# LENDING AND RESTRUCTURING ALERT
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**Warehouse Lender Avoids Equitable Subordination**

As lenders face heightened concerns about liability for the misconduct of their borrowers, a recent decision in California federal court may provide a measure of relief. The court rejected efforts by a bankruptcy liquidating trustee to equitably subordinate the $83 million claim of a warehouse lender that was found to have substantially assisted a mortgage originator in its fraudulent lending practices. This decision illustrates that it is quite difficult for a debtor or trustee to achieve equitable subordination of the claim of a non-fiduciary, non-insider.

**Understanding Equitable Subordination**

Equitable subordination is designed to adjust the equities between creditors who share in distribution from a debtor's estate. It is a seldom-applied remedy that may be utilized where: (1) a fiduciary of the debtor misuses its position to the disadvantage of others; (2) a third party dominates or controls a debtor to the disadvantage of others; or (3) a third party defrauds other creditors. The burden of proof and severity of conduct necessary to support an equitable subordination claim are considerably higher where the creditor is a nonfiduciary, non-insider.

In this particular case, the mortgage originator's sales force defrauded borrowers by convincing them to take out loans containing hidden and egregious fees, points and prepaid interest. The court determined that the lender, a prominent financial institution, knew, when it provided the originator a $150 million warehouse line of credit, and when it thereafter extended the loan and assisted the mortgage originator in securitizing pools of loans, that the mortgage originator was engaging in fraudulent practices designed to induce consumers to obtain loans. The court found that the lender significantly, actively and knowingly participated in the originator's fraud and substantially assisted in its fraudulent lending practices. But the court also found that, while the lender's conduct was "inequitable" in a general sense, it was not sufficiently egregious to warrant equitable subordination of its claim.

**Why Wasn't The Lender's Claim Equitably Subordinated?**

The court identified the following factors to support its holding that the lender did not engage in inequitable conduct sufficient to warrant equitable subordination of its claim: (1) the lender's conduct did not deplete or otherwise adversely impact the debtor's assets, nor were they related to its acquisition of its claim; (2) the lender did not have any communications with the borrowers, nor did it have any relationship with them; (3) the lender's provision of services to the mortgage originator did not result in misappropriation of funds by the debtor or otherwise increase the amount of its unsecured debt; (4) the lender's activities were undertaken at arms-length, in the normal course of business, without contemplation of the originator's bankruptcy; (5) the lender's conduct was not a contributing factor to bringing about the bankruptcy or determining the order of


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creditors of the estate; and (6) the lender’s conduct did not demonstrate “gross” or “egregious” misconduct to shock the conscience of the court.

**Analysis & Implications**

One could disagree with the court’s conclusion that the lender’s conduct did not result in misappropriation of funds by the debtor or increase the amounts of its unsecured debt. Arguably, by satisfying the originator’s financing needs, the lender kept the originator in business and enabled it to defraud more borrowers who ultimately would have claims against the originator’s bankruptcy estate. Nevertheless, the thrust of this decision is that courts are generally reluctant to equitably subordinate claims of non-fiduciary, non-insiders. Equitable subordination requires courts to make extremely subjective judgments concerning such creditors’ conduct, while starting from the proposition that equitable subordination is rarely granted against them. It is worth bearing in mind, however, that equitable subordination litigation, even where the lender ultimately beats back the challenge, can be protracted and expensive. For example, in this case, the federal court issued its decision after conducting a trial between February 13, 2003 and May 22, 2003 and considering written submissions from counsel.

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