Equitable Subordination and Recharacterization: Looming Threats in Bankruptcy
Strategies for Lenders, Creditors and Private Equity Sponsors to Avoid Claim Loss and Maintain Preference Status

A Live 90-Minute Teleconference/Webinar with Interactive Q&A

Today's panel features:
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Tuesday, April 13, 2010
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Equitable Subordination and Recharacterization

Ronald A. Landen

April 13, 2010
Typical Bankruptcy Priorities

- Administrative Claims
- Secured Claims
  - To the extent of value of collateral
- Unsecured Claims
- Equity Interests

Within each category, there may be sub-priorities (lower claims are “subordinated” to higher claims).

Note: “claims” vs. “interests”
Equitable Subordination

- What Happens?
  - Bankruptcy court modifies the priorities of the subject claim to put it behind the claims of other creditors
    - Normally applies to unsecured claims
    - Can apply to secured claims in unusual circumstances
  - Only subordinates “claims” to other claims or “interests” to other interests
    - Claim will remain ahead of equity interests
Development of Equitable Subordination Law

- 1939 – U.S. Supreme Court permitted subordination of claims in two cases
  - Pepper v. Litton 308 U.S. 295 (1939)
- 1948 – Supreme Court narrowed the use in Comstock v. Group of Institutional Investors 335 U.S. 211 by adding a bad faith requirement
- 1977 – Seminal case Benjamin v. Diamond (In re Mobile Steel Co.) 563 F.2d 692 (5th Cir. 1977)
- 1978 – Codified in Section 510(c) of the Bankruptcy Code
In re Mobile Steel

- Three part test
  - Creditor must have engaged in some form of inequitable conduct
  - Creditor misconduct must have caused injury to creditors or conferred an unfair advantage to subject creditor
  - Subordination must not be inconsistent with the Bankruptcy Code
    - Arguably not relevant now due to 510(c)
Inequitable Conduct

- Examples
  - Undercapitalization
  - Fraud, mismanagement or breach of fiduciary duty
  - Use of debtor as a mere instrumentality or “alter ego”

Usually by insiders
Direct Injury

- Only need to show that conduct reduced the chances of general creditors collecting their debts as a result thereof
Other Principles for Equitable Subordination

- Inequitable conduct must affect the bankruptcy results of other creditors.
- Subordination should be limited to the extent required to offset the harm to debtor and other creditors (not penal).
- Party seeking remedy has the burden of proof.
Key Equitable Subordination Issues

- If a debtor files for bankruptcy, a court may subordinate a claims if:
  1) Generally must prove creditor engaged in *inequitable conduct*;
     - **Note** for insiders *general misconduct* is sufficient.
     - Insiders may be those who “control” the Company.
     - For non-insiders “gross and egregious” conduct must be proven with particularity.
  2) The inequitable conduct (*general misconduct*) caused injury to the creditors or conferred an unfair advantage on the claimant; *and*
  3) Equitable subordination of the claim is consistent with bankruptcy law.
     - Some courts have suggested that this prong is moot because the Bankruptcy Code explicitly authorizes equitable subordination.
Recharacterization

- What Happens?
  - Modifies a creditor claim into an equity interest
  - Judicially imposed
- Results in creditor being at the “end of the line” with all other equity holders
- Rare remedy
  - Multi-factor considerations
Key Recharacterization Issues

- A bankruptcy court could recharacterize debt as equity if it found that the transaction between the Company and the lender was not an arms’ length negotiation.
  - The more specific, formal, and complete the agreement, the less likely the debt will be reclassified.
  - The better the Company’s financial situation at the time of the loan and the clearer the source of funds to repay the loan, the less likely the debt will be reclassified.
  - The greater the lack of identity between the Company and the lender, the less likely the debt will be reclassified.
    - The lender’s insider-status could lead to a finding of common identity.
Court Considerations for Recharacterization

- Undercapitalization
- Inability to obtain similar outside financing
- Presence or absence of fixed terms and obligations
- Ability to enforce payments
- Source of repayments
- Failure of the debtor to repay on the due date
- Identity of interest between creditor and stockholder
- Security
- Extent of subordination
- Participation in management
- Treatment in the business records
Recent Developments/Cases

