



NORTH CAROLINA  
BANKING INSTITUTE

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Volume 14 | Issue 1

Article 20

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2010

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## Recommended Citation

Marina Montes, *In Re Yellowstone Mountain Club: Equitable Subordination to Police Inequitable Conduct by Non-Insider Creditors*, 14 N.C. BANKING INST. 495 (2010).

Available at: <http://scholarship.law.unc.edu/ncki/vol14/iss1/20>

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## ***In re Yellowstone Mountain Club: Equitable Subordination to Police Inequitable Conduct by Non-Insider Creditors***

### I. INTRODUCTION

[C]reditors who cause debtors' financial ruin should not be allowed to use the courts as their collection agents. The United States courts should not be enforcers for loan sharks. The Bankruptcy Code currently gives courts that power to equitably subordinate creditors who act improperly. But . . . it is applied inconsistently.<sup>1</sup>

Equitable subordination provides bankruptcy courts with the authority to place the first lien position of a self-enriching secured creditor in an inferior position to that of other secured or unsecured creditors.<sup>2</sup> Historically, bankruptcy judges have been reluctant to use their power to subordinate<sup>3</sup> a secured creditor's unjust claims in circumstances where they are not fiduciaries.<sup>4</sup> For purposes of this Case Comment, a non-insider<sup>5</sup> refers to any creditor that does not have fiduciary obligations.

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1. *Abusive Credit Card Practices and Bankruptcy: Hearing Before the Subcomm. on the Judiciary*, 111th Cong. (2009) (testimony of Adam Levitin, Associate Professor of Law, Georgetown University Law Center).

2. See ELIZABETH WARREN, CHAPTER 11: REORGANIZING AMERICAN BUSINESSES, 123-24 (Vicki Been et al. eds., Aspen Publishers 2008).

3. Throughout this Case Comment the terms subordinate and equitably subordinate will be used interchangeably.

4. See e.g., Philip V. Martino, *Equitable Subordination of Non-Insider Claims*, DLA PIPER PUBL'N, May 2007, [http://www.dlapiper.com/equitable\\_subordination\\_non-insider\\_claims/](http://www.dlapiper.com/equitable_subordination_non-insider_claims/) ("Equitable subordination is typically applied when a fiduciary misuses his position to the disadvantage of other creditors, or a third party controls the debtor to the disadvantage of other creditors, or a third party actually defrauds other creditors.").

5. The term insider in this Case Comment includes officers, directors and shareholders of a debtor that have fiduciary duties.

The recent interim order in *In re Yellowstone Mountain Club, LLC (Yellowstone)*<sup>6</sup> suggests that courts may be more inclined to subordinate claims of secured creditors, including non-insiders, who have engaged in predatory lending practices.<sup>7</sup> This Case Comment examines the doctrinal difficulties in applying equitable subordination as a remedy when the relationship, specifically between a creditor and the debtor, does not give rise to a fiduciary duty.

In May 2009, in *Yellowstone*, a Bankruptcy Court for the District of Montana subordinated the \$232 million secured first lien position of Credit Suisse Group AG (Credit Suisse) on a luxurious ski resort to that of its unsecured creditors because Credit Suisse's commercial loan was so "overreaching and self-serving that they shocked the conscience of the court."<sup>8</sup> Judge Ralph B. Kirscher ruled in favor of the unsecured creditors, specifying Credit Suisse's "naked greed" and "predatory lending practices" as misconduct that warranted equitable subordination.<sup>9</sup> This novel application of equitable subordination caught the attention of lenders (and their attorneys) concerned that their first lien positions may be subordinated due to predatory creditor misconduct.<sup>10</sup> Thus, lenders fear that they are at greater risk for loss where once they thought they were secured.<sup>11</sup>

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6. See *Credit Suisse v. Official Comm. of Unsecured Creditors (In re Yellowstone Mountain Club, LLC)*, No. 08-61570-11, Adv. No. 09-00014, 2009 WL 3094930 (Bankr. D. Mont. May 12, 2009) (partial and interim order).

7. See *In re Yellowstone Mountain Club LLC—The Pitfalls of "Equitable Subordination" for the Unwary Lender*, WHITE & CASE BANK FIN., June 2009, <http://www.whitecase.com/alert-in-re-yellowstone-mountain-club-llc-the-pitfalls-of-equitable-subordination-for-the-unwary-lender-06-04-2009/> [hereinafter *Unwary Lender*] (PDF available at link).

8. *In re Yellowstone Mountain Club, LLC*, No. 08-61570-11, at \*8-10.

9. *Id.* at \*9; see Diane Davis, Credit Suisse's 'Predatory Loan' Shocks Conscience of Court; Results in Subordination, 21 BANKR. L. REP. (BNA) 760, 760-62, June 4, 2009.

10. See *Unwary Lender*, *supra* note 7, at 2; *Bankruptcy Court Equitably Subordinates Claim of Non-Insider Senior Lender*, CHOATE HALL & STEWART LLP, June 8, 2009, <http://www.choate.com/media/pnc/2/media.1982.pdf> [hereinafter *Non-Insider Senior Lender*] (recognizing the unusual ruling in *In re Yellowstone*).

11. *Unwary Lender*, *supra* note 7, at 2; see MARK RABINOWITZ & MATHEW ROTENBERG, PROBLEMS RESULTING FROM IMPROPER LENDER CONDUCT DURING THE WORKOUT, BUS. WORKOUTS MANUAL §8:26, available at Westlaw BUSWORK § 8:26 (Matthew W. Kavanaugh, Donald Lee Rome, & Randy B. Soref eds., 2009) (noting that subordinated claims are not necessarily disallowed).

