

---

---

## ARTICLES

# GOVERNANCE IN THE BREACH: CONTROLLING CREDITOR OPPORTUNISM

JONATHAN C. LIPSON\*

I. INTRODUCTION.....	1036
II. THE ROOTS AND DEFINITION OF CREDITOR OPPORTUNISM.....	1046
A. THE OLD MODEL—THE WORKOUT AND MICRO-GAPS .....	1046
B. THE NEW MODEL—SHADOW BANKRUPTCY AND MACRO- GAPS .....	1048
C. DEFINING CREDITOR OPPORTUNISM.....	1049
III. OPPORTUNITIES FOR OPPORTUNISM.....	1051
A. SELF-DEALING .....	1051
B. HOLDING OUT .....	1054
C. INSIDER TRADING.....	1058
IV. THE RISE AND DEMISE OF LENDER LIABILITY 1.0.....	1059
A. THE RISE OF LENDER LIABILITY 1.0—COMMUNITARIAN VALUES AND THE CIVIL JURY .....	1060
B. THE DEMISE OF LENDER LIABILITY 1.0—CONTRACTS, NOT COMMUNITIES .....	1064

---

\* Foley & Lardner Professor of Law, University of Wisconsin Law School. This Article has benefited from comments and discussions with Song Baio, Craig Green, Larry Hamermesh, Michelle Harner, Dave Hoffman, John Huber, Darian Ibrahim, Randall Klein, Kathleen Noonan, Lynn Stout, Harwell Wells, and Bill Whitford. Maryellen Fields, Paris Glazer, Erica Maier, Christopher Marotta, Ryan Moore, and Jennifer Torbeck provided helpful research assistance. I thank Deans Kenneth B. Davis, of the University of Wisconsin Law School, and Joanne Epps, of Temple Law School, as well as the University of Wisconsin East Asian Legal Studies Center and its director, John Ohnesorge, for supporting this work. Earlier versions were presented at workshops at Temple Law School, Tsinghua University School of Law, and Renmin (People's) University Law School. Errors and omissions are mine alone. © 2011 Jonathan C. Lipson, all rights reserved.

C. SUMMARY .....	1067
V. THREE MODELS OF GOOD FAITH.....	1069
A. BILATERAL GOOD FAITH—GOOD FAITH IN TRADITIONAL CONTRACT DOCTRINE—THE EXISTENTIAL QUESTION .....	1069
B. MULTILATERAL GOOD FAITH—GOOD FAITH IN CORPORATE GOVERNANCE—REREADING CREDIT LYONNAIS.....	1073
1. Good Faith in Corporate Governance Generally .....	1073
2. Good Faith and Governance of the Distressed Firm.....	1076
C. INSTITUTIONAL GOOD FAITH—GOOD FAITH BANKRUPTCY FILINGS .....	1081
VI. CONTROLLING CREDITOR OPPORTUNISM—LENDER LIABILITY 2.0 .....	1085
A. CONCEPTUAL CORRECTIONS .....	1085
1. Good Faith and Disclosure .....	1086
2. Good Faith and Choice .....	1087
B. PROCEDURAL GOOD FAITH—THE INSTITUTIONAL CHOICE...	1088
VII. OBJECTIONS AND FURTHER INQUIRY .....	1091
A. OBJECTIONS .....	1091
1. Good Faith as Independent Cause of Action .....	1091
2. Remedial Redundancy .....	1092
a. Fiduciary Review .....	1092
b. Traditional Bankruptcy-Related Powers.....	1094
B. FURTHER INQUIRY .....	1096
1. Standing.....	1096
2. Remedy.....	1096
3. Relationship to Other Doctrine.....	1097
VIII. CONCLUSION.....	1097

## I. INTRODUCTION

Firms rarely go from solvency to Chapter 11 in an instant.<sup>1</sup> Instead, the slide into bankruptcy will be marked by a period (the “zone of

