

A Rogue Loan, Not a Rogue Decision: A Response to a Recent Analysis of *Yellowstone*¹

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In the November 2009 *ABI Journal*, **Jo Ann J. Brighton** and **Felton E. Parrish**, attorneys at K&L Gates in Charlotte, N.C.,³ portray Bankruptcy Judge **Ralph B. Kirscher**'s recent decision in the *Yellowstone Club* case, in which he equitably subordinated Credit Suisse's secured loan to the claims of unsecured creditors as an anomalous and "disturbing" decision that would never "have withstood scrutiny on appeal."⁴ Their conclusions are premised on two suppositions: (1) that Credit Suisse's loan "was a fairly standard syndicated loan transaction,"⁵ and (2) that Judge Kirscher's primary concern was that Credit Suisse was "not going to be a long-term lender but instead was motivated by earning fees through the syndication process."⁶ However, these suppositions are wholly invalidated by Judge Kirscher's findings, which make it abundantly clear why it is Credit Suisse's loan—and not the court's decision—that must be viewed as anomalous.

An Anomalous Financial Product for Sale

In his decision, Judge Kirscher found that:

In 2005, Credit Suisse was offering a new financial product for sale. It was offering the owners of luxury second-home developments the opportunity to take their profits up front by mortgaging their development projects to the hilt. Credit Suisse would loan the money on a non-recourse basis, earn a substantial fee, and sell off most of the

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credit to loan participants. The development owners would take most of the money out as a profit dividend, leaving their developments saddled with enormous debt. Credit Suisse and the development owners would benefit, while their developments—and especially the creditors of their developments—bore all the risk of loss. This newly developed syndicated loan product enriched Credit Suisse, its employees and more than one luxury development owner, but it left the developments too thinly capitalized to survive. Numerous

to—to make its loan and pocket its fee—were shocking: Lending other people's money, Credit Suisse sold a colossal and unnecessary loan to the owner of the *Yellowstone Club*, a loan that *Yellowstone* could not possibly repay. It repeated this at numerous other luxury resort developments, and they all failed. Credit Suisse created a profitable business selling luxury resorts the seeds of their eventual financial demise.

A Loan for "Purposes Unrelated" to the Borrower's Business

Originally, Credit Suisse proposed to loan \$150 million to the *Yellowstone Club*. The loan was not intended to provide working capital for *Yellowstone* to execute its business plan. In fact, a salient feature of the loan was that the lion's share of its proceeds would *not* benefit *Yellowstone*—a whopping 94 percent of the loan proceeds were stipulated by Credit Suisse to be used "for

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entities that received Credit Suisse's syndicated loan product have failed financially, including Tamarack Resort, Promontory, Lake Las Vegas, Turtle Bay and Ginn. *If the foregoing developments were anything like [Yellowstone], they were doomed to failure once they received their loans from Credit Suisse.*⁷

Judge Kirscher subordinated Credit Suisse's loan to the claims of *Yellowstone Club*'s unsecured creditors because "the naked greed in this case combined with Credit Suisse's complete disregard for the Debtors or any other person or entity... shocks the conscience of the Court."⁸ If Credit Suisse had simply earned a fee for writing a "fairly standard" syndicated loan—as Brighton and Parrish submit—that would not have been controversial, but the lengths that Credit Suisse went

purposes unrelated" to *Yellowstone*'s business.⁹ The purpose of the loan was not to plow money into the business; it was to take money out. "[T]he transfer of loan proceeds *out* of the *Yellowstone Club* was a key feature of the product that Credit Suisse used to sell the loan."¹⁰

Ultimately, Credit Suisse loaned \$375 million to the *Yellowstone Club*.¹¹ The increase in the proposed loan—*nearly a quarter of a billion dollars*—was not driven by the borrower's business needs. Rather,

the Credit Suisse team only earned fees if they sold loans. Credit Suisse thus devised a loan scheme whereby it encouraged developers of high-end resorts, such as [Tim] Blixseth [the majority owner of the *Yellowstone Club*], to take unnecessary loans. The higher the loan amount, the fatter the fee to Credit Suisse.¹²

¹ Brighton, Jo Ann J., and Parrish, Felton E., "Yellowstone: New Standards for Lender Liability in Today's Economic Climate," *Am. Bankr. Inst. J. Vol. XXVIII, No. 7* (September 2009) 28, 84.