The doctrine of equitable subordination is founded on the principle that creditor misconduct disadvantages other creditors in bankruptcy proceedings.<sup>12</sup> Courts have labeled creditor misconduct as “inequitable conduct” that results in injury to other creditors.<sup>13</sup> Bankruptcy courts apply the doctrine in an effort to promote fairness and justice<sup>14</sup> but inconsistently define the boundaries of inequitable conduct.<sup>15</sup>

This Case Comment will argue that Judge Kirscher correctly subordinated Credit Suisse’s first lien position to that of Yellowstone Club’s other creditors.<sup>16</sup> Part II of this Case Comment presents the facts and procedural history of *Yellowstone* and explains the court’s rationale in equitably subordinating Credit Suisse’s claim.<sup>17</sup> Part III explains how the application of

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12. *E.g.*, ROBERT E. GINSBERG, ROBERT D. MARTIN & SUSAN V. KELLEY, GINSBERG & MARTIN ON BANKRUPTCY §10.11 (Aspen Publishers, Inc. 2009) [hereinafter BANKRUPTCY §10.11] (“Equitable subordination gives the bankruptcy court broad powers to undo inequality in the claim position of a creditor that will produce injustice or unfairness to other creditors with respect to distribution of the bankruptcy estate.”); *See generally* Wendell H. Adair et al., *Equitable Subordination: A Powerful Remedy*, J. CORP. RENEWAL, Oct. 1, 2000, <http://www.turnaround.org/Publications/Articles.aspx?objectID=1352> (“Typically, the actions of certain creditors have a negative impact upon the rights of other creditors and there are few responsive legal remedies available to an affected creditor.”).

13. *E.g.*, Adair et al., *supra* note 12.

14. Martino, *supra* note 4 (“Equitable subordination under section 510(c) is designed to ‘undo or offset any inequity in the claim position of a creditor that will produce injustice or unfairness to other creditors in terms of the bankruptcy results.’”(citing *In re Kreisler*, 331 B.R. 364, 380 (N.D. Ill. 2005))).

15. WARREN, *supra* note 2, at 126.

16. *See generally* Mara Der Hovanesian & Dean Foust, *Why This Real Estate Bust is Different*, BUS. WK., Nov. 5, 2009, at 46, available at [http://www.businessweek.com/magazine/content/09\\_46/b4155042792563.htm](http://www.businessweek.com/magazine/content/09_46/b4155042792563.htm) (“Some lenders may have drummed up business for themselves, enticing borrowers with more money than they needed. Consider Credit Suisse’s \$375 million loan to the Yellowstone Club in Big Sky, Mont., one of the starkest examples of poor underwriting in recent memory.”). *But see* Jo Ann J. Brighton et al., *Yellowstone: New Standard for Lender Liability in Today’s Economic Climate*, AM. BANKR. J. 28, Sept. 28, 2009, available at WL 28-SEP Am. Bankr. Inst. J. 28 (disagreeing with the subordination of Credit Suisse’s claim because they did not have a fiduciary duty to Yellowstone Club and that it is universally expected for a lender to act in its own self interest in bankruptcy proceedings); Ken Rathburn, “*Kreisler or Yellowstone?*” *The Reach of the Equitable Subordination Doctrine*, BANK. AND FIN. L. REPORT, August 21, 2009, <http://www.bankingandfinancelawreport.com/2009/08/articles/bankruptcy/kreisler-or-yell-owstone-the-reach-of-the-equitable-subordination-doctrine/> (acknowledging that *In re Yellowstone* is an “outlier” case because of its unique facts).

17. *See infra* Part II, pp. 498-504. The application of equitable subordination will be examined in relation to commercial bankruptcy filings. The Administrative Office

equitable subordination in *Yellowstone* differs from the traditional equitable subordination cases.<sup>18</sup> Additionally, Part III explains why courts underuse subordination as a remedy where parties are non-insiders.<sup>19</sup> Part IV argues for the use of equitable subordination in circumstances where non-insider creditors engage in underwriting misconduct and considers the possible implications that *Yellowstone* can have on non-insiders.<sup>20</sup>

## II. YELLOWSTONE: A BANKRUPTCY COURT'S CRITICAL EYE ON PREDATORY LENDERS

In 1999, “timber magnate”<sup>21</sup> Tim Blixseth and his then wife, Edra, established the “world’s only private ski and golf community,” Yellowstone Mountain Club (Yellowstone Club).<sup>22</sup> While the Blixseths financed Yellowstone Club by selling equity shares to “Pioneer and Frontier Members,” they retained control of approximately eighty-seven percent of Yellowstone Club through their Oregon holding company, Blixseth Group, Inc. (BGI).<sup>23</sup> In addition to equity financing, the Blixseths “carried a debt load ranging from a low of approximately \$4 to \$5 million to a

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of U.S. Courts reported that commercial bankruptcy filings increased sixty-three percent from July 1, 2007 to June 30, 2008, with 33,822 cases being filed during that time. For the purpose of this Case Comment, consumer bankruptcy filings are outside the scope.

18. See *infra* Part III, pp. 504-11.

19. See *infra* Part III, pp. 508-11.

20. See *infra* Part IV, pp. 511-13.

21. Der Hovanesian et al., *supra* note 16.

22. Credit Suisse v. Official Comm. of Unsecured Creditors (*In re* Yellowstone Mountain Club, LLC), No. 08-61570-11, Adv. No. 09-00014, 2009 WL 3094930, at \*2 (Bankr. D. Mont. May 12, 2009) (partial and interim order).

Yellowstone Club appeals to ultra-wealthy families as a second-home (or third-home) location for its private recreational facilities (particularly the ski area), views, proximity to winter and summer recreation. Prospective buyers are required to have a net worth of over \$3 million, but based on the costs of membership and housing, we would expect nearly all buyers to have investable assets of at least \$5 million, if not \$10 million. The membership price for residents is \$250,000 for a 30-year refundable deposit.

*Id.* at \*2 n.3.