1. Enacted in 1978, Chapter 11 of the United States Bankruptcy Code is the predominant—but by no means only—legal system for resolving corporate financial distress. Congress enacted the first version of the current Bankruptcy Code in 1978, Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (codified as amended primarily at 11 U.S.C. §§ 101–1532 (2006) and in scattered sections of 28 U.S.C.), and has amended it several times, most recently in 2005. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23 (codified as amended in scattered sections of 11, 18, 28 U.S.C. (2006)). Chapter 11 of the Bankruptcy Code appears in 11 U.S.C. §§ 1101–1174 (2006).

distress<sup>2</sup>) that begins with the breach of a lending contract<sup>3</sup> and ends, perhaps months or even years later, with either a formal bankruptcy case or some other resolution, such as a nonbankruptcy restructuring or liquidation.

In this period, the firm's governance will be up for grabs. Doctrinally, state corporate law gives directors the power and responsibility to manage the firm for the benefit of shareholders, subject to fiduciary review.<sup>4</sup> In fact, however, real control shifts away from directors and shareholders to creditors.<sup>5</sup> Yet, the law offers little to check this control. Creditors are not generally viewed as fiduciaries, and so they owe their borrowers neither duties of care nor loyalty.<sup>6</sup> In theory, regulation or contract could channel creditor conduct in the zone of distress, but three fundamental changes in the dynamics among distressed firms and their investors have weakened

---

2. I intentionally distinguish this from the "zone of insolvency" identified and developed in the controversial *Credit Lyonnais* decision. *Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp.*, No. 12150, 1991 Del. Ch. LEXIS 215, at \*107-08 (Del. Ch. Dec. 30, 1991). That case, which is discussed further in Part V below, has often mistakenly been viewed as creating directors' fiduciary duties to creditors when a firm is in the "vicinity of insolvency." *Id.* at \*108 n.55. This Article reinterprets *Credit Lyonnais*, showing that it may be better understood as a case about good faith.

3. Finance scholars have noted that, for a publicly traded company, the breach of a lending agreement signals to the market that its debt may be distressed, which, in turn, triggers trading in that debt. See Greg Nini, David C. Smith & Amir Sufi, *Creditor Control Rights, Corporate Governance, and Firm Value* (Working Paper Series, 2010), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1344302](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1344302).

4. See, e.g., DEL. CODE ANN. tit. 8, § 141(a) (2001) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors . . ."); MODEL BUS. CORP. ACT § 8.01(b) (2007) ("All corporate powers shall be exercised by or under the authority of the board of directors of the corporation, and the business and affairs of the corporation shall be managed by or under the direction, and subject to the oversight, of its board of directors . . .").

5. See Jonathan C. Lipson, *The Shadow Bankruptcy System*, 89 B.U. L. REV. 1609 (2009) [hereinafter Lipson, *Shadow Bankruptcy*]; Douglas G. Baird & Robert K. Rasmussen, *Antibankruptcy*, 119 YALE L.J. 648, 659 (2010); Stuart C. Gilson, *Bankruptcy, Boards, Banks, and Blockholders: Evidence on Changes in Corporate Ownership and Control when Firms Default*, 27 J. FIN. ECON. 355 (1990); Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669 (1993); Nini, Smith & Sufi, *supra* note 3 (presenting evidence of creditor control of distressed firms).

6. *Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting*, 908 F.2d 1351 (7th Cir. 1990). I acknowledge that in highly unusual cases, courts have treated a creditor as the principal of its debtor, and thus liable in a kind of fiduciary capacity for harm to the debtor. See, e.g., *Gay Jenson Farms Co. v. Cargill, Inc.*, 309 N.W.2d 285, 292-93 (Minn. 1981) (upholding jury finding that a debtor-creditor relationship had evolved into one of principal and agent because the lender was an "active participant" in the debtor's grain business, not "simply a financier"). See also RESTATEMENT (SECOND) OF AGENCY § 14O (1958) ("A creditor who assumes control of his debtor's business for the mutual benefit of himself and his debtor, may become a principal, with liability for the acts and transactions of the debtor in connection with the business."). As discussed in Part IV, however, fiduciary review and a variety of similar statutory and common law mechanisms that could check creditor misconduct have lost force since the late 1980s.

these constraints.

