006 (9th Cir. 2006)

⁷ The Wagoner doctrine, established in the case of *Shearson Lehman Hutton, Inc. v. Wagoner*, 944 F.2d 114, 120 (2nd Cir. 1991), states that, as a matter of standing, a trustee for a bankrupt corporation cannot pursue claims against those who defrauded the corporation with the cooperation of management. There, the court stated that a “claim against a third party for defrauding a corporation with the cooperation of management accrues to creditors, not to the guilty corporation.” *Id.* Similarly, the common law defense of *in pari delicto* bars plaintiffs from pursuing claims against a defendant where the plaintiff was involved in the defendant’s wrongful conduct on which the claims are based and is at least equally at fault.

Summary

The facts of the Yellowstone case reflect a relatively conventional struggle between stakeholders over an economically troubled real estate development.

The lender sought a declaratory judgment confirming the validity of a prepetition secured claim in the principal amount of US\$375 million arising out of a prepetition secured loan made to Yellowstone Mountain Club, LLC and several of its affiliates (collectively, “Yellowstone Mountain Club” or the “Debtors”).

The Debtors and creditors committee counterclaimed to disallow or subordinate the lender’s secured claim, asserting, among other things, that the loan and the security granted in support of it constituted a fraudulent obligation or transfer, respectively, and that the lender had aided and abetted the Debtors’ majority shareholder in breaching his fiduciary duties to the Debtors.

While one might have expected the ruling to focus on traditional “fraudulent transfer” analyses (as to whether the Debtors were solvent when the loan was advanced and whether they received adequate consideration), the ruling of the Bankruptcy Court instead focused on various actions and inactions of the lender, finding that the lender’s actions were so objectionable that they should in themselves result in equitable subordination of the loan (without regard to any “fraudulent transfer” analyses). Furthermore, by focusing on the actions of the lender as a “direct” actor (by virtue of it having marketed and sold the same loan product to a number of different investors around the country, with the same adverse financial consequences to other borrowers of similar loans), the Bankruptcy Court also avoided arguments that the Wagoner doctrine (in pari delicto defense) should apply.

Background

The developer, Timothy Blixseth, started in 1999 to develop what is apparently a highly desirable Montana tract of land as a second residence club for the ultra-wealthy. The property achieved prominence and cache in the real estate world. Thus, around December 2004, the lender contacted Blixseth, the club’s majority shareholder, President and CEO, regarding a “new loan product referred to as a syndicated term loan” which was described to Blixseth as “something akin to a ‘home equity loan.’”

This loan product was apparently being marketed by the lender to a number of other high end luxury resort developers. After initially declining the offer, Blixseth ultimately agreed to obtain a US\$375 million loan from the lender and the parties entered into a credit agreement in September 2005. Prior to entering into the credit agreement, the lender conducted due diligence on Blixseth and the Debtors, apparently completing a background check on Blixseth, hiring an appraisal firm to provide an independent assessment of the Debtors’ cash flows, and hiring a law firm to undertake a legal investigation of the Debtors’ assets with respect to title and similar property rights. In addition, the lender hired a financial advisor to analyze the Debtors’ cash flows and perform a newly devised form of valuation methodology (“total net value”) of the Debtors’ business. However, according to the Bankruptcy Court, the lender “curiously...never requested audited financial statements from the Debtors” and appeared “to have relied exclusively on the historical and future projections provided by Blixseth and the Debtors”.

Of the US\$375 million lent by the lender to the Debtors on a senior secured basis, only about US\$24 million was indisputably used for the Debtors’ corporate purposes—to refinance existing debt. Apparently from the outset and consistent with the lender’s intentions, Blixseth was allowed to dividend out to himself or his wife or lend to affiliates over US\$350 million that was not applied for the Debtors’ business needs. The lender received US\$7.5 million in fees in the transaction. These facts were not disputed by the parties.

According to the Debtors’ pleadings in the Chapter 11 cases, their decreasing revenues, brought on by, among other things, economic factors that caused difficulties in obtaining new credit and declines in the real estate market, ultimately impaired their ability to pay creditors. In addition, around September 2008, the Debtors assessed a need to make repairs and improvements to the development property in preparation for their peak business period and needed immediate funds to pay for this work. According to the Debtors, they therefore commenced their Chapter 11 cases on November 9, 2008 to address perceived liquidity shortfalls, to preserve and maximize their business as a going concern, to restructure and reorganize their business affairs and capital structure and develop a reorganization plan.

Legal Analysis

Equitable subordination is a court-created doctrine incorporated into Article 510(c) of the US Bankruptcy Code, which allows a court to “subordinate for purposes of distribution” all or part of an allowed claim or interest to all or part of another allowed claim or interest when equitable principles require. The Bankruptcy Code does not provide guidance as to when such subordination should take place, but courts generally apply a test created by the Court of Appeals for the Fifth Circuit,⁸ which comprises three conditions: (i) the claimant must have engaged in some type of inequitable conduct; (ii) the misconduct must have resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant; and (iii) equitable subordination of the claim must not be inconsistent with bankruptcy law. Moreover, as the Bankruptcy Court recognized, “[w]hen the remedy of equitable subordination involves a 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.’”⁹

What did the lender do wrong?