23. *Id.* at \*2.

high of approximately \$60 million on a revolving line of credit” to finance specific portions of construction.<sup>24</sup>

In December 2004, Jeffery Barcy, a director of Credit Suisse’s investment banking division, sent several teaser emails about a new “syndicated term loan” to Tim Blixseth.<sup>25</sup> By offering “real estate loans in the corporate bank loan market,” Credit Suisse, “was trying to break new ground.”<sup>26</sup> Specifically, Credit Suisse’s syndicated term loans provided access to “a loan product the size of which had previously been unavailable to [real estate] borrowers.”<sup>27</sup> To attract real estate developers like the Blixseths, Credit Suisse structured the syndicated term loans to be similar to home equity loans.<sup>28</sup> Specifically, developers would be able to distribute or lend some of the proceeds of the loan to equity holders in the development for purposes unrelated to the Yellowstone Club.<sup>29</sup> At first, Tim Blixseth declined the syndicated term loan but then decided that “he might have a use of the proceeds for the loan and would be interested in talking again.”<sup>30</sup> Barcy and another Credit Suisse representative met Blixseth and agreed to loan \$150 million to the Yellowstone Club.<sup>31</sup>

Under the final credit agreement, however, Credit Suisse loaned \$375 million to the Yellowstone Club.<sup>32</sup> Of the \$375 million, approximately \$24 million was allocated for purposes of Yellowstone Club; Blixseth was allowed to distribute or lend \$209 million for “‘purposes unrelated’ to the Yellowstone Club” and invest an additional \$142 million in “‘unrestricted subsidiaries’ for

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24. *Id.* at \*5.

25. *Id.* at \*2 (“Barcy testified that Credit Suisse’s syndicated loan product had previously been marketed to other . . . recreational communities such as Tamarack Resort, Promontory, Ginn, Turtle Bay and Lake Las Vegas.”). *Id.* at \*3.

26. *Id.* at \*3.

27. *Id.*

28. *See In re Yellowstone Mountain Club, LLC*, No. 08-61570-11, at \*2; *see also* Irvin W. Sandman et al, *Hotel Owners, Lenders, and Stakeholders Square Off: Equitable Subordination*, GRAHAM & DUNN HART FORCE, May 27, 2009, <http://www.grahamdunn.com/go/articles/hotel-owners-lenders-and-stakeholders-square-off-equitable-subordination> (noting that the hotel industry should take notice of the subordination of Credit Suisse’s home equity-like loan product).

29. *In re Yellowstone Mountain Club, LLC*, No. 08-61570-11, at \*4.

30. *Id.* at \*3 (quotation in original).

31. *Id.*

32. *Id.* at \*5.

‘purposes unrelated’ to the Yellowstone Club development.”<sup>33</sup> At the time the loan was distributed, Yellowstone Club had “approximately \$19 to \$20 million in debt on its book.”<sup>34</sup>

Prior to lending to Yellowstone Club, Credit Suisse testified that it did “a fair amount” of legal and financial due diligence.<sup>35</sup> This legal due diligence consisted of a criminal background check on Blixseth and ensuring that Yellowstone Club truly held the assets that were to serve as collateral.<sup>36</sup> To conduct financial due diligence, Credit Suisse hired an independent appraisal firm to assess Yellowstone Club’s cash flows and “Total Net Value,” an appraisal metric created by Credit Suisse for its syndicated term loans that is based on a debtor’s projections and not its audited financial statements.<sup>37</sup>

At trial, a certified insolvency advisor testified that Yellowstone Club had experienced several years of negative cash flow and had missed its “profitability projections [for the previous nine months] by a substantial amount.”<sup>38</sup> Although Credit Suisse chose to rely on its “Total Net Value” metric, it was also aware that the appraiser had previously conducted an “as-is” analysis of Yellowstone Club for another bank and had valued the development at \$420 million “based on a discount rate of 18.5[%].”<sup>39</sup> In spite of the “as-is” valuation and the “red flags” related to cash flow, Credit Suisse entered into a credit agreement with the Yellowstone Club.<sup>40</sup> Immediately after the loan was extended, Blixseth allocated \$209 million of the \$375 million loan to BGI, which he later used for personal expenses, including real estate purchases, payments on his luxury jet, and a 30,000 square

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33. *Id.*

34. *Id.* (consisting of a line of credit and a term loan).

35. *In re Yellowstone Mountain Club, LLC*, No. 08-61570-11, at \*3; see Davis, *supra* note 9.

36. *In re Yellowstone Mountain Club, LLC*, No. 08-61570-11, at \*3.

37. *Id.* (noting that Credit Suisse’s Total Net Value metric was not in compliance with the Financial Institutions Recovery Act of 1989 and that the valuations were based on future projections provided by Blixseth).

38. *Id.* at \*5 (“Such numbers show that [Yellowstone’s] projections for the future, upon which Credit Suisse relied without question, had no foundation in historical reality.”). *Id.*

39. *Id.* at \*4.

40. *Id.* at \*6.

foot home in Palm Springs, California.<sup>41</sup> Consequently, Credit Suisse collected a \$7.5 million fee upon distribution of the loan.<sup>42</sup> Credit Suisse then proceeded to sell-off the Yellowstone Club loan to third party investors.<sup>43</sup>

From the time the loan was extended to the filing of bankruptcy, the Yellowstone Club remained behind on its accounts payable to creditors and vendors.<sup>44</sup> To obtain operating funds, Blixeth sold Yellowstone Club lots to members at “substantially reduced prices” instead of demanding repayment of the Credit Suisse loan from BGI.<sup>45</sup> Still unable to fund improvements for the upcoming ski season, Yellowstone Club filed for bankruptcy protection in November 2008 in the U.S. Bankruptcy Court for the District of Montana.<sup>46</sup>

In the subsequent interim order, Judge Kirscher held that Credit Suisse’s actions “were so far overreaching and self-serving that they shocked the conscience of the Court” and held that under Bankruptcy Code section 510(c) equitable subordination of Credit Suisse’s claim to that of an unsecured creditor was an appropriate remedy.<sup>47</sup> Judge Kirscher conceded that “equitable subordination is seldom used in a non-insider, non-fiduciary scenario” and that the requisite heightened “gross and egregious conduct” must have been committed by the creditor in order to subordinate.<sup>48</sup>

To support this holding, Judge Kirscher reasoned that the “fee structure was undoubtedly the catalyst that led to the most shocking aspect of Credit Suisse’s newly developed loan

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41. Kahrin Deines, *Bankrupt Yellowstone Club Gets a Break—Sort of*, SUMMIT DAILY NEWS, May 13, 2009, <http://www.summitdaily.com/article/20090513/NEWS/905139997/1078&ParentProfile=1055> (noting that Blixeth’s accountant testified that \$80 million of the loan was used for real estate purchases in Mexico, Scotland and France).

42. *In re Yellowstone Mountain Club, LLC*, No. 08-61570-11, at \*5.