² The author and his firm represented the creditors' committee in the *Yellowstone* litigation and the underlying *Yellowstone* bankruptcy case. Michael Young and David Billings, associates at the firm, assisted greatly in both the trial and the preparation of this article. The litigation was co-prosecuted by the committee and the debtors. The debtors were masterfully represented by James A. Patten of Patten, Peterman, Bekkedahl & Green PLLC and Troy Greenfield, Thomas L. Hutchinson, David A. Ernst and Connie Sue Martin at Bullivant Hauser & Bailey PC.

³ K&L Gates represented Timothy Blixseth, a defendant in the *Yellowstone* litigation, in the underlying *Yellowstone* bankruptcy case. See *In re Yellowstone Mountain Club LLC, Yellowstone Dev. LLC, Big Sky Ridge LLC and Yellowstone Constr. Co. LLC*, Case No. 08-61570-RBK (Bankr. D. Mont. 2009), Docket No. 442.

⁴ Brighton and Parrish at 84.

⁵ *Id.* at 28.

⁶ *Id.* at 28, 84.

⁷ *Credit Suisse, Cayman Islands Branch and Timothy L. Blixseth v. Official Comm. of Unsecured Creditors, Yellowstone Mountain Club LLC, Yellowstone Dev. LLC, Big Sky Ridge LLC and Yellowstone Construction Company LLC*, Case No. 09-00014-RBK (Bankr. D. Mont. 2009), Docket No. 289 (Opinion) at 16 (emphasis added).

⁸ Opinion at 19. See also *id.* at 15 ("Credit Suisse's actions in this case were so far overreaching and self-serving that they shocked the conscience of the Court.").

⁹ See *id.* at 10.

¹⁰ *Id.* at 12. (Emphasis added.)

¹¹ See *id.* at 6.

¹² *Id.* at 17.

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Indeed, most of the loan proceeds went directly to Blixseth for his personal use. “Credit Suisse had not a single care how Blixseth used...the loan proceeds, and in fact authorized Blixseth to take \$209 million and use it [and another \$142 million] for any purpose unrelated to the Yellowstone Club.”¹³ Blixseth took Credit Suisse’s authorization to heart, purchasing jewelry, luxury cars, yachts, private jets, a golf course in Scotland, a resort in Mexico, an island in the Caribbean, a castle in France and so on.

Nonexistent Due Diligence

With nearly all the loan proceeds leaving the club, and with its debt burden increasing 18-fold with the Credit Suisse loan,¹⁴ Yellowstone’s ability to repay the loan should have been a primary concern for Credit Suisse. Not so. Although Credit Suisse testified that it conducted “a fair amount of due diligence,”¹⁵ the bankruptcy court found that it never even requested audited financial statements from Yellowstone, and concluded that Credit Suisse’s due diligence was “all but non-existent.”¹⁶ Credit Suisse simply “relied without question”¹⁷ on Blixseth’s financial projections.

Unfortunately, those projections “had no foundation in historical reality.”¹⁸ The club “had experienced negative cash flows in several of the years leading up to the Credit Agreement with Credit Suisse.”¹⁹ Even so, Blixseth bullishly projected more than \$83 million in EBITDA for 2005, the year during which the loan was made.²⁰ There was some disagreement at the trial

about Yellowstone’s exact financial performance in 2005.²¹ However, “[w]hatever the accurate number, it is clear that even though the Debtors had nine months of operations under their belt before the Sept. 30, 2005, [loan closing], they missed their [2005] profitability projections by a substantial amount.”²²

The Credit Suisse loan left the Yellowstone Club “too thinly capitalized to survive.”²³ “[T]he Credit Suisse syndicated loan team could not have believed under any set of circumstances that the Debtors could service such an increase[d] debt load.”²⁴ The Yellowstone Club was doomed to failure once it received its loan from Credit Suisse.²⁵

Brighton and Parrish contend that Credit Suisse did nothing “materially different than any other arranger of syndicated loans.” Not so. The evidence adduced at trial, as reported in Judge Kirscher’s decision, resoundingly disproves that contention.

A Noncompliant Appraisal

Prudent real estate loans are supported by conservative real estate appraisals. The Financial Institutions Recovery Reform Act of 1989 (FIRREA) requires that such appraisals reflect the fair-market value of the loan collateral. The Yellowstone Club commissioned a “fair market value” appraisal in 2004²⁶ before Credit Suisse made its loan to the club in 2005. That appraisal discounted

the projected future cash flows from the club at an 18.5 percent discount rate and valued the Club at \$420 million.²⁷ A Credit Suisse employee testified that Credit Suisse was aware of this appraisal at the time it made its loan.²⁸