- **In re Kreisler and Erenberg**, 546 F.3d 863 (7th Cir. 2008)
- **Credit Suisse v. Official Committee of Unsecured Creditors** (In re Yellowstone Mountain Club, LLC), Bankr. D. Mont., No. 09-00014
Private Equity Sponsors/Investors

- Examples:
  - Sponsor invests in a combination of debt and equity
  - Equity sponsor provides additional funding to portfolio company as a loan
Sponsor/Investor Considerations

- Equity sponsors/investors should not be concerned when only investing in equity.
- If investing a combination of debt and equity, equitable subordination or recharacterization principles may apply:
  - If equity holder later decides to loan money, risk is about the same.
- May be an issue if no present equity ownership.
- Highly fact-specific and will always be viewed with hindsight.
Steps for Private Equity Investors

- Preventative – monitor liquidity closely
  - Avoid emergency funding where no third party alternatives are available
- Negotiate loan on arms’ length, market terms
- Follow internal governance procedures
  - Avoid actual or appearance of misconduct
- Consider effect on other creditors
- Insiders should not loan money if company is insolvent or undercapitalized
Documentation Tips

- Give instrument a name consistent with a loan
- Include a fixed interest rate, maturity date and detailed payment schedule
- Payments should be fixed
- Consider enforceability
  - Sponsors should enforce obligation
- Do not reference equity ownership or that loan is in contemplation of such ownership
- Provide security interest if possible
Summary: Equitable Subordination and Recharacterization

1. Form matters
2. Avoid appearance of using control to influence debtor
3. Monitor developments closely
4. Understand the risk
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Weil, Gotshal & Manges LLP
Equitable Subordination

J. Thomas Beckett, counsel to the Committee in

Credit Suisse v. UCC (In re Yellowstone Mountain Club),
415 BR 769 (Bankr. D.Mont. 2009)
– a case study.
Intro: Equitable Subordination – the Code

- 11 U.S.C. § 510(c):
  - After 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 ….
Intro: Equitable Subordination – the principles

Accord *In re Mayo*, 112 B.R. 607, 650 (Bankr.D.Vt.1990) (“There are few cases in which gross misconduct has actually been applied to non-insiders, and even fewer where inequitable misconduct has caused a claim to be subordinated.”); *In re Dry Wall Supply, Inc.*, 111 B.R. 933, 938 (D.Colo.1990) (noting that “when [the fiduciary] relationship is absent, the party seeking equitable subordination of a claim must demonstrate even more egregious conduct by the creditor”). Although courts have struggled to articulate the misconduct that must be established to subordinate non-insider claims, it is clear that the non insider's misconduct must be “gross or egregious.” See Benjamin Weintraub & Alan N. Resnick, *Bankruptcy Law Manual* ¶ 5.15 at 5-96 (3d ed. 1992); see also *In re Osborne*, 42 B.R. at 997 (stating that “plaintiffs are required to make a showing of gross or egregious misconduct”). Thus, “[a] mere statement that the creditor is guilty of ‘inequitable conduct’ will not suffice.” *In re W.T. Grant*, 4 B.R. 53, 75-76 (Bankr.S.D.N.Y.1980), aff'd, 699 F.2d 599 (2d Cir.1983). Rather, the plaintiff must prove gross misconduct tantamount to “fraud, overreaching or spoliation.” *Id.*; see also *In re Fabricators, Inc.*, 926 F.2d 1458, 1465 (5th Cir.1991).
In re Yellowstone Club

- The law on equitable subordination is vague.
- It’s tough, but it’s vague.
- Consequently, what’s important about equitable subordination cases is the facts.
- The Yellowstone Club case is one of the very few cases where the claims of non-insiders have been equitably subordinated.
- So let’s focus on the facts of the Yellowstone case.
The Yellowstone Club
The Yellowstone Club
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The Yellowstone Club
Tim Blixseth – Founder / Former Owner
The Yacht
The Tooth Fairy
Chateau de Farcheville
Turks and Caicos
St. Andrews
YELLOWSTONE MOUNTAIN CLUB, LLC AND YELLOWSTONE DEVELOPMENT, LLC