43. *Id.* at \*8.

44. *Id.* at \*6.

45. *Id.*

46. *In re Yellowstone Mountain Club, LLC*, (Chapter 11) (Bankr. D. Mont. Nov.10, 2008).

47. *In re Yellowstone Mountain Club, LLC*, No. 08-61570-11, at \*7-8; 11 U.S.C. § 510(c) (2006).

48. *In re Yellowstone Mountain Club, LLC*, No. 08-61570-11, at \*7 (citing *In re First Alliance Mortg. Co.*, 497 F.3d 977, 1006 (9th Cir. 2006)).



product.”<sup>49</sup> Following the collection of the transaction fees, Credit Suisse encouraged loan officers to sell the Yellowstone Club loan to third parties investors.<sup>50</sup> Thus, by selling off the loan to third parties, Judge Kirscher recognized that Credit Suisse had created a scheme in which it was insulated from the risky loan but was still collecting the \$7.5 million in transaction fees.<sup>51</sup> Consequently, the larger the distribution of the loan to Yellowstone Club, the more Credit Suisse would collect in transaction fees.<sup>52</sup> He then determined that Credit Suisse’s new syndicated loan product was nothing more than a plot, “driven by the fees it was extracting from the loans it was selling, and letting the chips fall where they may,” and that Credit Suisse was “lin[ing] its pockets on the backs of the unsecured creditors.”<sup>53</sup>

To carry out the holding, Judge Kirscher ordered that Credit Suisse “must provide sufficient funds to pay . . . debtor-in-possession financing, administrative fees, the cost of [Yellowstone Club’s] bankruptcy estate and the allowed unsecured claims of non-member creditors,” but would be permitted to submit a credit bid of the \$232 million secured claim during the auction of Yellowstone Club’s assets.<sup>54</sup> Under a settlement agreement, however, Kirscher approved a deal between CrossHarbor Equity Partners (CrossHarbor) and Credit Suisse.<sup>55</sup> The settlement permitted CrossHarbor to purchase Yellowstone Club for \$115 million dollars contingent upon the bankruptcy court vacating the order to subordinate Credit Suisse’s claim.<sup>56</sup> Judge Kirscher vacated the order to subordinate and approved Yellowstone Club’s reorganization plan.<sup>57</sup>

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49. *Id.* at \*8.

50. *See id.*

51. *See id.* at \*5.

52. *See id.* at \*8.

53. *Id.* at \*9.

54. *In re Yellowstone Mountain Club, LLC*, No. 08-61570-11, at \*10; *see Non-Insider Senior Lender*, *supra* note 10.

55. *See Non-Insider Senior Lender*, *supra* note 10.

56. *Id.*; *see also* Ben Fidler, *CrossHarbor Capital Wins Yellowstone Club*, DAILY DEAL, (May 19, 2009), available at 2009 WLNR 9895538 (“Credit Suisse will be allowed to invest up to 15% of the equity in the new company, equal to about \$30 million.”).

57. *See Non-Insider Senior Lender*, *supra* note 10.

After the interim order, in June 2009, Blixseth motioned for a declaratory judgment claiming he “did not breach any fiduciary duties,” however, the Official Committee of Unsecured Creditors and Debtors (Committee) claimed joint and several liability of both Credit Suisse and Blixseth.<sup>58</sup> Expert forensic accountant Kent Mordy testified that the \$209 million that was immediately transferred to BGI constituted a distribution “and a return of capital to BGI and its then owner, Blixseth” and was not a loan.<sup>59</sup> The Committee argued that this amount should be treated as a distribution, in which case the \$209 million distribution “should have reflected negative equity of approximately \$141 million” and “left the [d]ebtors highly leveraged and with too little capital with which to fund their financial plans and projections.”<sup>60</sup> Blixseth’s motion to dismiss this claim was denied.<sup>61</sup>

*Yellowstone* exemplifies a novel way for bankruptcy judges to address predatory underwriting misconduct.<sup>62</sup> The subordination of Credit Suisse’s claim reflects a higher level of scrutiny courts may increasingly apply to creditors whose unjust conduct contributed to the current credit crisis.<sup>63</sup> The remainder of this Case Comment examines how courts have commonly applied the doctrine of equitable subordination and what ramifications a

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58. *Credit Suisse v. Official Comm. Of Unsecured Creditors (In re Yellowstone Mountain Club, LLC)*, 415 B.R. 769, 779 (Bankr. D. Mont. 2009). The Committee also claimed that Blixseth was the alter-ego of BGI and the proceeds of the Credit Suisse loan constituted a fraudulent transfer. *Id.* For the purposes of this Case Comment, these additional claims are outside the scope of discussion.

59. *Id.* at 788; see *Credit Suisse v. Official Comm. of Unsecured Creditors (In re Yellowstone Mountain Club, LLC)*, No. 08-61570-11, Adv. No. 09-00014, 2009 WL 3094930, \*4 (Bankr. D. Mont. May 12, 2009) (partial and interim order) (noting that originally the proceeds unrelated to the business were drafted as *loans*, but were later drafted as *distributions* to avoid tax consequences and negative owner’s equity accounts) (emphasis added).

60. *Credit Suisse v. Official Comm. Of Unsecured Creditors (In re Yellowstone Mountain Club, LLC)*, 415 B.R. 769,788 (Bankr. D. Mont. 2009).

61. *Id.* at 791.

62. *See id.*

63. *See Unwary Lender, supra* note 7, at 1. *But see* Rathburn, *supra* note 16 (arguing that *In re Yellowstone* is simply an “outlier case” because if the Bankruptcy Court did not subordinate Credit Suisse’s claim, many local creditors and vendors would not have received any money). “[A]ny bankruptcy judge looking to protect businesses of the surrounding area could follow Yellowstone’s lead and use the doctrine of equitable subordination as a means to an end.” *Id.* (underlining in original).

Yellowstone-type use of equitable subordination could have on lenders.