First, creditors today are organizationally (and probably culturally) very different entities than they once were. Unlike heavily regulated banks and institutional lenders of the past, today's creditors are often professional distress investors (e.g., hedge funds, private equity funds, investment banks), which are largely unregulated for these purposes.<sup>7</sup> Being unregulated, they have far greater latitude in what they can do for—or to—distressed firms and their stakeholders.<sup>8</sup>

Second, a key consequence of being unregulated is that private investors can hold complex, heterogeneous sets of claims against, or affecting, a distressed firm. They can, for example, hold debt and equity of various tranches,<sup>9</sup> as well as derivative securities, such as credit default swaps and equity short sales.<sup>10</sup> Such complex holdings may reflect rational

---

7. See Lipson, *Shadow Bankruptcy*, *supra* note 5, at 1638–60 (describing private distress investors).

8. We should not assume that if a lender is regulated (e.g., a commercial bank), it is necessarily more (or less) concerned with the welfare of its corporate borrower than an unregulated creditor. As others have argued, regulatory structures may, at least today, conflict in ways that lead regulated creditors to act antithetically to the long-term health of their borrowers. See, e.g., Sarah P. Woo, *Micro-Prudence, Macro-Risk: Where Financial Regulation Meets Bankruptcy* (N.Y.U. Sch. of Law Working Paper Series, 2010), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1639606](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1639606).

9. Mark Berman & Jo Ann J. Brighton, *Will the Sunlight of Disclosure Chill Hedge Funds? The Tale of Northwest Airlines*, AM. BANKR. INST. J., May 2007, at 24, 24 (“[H]edge funds are not confined to a single type of investment and might acquire an interest at any one or more places in a company’s capital structure . . .”); Marcel Kahan & Edward Rock, *Hedge Fund Activism in the Enforcement of Bondholder Rights*, 103 NW. L. REV. 281, 282 (2009) (“What distinguishes hedge funds from other investors is that hedge funds tend to pursue active and aggressive investment strategies. Thus, hedge funds use leverage, sell short, and invest in derivatives. They trade much more frequently than other investors.”).

10. A credit default swap is essentially a form of insurance that a creditor may purchase against the risk that a debtor defaults; if the debtor fails to pay, the insurer will. For more on concerns about credit default swaps see Henry T. C. Hu & Bernard Black, *Debt, Equity and Hybrid Decoupling: Governance and Systemic Risk Implications*, 14 EUR. FIN. MGMT. 663, 680–89 (2008) (discussing the use of credit default swaps and the implications for individual and systemic risks); Stephen J. Lubben, *Credit Derivatives and the Future of Chapter 11*, 81 AM. BANKR. L.J. 405, 427–30 (2007) (discussing concerns that credit default swaps will encourage riskier lending practices to maximize the debtor’s value); Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019, 1034–35 (2007) (explaining that credit derivatives may create perverse incentives for an investor to force the debtor into default and affirmatively destroy value); Mark J. Roe, *The Derivatives Market’s Payment Priorities as Financial Crisis Accelerator*, 63 STAN. L. REV. 539, 547–49 (2011) (arguing against extensive bankruptcy advantages for swaps).

The short sale of an equity security—

is the sale of a share that is borrowed from a third party rather than owned by the seller. At a later time, the short seller extinguishes the obligation to this third party by “covering”—purchasing an identical share in the market and then returning it to the third party. If the share price drops, the cost of covering will be less than the proceeds received earlier from the sale and the short seller will make money.

hedging strategies, reducing losses in the event of borrower distress (or recovery). They may, however, also reflect a desire to obtain the so-called “fulcrum” position: the maximum control for the minimum investment in the firm.<sup>11</sup> Traditional lenders, by contrast, generally held only debt, either by choice or regulatory fiat.<sup>12</sup> Either way, modern investors’ rights against or affecting distressed firms are often vastly more complex than were creditors’ rights in the past. This complexity can add significant transaction and agency costs to the price of resolving financial distress.