CREDIT AGREEMENT

This CREDIT AGREEMENT (this “Agreement”) is dated as of September 30, 2005 and entered into by and among YELLOWSTONE MOUNTAIN CLUB, LLC, a Montana limited liability company, YELLOWSTONE DEVELOPMENT, LLC, a Montana limited liability company, and BIG SKY RIDGE, LLC, a Montana limited liability company (collectively, the “Borrower”), THE BANKS, FINANCIAL INSTITUTIONS AND OTHER ENTITIES LISTED ON THE SIGNATURE PAGES HEREOF (each individually referred to herein as a “Lender” and collectively as the “Lenders”), and CREDIT SUISSE (“Credit Suisse”), as administrative agent for the Lenders (in such capacity, the “Administrative Agent”), as collateral agent (in such capacity, the “Collateral Agent”), as lead arranger for the Lenders (in such capacity, the “Arranger”) as paying agent (in such capacity, the “Paying Agent”), and as sole bookrunner (in such capacity, the “Bookrunner”); together with the Administrative Agent, the Arranger, the Collateral Agent and the Paying Agent, the “Agents”) for the Lenders.

RECITALS

A. WHEREAS, the Borrower desires that the Lenders extend certain senior term loans to the Borrower hereunder, the proceeds of which, will be used: (i) for distribution or loans up to $209,000,000 to members of the Borrower for purposes unrelated to the Yellowstone Development, (ii) for investments up to $142,000,000 into Unrestricted Subsidiaries for purposes unrelated to the Yellowstone Development, (iii) to pay the Transaction Costs, (iv) to refinance the Existing Indebtedness, (v) to finance a portion of the development and construction costs associated with the Yellowstone Development in 17 accordance with the Financial Plan; and
“Control” means the possession, directly or indirectly, of the power to direct or cause the direction of the management or policies of a Person, whether through the ability to exercise voting power, by contract or otherwise. “Controlling” and “Controlled” have meanings correlative thereto.

“Control Agreement” means an authenticated record, as that term is used under UCC §9.104(1)(B), in form and substance substantially similar to Exhibit XVI attached hereto or as otherwise reasonably acceptable to the Administrative Agent.

“Credit Suisse” means Credit Suisse, Cayman Islands Branch, or one or more of its other branches and any Affiliate thereof.

“Debt Service” means, for any period, all payments of interest and all scheduled and voluntary prepayments of principal made during such period for all Indebtedness of the Borrower and its Subsidiaries.
Loan Problem #1

- Loan to Value:
  - The Club had recently been appraised for $420 million.
  - The $375 million loan, consequently, would have an absurd loan to value ratio of 90%.
  - Credit Suisse needed a new (higher) valuation.
  - So it instructed Cushman & Wakefield to apply something novel, which it called the “Net Total Value” methodology.
  - Using a zero discount rate, Cushman & Wakefield was able to “value” the property at $1.2 billion. Voila! A 30% LTV.
  - New problem: NTV methodology is illegal under FIRREA for US banking entities: Thus, while the loan was developed by Credit Suisse First Boston, it was ultimately made by Credit Suisse, Cayman Islands Branch.
Loan Problem #2

- Distributions or Loans:
  - This was not the first such “equity recap” loan that Credit Suisse had made to a luxury resort. But the prior loans had all provided solely for “distributions” to the members (owners) of the resort.
  - Here, however, Tim Blixseth was not the only member; Greg LeMond, the legendary cyclist, was also a member of Yellowstone. (And a member of the UCC.)
  - Tim did not want to share his “distribution” with his other members, so Credit Suisse agreed to revise the loan agreement to provide for “distributions or loans” so Tim could tell Greg that he’d simply taken a loan, and there had been no “distribution.”
Loan Problem #3

- With nearly all the loan proceeds being taken out of the development, Yellowstone was left with unreasonably small capital to pay its debt.
- There was a dispute at trial about how badly Yellowstone missed its projections for 2005, the year in which it took the Credit Suisse loan.
- In its decision, the Montana Court stated,
  - Whatever the accurate number, it is clear that even though the Debtors' had nine months of operations under their belt before the September 30, 2005, Credit Agreement, they missed their profitability projections by a substantial amount. Such numbers show that Debtors' projections for the future, upon which Credit Suisse relied without question, had no foundation in historical reality.
Loan Problem #4