### III. EQUITABLE SUBORDINATION AND ITS APPLICATION TO NON-INSIDERS

The doctrine of equitable subordination addresses situations where creditor misconduct generated unjust inequity among claimants<sup>64</sup> and is not intended to punish those subordinated.<sup>65</sup> Equitable subordination, originally a common law doctrine, is now codified at Section 510(c) of the U.S. Bankruptcy Code:

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.<sup>66</sup>

Section 510(c) does not establish a bright line test.<sup>67</sup> Instead, Congress allowed bankruptcy courts to continue developing the doctrine.<sup>68</sup> When a bankruptcy court subordinates a claim, the court typically orders that the claimant will collect with or behind a class of creditors or security holders.<sup>69</sup> Equitable subordination

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64. Andrew DeNatale & Prudence B. Abram, *The Doctrine of Equitable Subordination as Applied to Nonmanagement Creditors*, 40 BUS. L. 417, 422 (1985).

65. *Id.*

66. See 11 U.S.C. § 510(c) (2006); see generally Mark G. Douglas, *Bankruptcy Court Empowered to Recharacterize Debt as Equity*, BUS. RESTRUCTURING REV., Oct. 2003, at 1, 1-3, available at <http://www.jonesday.com/newsknowledge/publicationdetail.aspx?publication=1414> (PDF available at link) (explaining the difference between subordination and recharacterization).

67. DeNatale & Abram, *supra* note 64, at 421 (“[A]lthough the Bankruptcy Code recognizes the possibility of equitable subordination of claims, it does not specify any standards by which the doctrine is applied.”).

68. *Id.* (citing 124 Cong. Rec. H11, 095 (daily ed. Sept. 28, 1978) (remarks of Rep. Edwards) *id.* at S17, 412 (daily ed. Oct. 6, 1978) (remarks of Sen. DecConcini)).

69. See *e.g.*, Martino, *supra* note 4 (“Allows the court to re-prioritize a claim in bankruptcy on account of inequitable conduct by the claimant.”).

has a significant effect on a creditor's ability to maintain a first lien position and thus, be the first compensated from liquidation proceedings.<sup>70</sup>

Traditionally, bankruptcy courts have applied equitable subordination under the *Mobile Steel* test.<sup>71</sup> Based on *Mobile Steel*, a bankruptcy court should subordinate a claim where “(1) the claimant engaged in inequitable conduct, (2) the inequitable conduct resulted in injury and disadvantage to other claimants, and (3) subordination of the claim is consistent with the Bankruptcy Code.”<sup>72</sup> Bankruptcy courts have found inequitable conduct in instances where a claimant engaged in “fraud, illegality, or breach of fiduciary duties;” where a claimant’s conduct caused the debtor to become undercapitalized;<sup>73</sup> and where a “claimant[] use[s] the debtor corporation as a mere instrumentality or alter ego.”<sup>74</sup> However, courts’ treatment of inequitable conduct differs depending on whether the creditor-debtor relationship constitutes a relationship between insiders or non-insiders.<sup>75</sup>

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70. See RABINOWITZ & ROTENBERG, *supra* note 11, at § 8:26 (“Lender’s goal in workout is to reduce the potential for losses . . . [i]f the misconduct is established, the entire unpaid balance owed to the lender can be equitably subordinated to the claims of the other creditors and parties in interest. The last party out of a troubled company may have a zero recovery.”); see NUWIRE INVESTOR, Definition of First Lien Position, <http://www.nuwireinvestor.com/wiki/pages/first-lien-position.aspx> (last visited Feb. 6, 2010).

71. Benjamin v. Diamond (*In re Mobile Steel Co.*), 563 F.2d 692, 699-700 (5th Cir. 1977); see Jeremy W. Dickens, Note, *Equitable Subordination and Analogous Theories of Lender Liability: Toward a New Model of “Control,”* 65 TEX. L. REV. 801, 809-10 (1987). Dickens’s references to nonmanagement creditors are synonymous with this Case Comment’s references to insiders.

72. Benjamin v. Diamond (*In re Mobile Steel Co.*), 563 F.2d at 700.

73. *In re Herby’s Foods, Inc.*, 2 F.3d 128, 131-32 (5th Cir. 1993) ((citing *Fabricators, Inc. v. Technical Fabricators, Inc.* (*In re Fabricators, Inc.*) 926 F.2d 1458, 1469 (5th Cir. 1991)) (“Capitalization is also inadequate ‘if, at the time when the advances were made, the bankrupt could not have borrowed a similar amount of money from an informed outside source.’ Even though undercapitalization alone generally does not justify equitable subordination, evidence of additional inequitable conduct may do so. For example, if an insider makes a loan to an undercapitalized corporation, the combination of undercapitalization and the insider loan may allow the bankruptcy court to recharacterize the loan as a capital contribution, or to equitably subordinate the loan to the claims of other creditors.”); *Pepper v. Litton* 308 U.S. 295, 309-10 (1939).

74. See, e.g., *In re Herby’s Foods, Inc.*, 2 F.3d at 131.

75. See Justin R. Fogarty et al., *Lender Liability in Corporate Finance Transactions and Equitable Subordination in the U.S. – Towards a Canadian Perspective*, 21 NAT’L INSOLVENCY REV. 49, 49 (2004), available at <http://www.free>

Courts typically apply equitable subordination when insiders, such as corporate officers, directors, or managers, all of whom are fiduciaries of the debtor, commit misconduct.<sup>76</sup> They are less likely to subordinate the claims of non-insiders.<sup>77</sup> Commercial transactions between lenders and their debtors are usually determined to be that of non-insiders because no fiduciary duty exists.<sup>78</sup> Case law holds that “[c]laims arising from dealings between a debtor and an insider are rigorously scrutinized.”<sup>79</sup> By contrast, courts apply a “gross and egregious” standard to dealings between the debtor and non-insiders to determine whether equitable subordination should be applied to the non-insider’s claims.<sup>80</sup> Thus, courts are less likely to subordinate claims of non-insiders who have engaged in misconduct unless the non-insider’s conduct satisfies the “gross and egregious” standard.<sup>81</sup>

*In re First Alliance Mortgage Co.*<sup>82</sup> highlighted the “gross and egregious” standard. There, non-insider claimants sought to subordinate a \$77 million secured claim to those of unsecured

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bornpeters.com/docs/publications/Lender%20Liability%20in%20Corporate%20Finance%20Transactions%20and%20Equitable%20Subordination%20in%20the%20U.S.%20-%20Towards%20a%20Canadian%20Perspective.pdf; Martino, *supra* note 4; Dickens, *supra* note 71, at 816 (noting that application of gross and egregious conduct is difficult to delineate in practice) (quotations omitted).