Third, private investors are often not a firm’s original lenders, but instead purchase debt claims at a discount on a secondary market.<sup>13</sup> This secondary debt market, which one observer characterizes as “the single most important development in the bankruptcy world since the Bankruptcy Code’s enactment in 1978,”<sup>14</sup> began to take off in the early 1990s. It permits private investors to buy and sell distressed debt claims—and the control they may reflect—quickly and opaquely in ways that can destabilize restructurings, driving up costs and reducing recoveries for firms’ less sophisticated or aggressive stakeholders.

Private distress investors are sometimes lauded as being “activists” for the liquidity and expertise they can bring to troubled firms.<sup>15</sup> Yet, they operate in an environment that is remarkably free from scrutiny. The secondary debt market is essentially an unregulated securities market.<sup>16</sup>

---

Merritt B. Fox, Lawrence R. Glosten & Paul C. Tetlock, *Short Selling and the News: A Preliminary Report on an Empirical Study*, 54 N.Y.L. SCH. L. REV. 645, 646 (2009/2010).

11. Mark S. Lichtenstein & Matthew W. Cheney, *Riding the Fulcrum Seesaw: How Hedge Funds Will Change the Dynamics of Future Bankruptcies*, N.J.L.J., Jan. 14, 2008, at S-14.

12. 12 U.S.C. § 1831w (2006) (governing commercial banks).

13. See Michelle M. Harner, *Trends in Distressed Debt Investing: An Empirical Study of Investors’ Objectives*, 16 AM. BANKR. INST. L. REV. 69 *passim* (2008). See also Lipson, *Shadow Bankruptcy*, *supra* note 5, at 1645 (discussing unregulated nature of claims trading market).

14. Adam J. Levitin, *Bankruptcy Markets: Making Sense of Claims Trading*, 4 BROOK. J. CORP. FIN. & COM. L. 67, 67 (2009).

15. See, e.g., Baird & Rasmussen, *supra* note 5, at 661 (discussing liquidity and expertise that private investors may bring to distressed firms). See also Robert Frank, *Tilton Flaunts Her Style at Patriarch*, WALL ST. J., Jan. 8, 2011, at B1 (describing one private investor’s strategy as being “to buy manufacturers headed for the scrap heap and bring them back to life with new management teams and products”).

The term “activism” in this context is usually associated with shareholders (not creditors) who seek to assert control of a firm in ways that may (or may not) benefit other shareholders and the firm as a whole. See Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255, 1258 (2008) (“Shareholder activism, accordingly, has been assumed to be a beneficial influence.”). Harvard law professor Lucian Bebchuk is among the most prominent advocates of shareholder activism. See generally Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005) (concluding that increasing shareholder power is desirable).

16. See Lipson, *Shadow Bankruptcy*, *supra* note 5.

Derivative rights have been (and are likely to remain) largely unregulated for this purpose.<sup>17</sup> Although the Securities and Exchange Commission (“SEC”) once played an important role in bankruptcy reorganizations, it has in recent years tended to ignore problems of financial distress, except those precipitated by notorious prebankruptcy securities fraud.<sup>18</sup> Bankruptcy courts have little power here, because the important action often occurs before (or in lieu of) bankruptcy, when controlling creditors may replace management of a distressed firm with professional “turnaround experts” whose loyalties may not run to the firm and its larger constituencies.<sup>19</sup> Being aimed at “systemic” effects, the 2010 Dodd-Frank financial reform appears unlikely to change much of this.<sup>20</sup>