However, this \$420 million appraisal created a problem for Credit Suisse with respect to its \$375 million proposed loan—it yielded a fearsome 90 percent loan-to-value ratio.²⁹ Credit Suisse had developed a “new form of appraisal methodology which [it] termed ‘total net value.’”³⁰ This new methodology was not intended to provide a “fair market value” appraisal of the loan collateral. Rather, it was simply an arithmetic summation of all projected future cash flows. In effect, it utilized a discount rate of 0 percent.³¹ Consequently, it did not comply with FIRREA, so Credit Suisse had to fund the Yellowstone loan through its Cayman Islands Branch, which is not subject to FIRREA (although Credit Suisse had no physical presence in the Cayman Islands, it still claimed to have a “Cayman Islands Branch”).³² The result of this new methodology was an appraised “value” of the club of \$1.16 billion.³³ Voila! Credit Suisse’s proposed loan could now boast a 35 percent loan-to-value ratio.

The bankruptcy court found particularly damning Credit Suisse’s decision to rely “solely” on the newly-devised “total net value” methodology.³⁴ As it explained, Credit Suisse

knew or should have known that the collateral that Blixseth proposed for the Credit Suisse loan had a fair market value of \$420 million in 2004. The Court highly doubts that Credit Suisse could have successfully

¹³ *Id.*

¹⁴ “The day before the loan transaction, the Yellowstone Club carried approximately \$19 [million to] \$20 million in debt on its books.” *Id.* at 10.

¹⁵ *Id.* at 7.

¹⁶ *Id.* at 18. See also *Murphy v. Meritor Sav. Bank (In re O’Day Corp.)*, 126 B.R. 370, 381 (Bankr. D. Mass. 1991) (“Notwithstanding the availability of current information about the company’s financial performance, neither Funston nor Meritor took steps to revise the reduced sales scenario projections, which implicitly assumed a gross profit margin of 21.84 percent.”).

¹⁷ *Id.* at 11.

¹⁸ *Id.* See also *Moody v. Sec. Pac. Bus. Credit Inc.*, 971 F.2d 1056, 1073 (3d Cir. 1992) (“[R]eliance on historical data alone is not enough. To a degree, parties must also account for difficulties that are likely to arise, including interest rate fluctuations and general economic downturns, and otherwise incorporate some margin for error.”); *ASARCO LLC v. Americas Mining Corp.*, 396 B.R. 278, 398-99 (S.D. Tex. 2008) (court should only consider those cash inflows that are reasonable for debtor to have expected to receive); *Peltz v. Hatten*, 279 B.R. 710, 744 (D. Del. 2002) (court must look at whether financial projections were objectively reasonable); *Pajero Dunes Rental Agency v. Spitters (In re Pajero Dunes Rental Agency Inc.)*, 174 B.R. 557, 593 (Bankr. N.D. Cal. 1994) (if cash-flow projections and other forward-looking sources utilized at time of transfer were “flawed and overly optimistic from the beginning, then they were unreasonable”).

¹⁹ Opinion at 10.

²⁰ See *id.* at 11.

²¹ See *id.*

²² *Id.*

²³ Brighton and Parrish chide the creditors’ committee for throwing the “kitchen sink” at Credit Suisse. See Brighton and Parrish at 28. In fact, the committee’s complaint simply showed how many claims and causes of action arise from a set of facts that show that a lender knew or should have known that its loan would cause substantial and unnecessary harm to its borrower and its borrower’s unsecured creditors.

²⁴ Opinion at 18.

²⁵ See *id.* See also *ASARCO LLC v. Americas Mining Corp.*, 396 B.R. 278, 398-99 (S.D. Tex. 2008) (“In 2003, ASARCO might accurately have been described as insolvent and ‘doomed to failure.’”); *MFS/Sun Life Trust-High Yield Series v. Van Dusen Airport Servs. Co.*, 910 F.Supp. 913, 944 (S.D.N.Y. 1995) (stating that unreasonably-small-assets test “is aimed at transfers that leave the transferor technically solvent but doomed to fail”); *Daley v. Chang (In re Joy Recovery Tech. Corp.)*, 286 B.R. 54, 76 (Bankr. N.D. Ill. 2002) (“unreasonably small capital means... the transaction at issue put [the debtor] on the road to ruin.”).

²⁶ See Opinion at 18.

²⁷ See *id.* at 8.

²⁸ See *id.*

²⁹ See *id.* at 18.

³⁰ The methodology was subsequently renamed “total net proceeds,” as Cushman & Wakefield was uncomfortable with the word “value” even being associated with the technique. For a definition of total net proceeds, see *In re Yellowstone Mountain Club LLC, Yellowstone Dev. LLC, Big Sky Ridge LLC and Yellowstone Constr. Co. LLC*, Case No. 08-61570 (Bankr. D. Mont.), Docket No. 181 at 8 n.4.