76. See 11 U.S.C. § 101(31) (2006); see Dickens, *supra* 71, at 802. For a more current definition of insider, see 11 U.S.C.S. § 101(26) (2009) (defining an insider as one who has a sufficiently close relationship with the debtor and subject to closer scrutiny than those dealing at arm’s length with the debtor); see *infra* note 81.

77. *E.g.* Kham & Nate’s Shoes No. 2, Inc. v. First Bank, 908 F.2d 1351, 1356 (7th Cir. 1990).

78. See Dickens, *supra* note 71, at 814-15.

79. BANKRUPTCY §10.11, *supra* note 12, at 10-103.

80. See *In re First Alliance Mortgage Co.*, 471 F.3d 977, 1006 (9th Cir. 2006) (citing *In re Pacific Express, Inc.* 69 B.R. 112, 116 (B.A.P. 9th Cir. 1986). “The primary distinctions between subordinating the claims of insiders versus those of non-insiders lie in the severity of misconduct . . . [w]here non-insider egregious conduct must be proven with particularity.” *Id.*

81. See Kham & Nate’s Shoes No. 2, Inc. v. First Bank, 908 F.2d at 1356 (“Cases subordinating the claims of creditors that dealt at arm’s length with the debtor are few and far between.”); *Credit Suisse v. Official Comm. of Unsecured Creditors (In re Yellowstone Mountain Club, LLC)*, No. 08-61570-11, Adv. No. 09-00014, 2009 WL 3094930, at \*9 (Bankr. D. Mont. May 12, 2009) (partial and interim order) (finding no evidence to suggest that Blixseth and Credit Suisse were not dealing at arm’s length, as depicted when “Credit Suisse, via Barcy, and Blixseth ultimately agreed to ‘flip a coin’ to decide the [transaction] rate”).

82. *In re First Alliance Mortgage Co.*, 471 F.3d 977 (9th Cir. 2006).

creditors.<sup>83</sup> First Alliance was a subprime mortgage lender underwritten by Lehman Brothers (Lehman) that “utilize[d] marketing methodology designed to target individuals who had built up substantial equity in their homes, many of whom were senior citizens.”<sup>84</sup> During the late 1990’s, First Alliance’s lending practices, especially to elderly homeowners, “became subject to increasing scrutiny including allegations that the borrower’s loans were fraudulently induced and that First Alliance deceived borrowers into paying large loan origination fees.”<sup>85</sup> When the predatory practices became publicized,<sup>86</sup> many of First Alliance’s secondary lenders withdrew their funding, but not Lehman.<sup>87</sup> In 1999, even after Lehman conducted an internal investigation that revealed First Alliance’s “unfavorable” and “unethical” business practices, “Lehman stepped forward to provide a \$150 million credit line and became First Alliance’s sole source of . . . funding and underwriting.”<sup>88</sup> Nevertheless, the Ninth Circuit concluded that equitable subordination of Lehman’s claim was not an appropriate remedy because Lehman did not engage in inequitable conduct, thereby failing the first step of *Mobile Steel*.<sup>89</sup>

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83. *See id.* at 1006.

84. *Id.* at 983-984.

85. *Id.* at 985. In 1998, seven state Attorney Generals and the U.S. Department of Justice launched an official investigation on First Alliance’s lending practices. Additionally, American Association of Retired Persons (AARP) quickly filed suit. *Id.*

86. *See* Diana B. Henriques, *Lehman Aided in Loan Fraud, Jury Says*, N.Y. TIMES, June 17, 2003, available at <http://www.nytimes.com/2003/06/17/business/lehman-aided-in-loan-fraud-jury-says.html?pagewanted=1>.

87. *In re First Alliance Mortgage Co.*, 471 F.3d at 986.

88. *See In re First Alliance Mortgage Co.*, 471 F.3d at 987 (9th Cir. 2006) (“[A]ccording to the terms of their agreement, Lehman made secured loans to First Alliance by advancing 95 [%] of the value of the mortgages First Alliance pledged as collateral.”). *Id.*

89. *See id.* at 1007.

The Trustee based his claim to equitable relief on the theory that by aiding and abetting First Alliance’s fraud, Lehman’s actions increased the amount of creditors and claims, thus depleting the pro rata share that each creditor would have of the remaining assets. At first blush, the Trustee’s argument has a certain allure, because there is surely something “inequitable” in an abstract sense about aiding and abetting fraud. Upon closer look, the success of this argument requires us to treat the standard for holding Lehman liable for aiding and abetting First Alliance’s fraud . . . as a stand-in for inequitable conduct under the

The Ninth Circuit affirmed the district court's findings, moreover, that "Lehman's conduct does not demonstrate 'gross' or 'egregious' misconduct that "shocks the conscience of the court."<sup>90</sup>

Generally, non-insiders' secured claims will be subordinated under the "gross and egregious" standard if they engaged in "gross misconduct tantamount to fraud, overreaching or spoliation to the detriment of others,"<sup>91</sup> which must be "proven with particularity."<sup>92</sup> As the court's analysis in *In re First Alliance Mortgage Co.* proves, "the circumstances are few and far between."<sup>93</sup> The majority of cases that have satisfied the "gross and egregious" standard have involved fraud or misrepresentation by the creditor.<sup>94</sup> However, inequitable conduct between non-insiders can stem from underwriting misconduct between the lender and debtor, not only from creditors' fraud or misrepresentation.<sup>95</sup>

In determining whether to subordinate a secured creditor's interests, courts have relied on the presumption that "creditor conduct within the express written terms of a contract is presumptively not inequitable."<sup>96</sup> Thus, bankruptcy courts typically do not look beyond the terms of the loan when determining whether the non-insider's misconduct satisfies the inequitable conduct requirement.<sup>97</sup> This presumption is also referred to as a "formalist contracts-right presumption."<sup>98</sup> For

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test for equitable subordination of bankruptcy claims. This we cannot do.