It is thus not surprising that distress investors are sometimes tempted to be more than activists, and to act opportunistically. On a conventional definition, a creditor acts opportunistically when it “attempts to obtain, at the expense of the [debtor], a benefit not contemplated by the initial agreement, either explicitly or implicitly.”<sup>21</sup> Opportunism in the context of distressed firms can take many forms. Three especially troubling examples involve creditor self-dealing, holding out destructively in workout

---

17. The Dodd-Frank Wall Street Reform and Consumer Protection Act may indirectly result in regulation of derivative securities or certain entities (hedge funds) that trade in them. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) [hereinafter Dodd-Frank Act]. For example, Title VII of Dodd-Frank Act would require certain types of derivative securities to be reported and cleared publicly. Dodd-Frank Act §§ 723, 727, 124 Stat. at 1675–82, 1696–97. Similarly, hedge funds—one type of private distress investor—will be required to register with the Securities and Exchange Commission. § 403. Yet, these changes are largely peripheral to problems of creditor opportunism.

18. *See generally* Jonathan C. Lipson & Christopher M. DiVirgilio, *Controlling the Market for Information in Reorganization*, 18 AM. BANKR. INST. L. REV. 647 (2010) (describing changes in SEC’s role in bankruptcy).

19. *See, e.g.*, A. Mechele Dickerson, *Privatizing Ethics in Corporate Reorganizations*, 93 MINN. L. REV. 875, 876–77 (2009) (“[I]t is unclear how privatized trustees can adequately represent the interests of all parties in the case when they are hired because of, and often report to, one creditor or creditor group.”). To be sure, bankruptcy courts could do more to check creditor opportunism in cases where a bankruptcy is actually commenced, and Part VI offers suggestions to that end.

20. According to its preamble, Dodd-Frank Act seeks “[t]o promote the financial stability of the United States by improving accountability and transparency in the financial system, to end ‘too big to fail’, to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes.” Dodd-Frank Act Preamble, 124 Stat. at 1376. Indeed, section 202(c) of Dodd-Frank Act expressly provides that the newly created orderly liquidation power is an alternative to bankruptcy for distressed firms that the Secretary of the Treasury (in consultation with the Board of Governors of the Federal Reserve) deems “too big to fail.” § 203(a)(1)(F) (stating that a recommendation to commence an orderly liquidation proceeding under Dodd-Frank Act shall include “an evaluation of why a case under the Bankruptcy Code is not appropriate for the financial company.”).

21. Daniel R. Fischel, *The Economics of Lender Liability*, 99 YALE L.J. 131, 138 (1989).

negotiations, and insider trading with derivative securities affecting distressed borrowers.

In the case of self-dealing, creditors may force a troubled borrower to sell a valuable asset at below-market prices to an affiliate of the creditor, as happened in the 2007 *MarketXT* case.<sup>22</sup> In the case of holding out, distress investors may delay a restructuring that is otherwise wealth maximizing (or loss reducing) for the debtor and its other stakeholders because the investors have derivative rights that will pay more if the debtor's default persists, as allegedly happened with the Kellwood Companies.<sup>23</sup> The use of derivative securities can present other problems as well, in particular by abetting insider trading, which can push down the value of a firm's debt or shares, making recovery even more difficult.<sup>24</sup>

Problems of creditor opportunism are complex forms of rent seeking and externalization, social costs that markets themselves cannot police because those who seek or exert control—private investors—typically have little incentive to check their behavior. Those who are harmed—employees, smaller trade creditors, involuntary tort creditors, local taxing authorities—are simply not sufficiently well organized or represented to negotiate protections *ex ante*.<sup>25</sup> While certain forms of regulation might be appropriate, Congress has chosen to leave these problems to courts. Yet, the key courts that might address these problems—bankruptcy courts—often have little reach, because creditor control arises well before bankruptcy. Sophisticated creditors can, under certain circumstances, determine whether a distressed firm ever reaches bankruptcy court or heavily influence the outcome if it does.<sup>26</sup>

---

22. *In re MarketXT Holdings Corp.*, 361 B.R. 369, 387 (Bankr. S.D.N.Y. 2007). The *MarketXT* case is described in Part III.

