



# BANKRUPTCY ALERT

## MAY 2009

### *Secured Lenders Beware: You May Not Be*

In a ruling that should sound the alarm for secured creditors, a bankruptcy court has equitably subordinated the claim of a first-lienholder to the claims of a debtor's unsecured trade creditors. Though the ruling is narrowly tailored to the facts of the case, debtors and subordinated creditors may use it to attack the sanctity of first liens in other cases.

#### **The Case**

The owner of an exclusive golf and ski community in Montana filed for bankruptcy. The first lienholder is a lending syndicate led by Credit Suisse. The unsecured creditors' committee challenged the lien because of Credit Suisse's conduct in making the loan, and on May 13, the Montana Bankruptcy Court equitably subordinated the lenders' \$232 million claim to those of the local trade creditors.

#### **The Effect on You**

The equitable subordination of the claim of a non-insider, non-fiduciary lender is extremely rare, and the good news for secured creditors is that the court's decision is based on unusual facts and appears to be designed to protect the interests of local unsecured trade creditors. However, the decision may have significant implications for secured creditors, who can expect that distressed borrowers and creditors' committees seeking to challenge their claims will cite this case to justify equitable subordination on novel grounds. Aggressive commercial borrowers may go so far as to challenge their senior lenders' claims on what have previously been considered frivolous grounds, such as "they shouldn't have made me a loan because they knew I couldn't repay it."

#### **How to Protect Yourself**

This ruling is very fact-specific, and it is unlikely that you will find yourself in Credit Suisse's position. But it's helpful to know what caused the court to toss out their first lien. If you can avoid these factors in the future, it will be harder for borrowers to use this case to challenge your position.

- Require the loan proceeds to be used only for the project you're financing. In this case, the loan documents expressly permitted \$209 million of the \$375 million loan proceeds to be distributed to the borrowers' owners for purposes unrelated to the project, and the investment of another \$142 million from the loan into "unrestricted subsidiaries" for purposes unrelated to the project.
- Do your due diligence. Credit Suisse never requested audited financial statements from the borrowers and relied on the borrowers' projections that had no foundation in reality.
- Don't make a loan you know the debtor can't repay. Given the debtors' prior history, Credit Suisse could not have believed under any circumstances that the debtors could service the loan.

HERRICK

#### **New York Office**

2 Park Avenue  
New York, New York 10016  
Phone: (212) 592-1400  
Fax: (212) 592-1500

#### **Princeton Office**

210 Carnegie Center  
Princeton, New Jersey 08540  
Phone: (609) 452-3800  
Fax: (609) 520-9095

#### **Newark Office**

One Gateway Center  
Newark, New Jersey 07102  
Phone: (973) 274-2000  
Fax: (973) 274-2500

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It has been reported that after this ruling was issued, Credit Suisse, the debtors and the creditors' committee reached a settlement and that the court's decision may be vacated. But the risk is there, and you should be aware that the ruling will embolden debtors and unsecured creditors' committees.

For more information regarding this decision or other lender liability issues, please contact Paul Rubin (212) 592-1448 or [prubin@herrick.com](mailto:prubin@herrick.com) or Gary Eisenberg (973) 274-2055 or [geisenberg@herrick.com](mailto:geisenberg@herrick.com).

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