*Id.*

90. *Austin v. Chisick (In re First Alliance Mortgage Co.)*, 298 B.R. 652, 668 (C.D. Cal. 2003).

91. *See, Dickens supra* note 71, 815 (footnote omitted).

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

93. *Id.* (internal quotations omitted) (citation omitted).

94. *Dickens, supra* note 71, 815.

95. *DeNatale & Abram, supra* note 64, at 432 ("The most commonly feared equitable subordination cases arise in connection with allegations of domination and control on the part of a nonmanagement creditor, generally a financial institution.").

96. *See Jay L. Koh, Equity Unbound: A Meaningful Test for Equitable Subordination*, 16 YALE L. & POL'Y REV. 467, 471 (1998) (emphasis added).

97. *Id.* at 487.

98. *Id.* at 473.

example, in *In re Clark Pipe & Supply Co. (Clark Pipe II)*,<sup>99</sup> the Fifth Circuit issued a revised opinion rejecting its original ruling and determined that the conduct of a non-insider creditor, Associates Commercial Corporation (Associates), did not constitute inequitable conduct over the debtor (Clark).<sup>100</sup> The court stated:

Upon reconsideration, we have concluded that we cannot say that the sort of control Associates asserted over Clark's financial affairs rises to the level of unconscionable conduct necessary to justify the application of the doctrine of equitable subordination. We have reached our revised conclusion primarily because we cannot escape the salient fact that, pursuant to its loan agreement with Clark, Associates had the right to reduce funding, just as it did, as Clark's sales slowed . . . .

. . . .

In our original opinion, we failed to focus sufficiently on the loan agreement, which gave Associates the right to conduct its affairs with Clark in the manner in which it did.<sup>101</sup>

The *Clark Pipe II* court highlights the presumption that “[i]f a creditor has acted within the rights articulated in a contract with a debtor, the creditor will be presumed not to have engaged in inequitable conduct for the purposes of equitable subordination.”<sup>102</sup>

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99. *In re Clark Pipe & Supply Co.*, 893 F.2d 693 (5th Cir. 1990); see Koh, *supra* note 96, at 472 (noting that the Fifth Circuit originally affirmed the bankruptcy court's equitable subordination of Associate's assets).

100. *In re Clark Pipe & Supply Co.*, 893 F.2d at 702 (discussing that Associates knew that Clark was heading into bankruptcy and therefore, sought to postpone bankruptcy in order to recover the majority of its investment). The Court held that “Associates was not a fiduciary of Clark, it did not exert improper control over Clark's financial affairs, and it did not act inequitably in exercising its rights under its loan agreement with Clark.” *Id.*

101. *Id.* at 699-700.

102. See Koh, *supra* note 96, at 473.



The *Yellowstone* decision is novel because the bankruptcy court considered Credit Suisse's underwriting practices to constitute misconduct.<sup>103</sup> Traditionally, bankruptcy courts have been reluctant to subordinate creditors' claims in cases where parties have contracted the terms of their agreement, such as the loan agreement between Credit Suisse and Yellowstone Club.<sup>104</sup> Courts should look beyond the express terms of the loan, as Judge Kirscher attempted to do in *Yellowstone* when making a determination of inequitable conduct.<sup>105</sup>

Judge Kirscher found that Credit Suisse's underwriting practices warranted subordination even for non-insiders.<sup>106</sup> To determine that the threshold standard of "gross and egregious" conduct was satisfied, the *Yellowstone* Bankruptcy Court relied primarily on the following five facts:

- (1) Credit Suisse created a "new" credit valuation analysis that failed to consider historical or current financial statements;
- (2) Credit Suisse planned to resell the loan to third-party investors, instead of retaining it on the loan books;
- (3) the majority of the loan could be used for purposes unrelated to the business;
- (4) Credit Suisse earned large fees for a loan product that was "unnecessary" to the debtor; and
- (5) Credit Suisse made similar loans to other luxury real estate developments that also resulted in financial shambles.<sup>107</sup>

Underwriting conduct, like that of Credit Suisse and Lehman, reflects a reliance on the presumption that bankruptcy courts will

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103. See *infra* pp. 501-04; *DeNatale, supra* note 64 (noting that because creditors are making more risky investments, usually reserved for insiders, it is not surprising why courts would be more inclined to use equitable subordination as a remedy to combat misconduct.).

104. See Koh, *supra* note 96, at 469.

105. See *id.* at 467.

106. See *supra* pp. 501-02.

107. See *Unwary Lender, supra* note 7 (outlining *Yellowstone's* reasoning).

hesitate to apply equitable subordination to remedy inequitable contract terms.<sup>108</sup> Judge Kirscher's application of equitable subordination is consistent with the implicit duty of good faith dealings employed by modern contract law.<sup>109</sup>

#### IV. YELLOWSTONE FOR NON-INSIDERS

Predatory underwriting should reach the threshold requirement for inequitable conduct set forth in the *Mobile Steel* test when the non-insider lender has controlling influence over the debtor which results in an injustice to other creditors.<sup>110</sup> Unlike in *Yellowstone*, bankruptcy courts have generally been reluctant to subordinate creditors' claims in cases where parties have contracted the terms of their agreement.<sup>111</sup> Courts should, however, scrutinize creditors' conduct in contractual relationships where the creditor has indirect control vis-à-vis financial domination.<sup>112</sup> In some contracts, for example, where creditors provide the "sole source of financing" or are in "exclusive control of the debtor's source of income," a non-insider has the ability to influence management decisions.<sup>113</sup> A non-insider can indirectly control a debtor through financial domination.<sup>114</sup> In these types of situations, the creditor should be treated as a de-facto fiduciary with the *Mobile Steel* test applied.<sup>115</sup>

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108. See Koh, *supra* note 96, at 476-77.

109. *Id.* at 477 ("Unlike the formalist contract-rights presumption, modern contract law recognizes and requires an inquiry into the relations between the contracting parties to determine whether a party's conduct is within contractual rights.").

110. *But see* Dickens, *supra* note 71, at 832 (contending that financial domination and management control must be found in order to make a finding of control for the purpose of subordination) (emphasis added).