- “In 2005, Credit Suisse had a new financial product for sale”
  - Same type of loan made to numerous luxury resorts:
    - Promontory
    - Lake Las Vegas
    - Ginn
    - Turtle Bay
    - Tamarac
    - Others
  - Every single one of these resorts has since failed financially.
Loan Problem #5

- Credit Suisse’s risk and fees:
  - In connection with making this loan for $375 million, Credit Suisse syndicated 100% of it. Credit Suisse had no credit risk.
  - Nevertheless, Credit Suisse made more than $7.5 million in fees in connection with making this loan.
  - Credit Suisse was in the business of making money selling resorts the seeds of their own destruction.
Loan Problem #6

- Should be obvious:
  - The Yellowstone Club was obligated to repay the loan,
  - But Tim Blixseth got all the money, and
  - Tim Blixseth did not sign a guarantee.
  - Thus it was a fraudulent transfer: the debtor got less than reasonably equivalent value and the transfer left it with unreasonably small assets and unlikely to pay its debts as they mature
The Bankruptcy

- Filed in October, 2008.
- Trade creditors owed approximately 20 million.
- Interim DIP by Credit Suisse, which then failed to fund the permanent DIP and proposed a chapter 7.
- Permanent DIP by Sam Byrne ($30 million) to keep the Club afloat until May 31, 2009.
- Credit Suisse’s adequate protection was a 20% equity cushion that would be eaten up by the DIP.
- Consequently, a resolution was necessary by May 31, 2009.
Sam Byrne – DIP Lender
The Litigation

- Fast Track – 10 weeks from UCC request for standing to Court’s decision: 25 depositions; 200,000 documents; emergency telephonic hearings almost every day.
- UCC’s standing.
- Credit Suisse’s lawsuit against UCC.
- Tim Blixseth’s intervention.
- Primary focus of UCC lawsuit: Fraudulent transfer.
- Problem: $300 million CS claim; $30 million UCC claim.
- Secondary (but necessary) focus: Equitable Subordination.
Credit Suisse v. UCC
Credit Suisse v. UCC
All the Red Flags

- “for purposes unrelated”
- “distributions or loans”
- Illegal “net total value” valuation,
- “Credit Suisse, Cayman Islands Branch,”
- No meaningful due diligence; projections with no historical basis.
- Yellowstone was just one of many Credit Suisse borrowers that failed financially,
- Credit Suisse earned huge fees, but took no risk itself, syndicating the risk to various hedge funds.
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, 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.
The Decision

- Against Credit Suisse only, not Tim Blixseth.
- Court made all the Fraudulent Transfer findings, but then awarded Equitable Subordination. Why?
  - Unsecured creditors’ (trade) claims ($30m) would have been overwhelmed by Credit Suisse’s $300 million unsecured claim:
    - The trade would have received only 9% of any recovery.
    - With equitable subordination, the Court assured that the trade creditors would be paid in full.

- If the judgment were for fraudulent transfer, Credit Suisse could not credit bid.
The Settlement

- A settlement was reached in the midst of an auction between Credit Suisse and Sam Byrne, the DIP lender.
- Credit Suisse had to start with cash, then it could credit bid.
- Sam Byrne started with credit (the DIP), then he had to bid cash.
- The settlement resulted in Sam purchasing the Club:
  - He gave Credit Suisse a secured note for $80 million. (This is a 25% recovery for CS.)
  - He promised the UCC that he would purchase up to $27 million of trade claims.
  - Credit Suisse agreed to subordinate future recoveries from Tim Blixseth to repaying Sam on those trade claims first.
  - The Montana Court's decision was vacated.
The Aftermath

- Virtually all unsecured claims were purchased by Sam at par within 90 days of the Effective Date. All trade claims have been paid in full.
- Court’s decision regarding Tim Blixseth is expected any day. If Tim disgorges $100 million, Credit Suisse will have a 50% recovery.
- In Promontory, by contrast, Credit Suisse lost all of its (participants’) $300 million loan. (Still, the trade debt did get paid in full.)
Lessons Learned

- The law on equitable subordination offers little guidance other than that the claims of non-insiders will not be subordinated unless the facts show that those claims resulted from activities that “shock the conscience of the court.”
- In Yellowstone, the facts showed Credit Suisse’s naked greed.
- Naked greed shocks the conscience of the court.