As mentioned above, the loan (and its intended application) was not that unusual—lending to an owner based on a judgment of accreted equity value, thus allowing the owner to monetize the gain. Moreover, the Bankruptcy Court found nothing in the record suggesting that the loan between the lender and Blixseth was not at arm’s length. In fact, the decision specifically noted that Blixseth had been successful in reducing the lender’s transaction fee from three percent to two percent.

The problem noted by the Bankruptcy Court was apparently the nature of the lender’s marketing and credit analysis. Noting that the new financial “product” the lender was offering to owners of luxury second-home developments allowed them “to take their profits up front while mortgaging their development projects to the hilt”, the Bankruptcy Court was concerned that while the lender earned a substantial fee on the transaction and sold off most of the credit to loan participants, and the development owners benefited by taking most of the money out as a profit

dividend, the developments themselves were left saddled with debt and thus, along with the creditors of the developments, bore all of the risk of loss. Pointing to similar syndicated loans that the lender’s Cayman Islands branch had previously marketed and provided to other master-planned residential and recreational communities, the Bankruptcy Court was concerned that a number of such entities had also failed financially.

The Bankruptcy Court found that the lender’s fee structure, pursuant to which fees were earned if loans were sold and the fee amount increased with the size of the loan, led to it to devise “a loan scheme whereby it encouraged developers of high-end residential resorts, such as Blixseth, to take unnecessary loans.” Moreover, the Bankruptcy Court found that such “fee structure was undoubtedly the catalyst that led to the most shocking aspect of the lender’s newly developed loan product”, namely, that it permitted developers to take out loan proceeds as a distribution or a loan. Citing the US\$209 million “loan” to Blixseth authorized by the credit agreement, the Bankruptcy Court held that “[a] sophisticated lender such as the lender had to have known what a distribution would do to the Debtors’ financial statements, and in particular, their balance sheet, yet the lender proceeded with the loan and thus earned its large fee.”

The Bankruptcy Court was also very critical about what it termed to be the lender’s “almost all but non-existent” financial due diligence, noting that the lender relied almost exclusively on the Debtors’ future financial projections “even though such projections bore no relation to the Debtors’ historical or present reality.” Among other things, the Bankruptcy Court was concerned about the “new form of appraisal methodology” that the lender used (“total net value” methodology), which methodology apparently did not comply with the Financial Institutions Recovery Reform Act of 1989. The Bankruptcy Court noted that non-compliance with this Act was not an issue for the lender in the Yellowstone transaction as it planned to syndicate the loan to non-bank institutions. According to the Bankruptcy Court, the lender also ignored a previous appraisal done by the financial advisors which

⁸ See *Benjamin v. Diamond* (In re Mobile Steel Co.), 563 F.2d 692, 699-700 (5th Cir. 1977)

⁹ Quoting *In re First Alliance Mortg. Co.*, 497 F.3d 977, 1006 (9th Cir. 2006).

would have indicated that the loan to value ratio was 90 percent and would thus have made syndication difficult for the lender. Moreover, the Bankruptcy Court found that, since the loan from the lender increased the Debtors' debt load (which, previously had fluctuated from between US\$4 – 5 million on the low end to US\$60 million on the high end, and was approximately only US\$19 – 20 million immediately before the Debtors incurred the loan) by at least six times, the lender and its syndicated loan team could not have believed under any set of circumstances that the Debtors could service such an increased debt load, particularly when they had previously experienced "several years of net operating losses, mixed in with a couple of years of net operating revenues." In addition, the Bankruptcy Court noted that from "2005 through the filing of the bankruptcy, the Yellowstone Mountain Club was persistently behind in its accounts payable", and when funds were tight, instead of making demand on the promissory note that Blixseth's company had issued in respect of the US\$209 million loan, the Debtors instead looked to Yellowstone Mountain Club members to obtain funding for operating costs.

The Bankruptcy Court found that the "only plausible explanation for the lender's actions is that it was simply driven by the fees it was extracting from the loans it was selling, and letting the chips fall where they may", and that the lender had "lined its pockets on the backs of unsecured creditors." It thus held that the only equitable remedy to compensate for the lender's "overreaching and predatory lending practices" was to subordinate them to the post-petition financing for the Debtors during their Chapter 11 cases and the allowed claims of unsecured creditors.

Issues to Consider

What issues should a lender consider in evaluating whether conduct in entering into a loan transaction or selling a loan product puts the lender's claim in bankruptcy at risk of equitable subordination?

- How thorough is the analysis of the borrower's finances? Is there a focus on historical or current operating performance and results that have been audited? Is any decision to lend based on projections prepared solely by the borrower without any independent verification or analysis?
- Is the lender retaining all or some portion of the loans that are being underwritten or does it plan to on-sell all of the loans to third-party investors and would the lender, from an objective viewpoint, be likely to carry out further checks or diligence if it planned to retain all or any portion of the loan on its own books?
- How would any potential syndication of a loan be affected by applying more traditional valuation methodology or risk assessment (e.g. comparing a traditional real estate syndicated loan sized on a certain loan to value ratio with a loan sized according to a new valuation methodology)?
- Will the loan proceeds be used to benefit only the borrower or will credit documentation permit part of the loan proceeds to be used to finance distributions to equity investors for purposes unrelated to the borrower's activities?
- Has the lender effectively considered the risk to the borrower and its creditors in incurring the loan and who is assuming that risk, given pricing of the loan, projected future financial performance, the projected leverage of the borrower after incurring the loan and anticipated ability to service the loan?

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