111. *Id.*

112. See Dickens, *supra* note 71, at 821 (recognizing that there are limited circumstances that give rise to financial domination by a non-insider). "Control through financial domination is the ability to influence those individuals or groups having voting or management control of the debtor." *Id.* at 822; Koh, *supra* note 96, at 467; DeNatale, *supra* note 64, at 432 ("[a]lthough the existence of control does create a duty to the other creditors, control alone does not automatically result in the equitable subordination of a creditor's claim.").

113. Dickens, *supra* note 71, at 822.

114. Dickens, *supra* note 71, at 819.

115. Rabinowitz & Rotenberg, *supra* note 11, at §8:26 ("Where a noninsider creditor stands in a controlling relationship with a debtor, the creditor may be treated

Because equitable subordination can be a harsh remedy, however, the doctrine should not be applied simply because a lender is the “sole source of financing” or has “exclusive control of the debtor’s source of income.”<sup>116</sup> Rather, subordination is appropriate when a lender gains financial domination because of its previous underwriting conduct.<sup>117</sup> In particular, courts should consider whether creditors engaged in any predatory underwriting.<sup>118</sup> The court in *Yellowstone* did not err in subjecting Credit Suisse’s secured loan to equitable subordination.<sup>119</sup> Credit Suisse exerted financial control by extending an “unnecessary loan,” motivated by transaction fees, to Yellowstone Club.<sup>120</sup>

Equitable subordination has both direct and indirect costs associated with its application.<sup>121</sup> Direct costs include the possibility of increased rates in transacting a loan agreement and the expenses associated with litigation from a subordinated claim.<sup>122</sup> Indirect costs include increases in fees and rates associated with obtaining a loan and a reduction in their availability caused by lenders who fear that their secured loans can be subordinated.<sup>123</sup> For example, *Yellowstone* became cause for litigation in January 2010, when Yellowstone Club, along with three other high-end resort owners, filed a class action suit against Credit Suisse “seeking damages on behalf of more than 3,000

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as a fiduciary and held to a higher standard of conduct . . . [t]he primary distinction between subordinating claims of insiders versus non-insiders lies in the severity of the misconduct . . . towards the debtor or its creditors.”); *see also supra* pp. 508-10.

116. Dickens, *supra* note 71, at 831 (“[E]quitable subordination is tied inextricably to the facts of each case”); Rabinowitz & Rotenberg, *supra* note 11, at § 8:26.

117. *See supra* pp. 510-11 and notes 103-15.

118. *See Koh, supra* note 96, at 467.

119. *See supra* p. 510 and note 109.

120. *See Credit Suisse v. Official Comm. of Unsecured Creditors (In re Yellowstone Mountain Club, LLC)*, No. 08-61570-11, Adv. No. 09-00014, 2009 WL 309430, at \*8 (Bankr. D. Mont. May 12, 2009) (partial and interim order); *see supra* pp. 501-02.

121. Adam Feibelman, *Equitable Subordination, Fraudulent Transfer, and Sovereign Debt*, 70 LAW & CONTEMP. PROBS. 171, 187 (2007) (arguing for the application of subordination as a solution for odious debts).

122. *Id.*

123. *Id.* (“The less precise the definition of inequitable conduct, the larger the range of behavior by creditors it will likely affect and the more uncertainty creditors will face about their potential liability.”).

investors who purchased property” in those developments.<sup>124</sup> The property owners claim that Credit Suisse “engaged in a plan to artificially inflate the values of the resort so it could make huge loans” and thus, collect high fees.<sup>125</sup> According to the complaint, “Credit Suisse raked in huge fees on loans against the properties, which it syndicated and sold to hedge fund managers.”<sup>126</sup> The owners also brought the suit against Cushman & Wakefield, Inc., the commercial appraisal firm that computed the valuations of the property.<sup>127</sup>

Both direct and indirect costs can be limited by referring to *Yellowstone* as a guide to narrowly apply equitable subordination in those instances where a lender’s inequitable underwriting permits financial domination over the debtor.<sup>128</sup> Thus, the “potential liability [of subordination] should reduce the incentives for creditors to engage in harmful or inefficient opportunistic behavior in the first place.”<sup>129</sup> Consequently, secured creditors will be more apprehensive before engaging in predatory lending.<sup>130</sup> More importantly, the creditor misconduct will not disadvantage junior creditors who have acted in good faith.<sup>131</sup>

## V. CONCLUSION

Predatory loan agreements allow the lender to control the debtor in a manner that could amount to non-insider inequitable conduct.<sup>132</sup> Although contractual agreements have typically shielded lenders from subordination,<sup>133</sup> *Yellowstone* suggests that

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124. Jacqueline Palank, *Luxury Property Owners Sue Credit Suisse for \$24 Billion*, WALL ST. J., January 5, 2010, <http://online.wsj.com/article/SB10001424052748703580904574638052691063912.html>. Additionally, there is an expected 4,000 to 5,000 more litigants to join the suit and an additional ten other resorts. *Id.*; *supra* note 25.

125. *Id.*

126. Jim Robbins *Credit Suisse Is Accused of Defrauding Investors in 4 Resorts* N.Y. TIMES, B1 January 5, 2010 available at <http://www.nytimes.com/2010/01/05/business/05resorts.html?scp=1&sq=yellowstone%20club&st=cse>.

127. Palank, *supra* note 127.

128. Feibelman, *supra* note 121, at 188.

129. *Id.* at 189.

130. *See supra* p. 513 and notes 121-23, 128-29.

131. *See supra* p. 512 and note 109.

132. *See Rabinowitz & Rotenberg, supra* note 11, at §8:26.

133. *See supra* pp. 508-10.

courts may consider predatory underwriting as inequitable conduct.<sup>134</sup> Accordingly, courts may be more willing to review the suspicious dealings of lenders with a critical lens.<sup>135</sup> Consequently, subordinating claims of predatory lenders would encourage all lenders to consider more diligently the risk to the debtor and their other creditors before offering risky loans; otherwise, their first lien position risks being moved to the back of the line in bankruptcy proceedings.<sup>136</sup>

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134. See *supra* Part II, pp. 499-502 and note 9.

135. See *supra* notes 7, 9, and 103.

136. See *supra* p. 512 and notes 121-23.