³¹ See *id.*

³² Opinion at 6.

³³ See *Credit Suisse, Cayman Islands Branch and Timothy L. Blixseth v. Official Committee of Unsecured Creditors, Yellowstone Mountain Club LLC, Yellowstone Development LLC, Big Sky Ridge LLC and Yellowstone Construction Company LLC*, Case No. 09-00014-RBK (Bankr. D. Mont. 2009), Exhibit CS 4.

³⁴ See Opinion at 8; *In re O’Day Corp.*, 126 B.R. at 379 (“[T]here was information available to Funston and the Bank in the files of the company...all of which highlight the general cyclical nature of the industry and the company’s earnings.”).

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syndicated the Yellowstone Club Loan if the loan to value ratio was 90 percent.³⁵

Distribution “or Loans”

“Similar to [Credit Suisse’s] syndicated loans [to other resort developments], the Yellowstone Club Credit Agreement was originally drafted to provide that the proceeds of the loan would be used, in part, for ‘distributions’ to the members of the borrower.”³⁶ “Blixseth, however, had a problem in this case.”³⁷ First, “he was not the sole owner of the Yellowstone Club and he did not want to share the loan proceeds with the B shareholders.”³⁸ Second, he “would have tax consequences on a distribution.”³⁹ Third, “recording such a large distribution on the Debtors’ books would result in negative owners’ equity accounts.”⁴⁰ The Yellowstone Club Credit Agreement was revised to insert the phrase “or loans” after the word “distribution” in reference to the \$209 million that was destined for Blixseth’s personal account.⁴¹ With this modification, Credit Suisse gave Blixseth the option to take the \$209 million out as a distribution or (wink, wink) as a loan. Incidentally, the “transfer of funds out of the Yellowstone Club to... Blixseth was not memorialized in any contemporaneous loan documents but was simply reflected on the Debtors’ books with a journal entry.”⁴² It was only

after the minority members threatened to sue, some eight months later, that Blixseth drafted and executed a two-page promissory note for \$209 million and backdated it to Sept. 30, 2005, the date of the Credit Suisse loan.⁴³

Credit Suisse knew that Blixseth had minority shareholders,⁴⁴ including legendary cyclist Greg LeMond. “A sophisticated lender such as Credit Suisse [also] had to have known what a distribution would do to the Debtors’ financial statements, and in particular, their balance sheets.” Yet, despite the paucity of any documentation of a bona fide “loan” from Yellowstone to Blixseth, “Credit Suisse proceeded with the loan, and thus earned its large fee.”⁴⁵

All the Red Flags

The Credit Suisse loan to the Yellowstone Club was unnecessary. The purpose of the loan was not to benefit the club but to take money out of the club for the exclusive enjoyment of its owner. The colossal size of the Credit Suisse loan was justified by fictitious projections and an appraisal that did not comply with U.S. law. Credit Suisse did no meaningful due diligence. The club could not possibly repay the loan. Nevertheless, “[d]espite all the red flags, the Credit Agreement was consummated”⁴⁶ and Credit Suisse was paid its fee. Justifiably, these facts persuaded the bankruptcy court that:

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... 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.⁴⁷

Conclusion

Brighton and Parrish contend that Credit Suisse did nothing “materially different than any other arranger of syndicated loans.”⁴⁸ Not so. The evidence adduced at trial, as reported in Judge Kirscher’s decision, resoundingly disproves that contention. Yellowstone’s lesson for secured lenders is not that “creditors’ committees have every incentive to be as creative and aggressive as possible...in cases where the perception is that the secured lenders made too much money on a particular deal.”⁴⁹ Rather, Yellowstone’s lesson is that when secured lenders make reckless loans that harm their borrowers and their borrowers’ trade creditors, there will be debtors and committees and courts aplenty willing and able to hold them fully accountable. ■

³⁵ Opinion at 18.

³⁶ *Id.* at 8.

³⁷ *Id.* at 17.

³⁸ *Id.*

³⁹ *Id.* at 8.

⁴⁰ *Id.*

⁴¹ *Id.* at 9.

⁴² *Id.* at 12.

⁴³ See *id.* at 12. See also *Williams v. Commissioner*, 627 F.2d 1032, 1035 (10th Cir. 1980) (citing a “failure to execute notes until the tax problems became acute”).

⁴⁴ See *id.* at 9.

⁴⁵ *Id.* at 18.

⁴⁶ *Id.* at 11.

⁴⁷ *Id.* at 19.

⁴⁸ Brighton and Parrish at 84.

⁴⁹ *Id.*

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