23. See discussion *infra* Part III.B.

24. See Viral V. Acharya & Timothy C. Johnson, *Insider Trading in Credit Derivatives*, 84 J. FIN. ECON. 110 (2007); Nadia Massoud et al., *Do Hedge Funds Trade on Private Information? Evidence from Syndicated Lending and Short-Selling*, 99 J. FIN. ECON. 477 (2011), available at <http://ssrn.com/abstract=1462561>. See also Gregory Zuckerman, *Hedge-Fund Lending Draws Scrutiny*, WALL. ST. J., July 3–4, 2010, at B1; discussion *infra* Part III.C.

25. I have elsewhere characterized these sorts of creditors as having low levels of “volition, cognition, and exit” (“VCE”). See Jonathan C. Lipson, *Directors’ Duties to Creditors: Power Imbalance and the Financially Distressed Corporation*, 50 UCLA L. REV. 1189, 1245–49 (2003) [hereinafter Lipson, *Directors’ Duties*] (discussing four categories of low VCE creditors). Low VCE creditors probably do not choose to extend credit; they likely know little about the debtor (or lack the resources to conduct meaningful diligence) and there may be no secondary market into which they can sell their claims (because, for example, the amounts are too small or the discounts too high). See *id.* See also Jonathan C. Lipson, *The Expressive Function of Directors’ Duties to Creditors*, 12 STAN. J.L. BUS. & FIN. 224 (2007) [hereinafter Lipson, *Expressive Function*].

26. As discussed in Part VI, this raises the important question of bankruptcy court capture, a

Commentators are aware of the problems presented by creditor opportunism. Yet none have proposed convincing solutions. Some are equivocal, suggesting that the “antibankruptcy” of creditor opportunism may be an inevitable and insoluble feature of an increasingly complex world.<sup>27</sup> Others think the market will correct itself.<sup>28</sup> Still others hope that adjustments to the mechanics of fiduciary review will lead corporate directors to make better decisions on behalf of troubled firms which will, in turn, constrain opportunistic creditors.<sup>29</sup> These efforts are laudable, but tend to underestimate the problem or overestimate the likelihood that market forces will constrain opportunism.

None have recognized that, at their core, problems of creditor opportunism are problems of good faith.<sup>30</sup> Although the meaning of “good faith” has long been contested,<sup>31</sup> we conventionally understand it to be a

---

claim some (e.g., Lynn LoPucki) assert and others (e.g., David Skeel and Kenneth Ayotte) challenge with equal vigor. *See, e.g.*, LYNN M. LOPUCKI, *COURTING FAILURE: HOW COMPETITION FOR BIG CASES IS CORRUPTING THE BANKRUPTCY COURTS* (2005); Kenneth Ayotte & David A. Skeel, Jr., *An Efficiency-Based Explanation for Current Corporate Reorganization Practice*, 73 U. CHI. L. REV. 425 (2006). I take no position on this debate, as it is largely beyond the scope of this Article. I do note, however, that while I call for greater use of bankruptcy courts to resolve claims of creditor opportunism, we should be alert to the possibility of capture.

27. *See* Baird & Rasmussen, *supra* note 5, at 652 (“The current environment is one in which there are no natural leaders (or followers) among the creditors to perform the shuttle diplomacy required to build a consensus. Without familiar benchmarks, there is no shared understanding of what form a plan should take. Coalition formation is harder. Worse yet, in some cases there may be no stable equilibrium at all. To use the language of cooperative game theory, the core may be empty.”) (footnotes omitted).

28. *See* Kahan & Rock, *supra* note 9, at 308–10 (proposing modified contract provisions to address problems of “selective enforcement” of bondholder rights); Frederick Tung, *Leverage in the Board Room: The Unsung Influence of Private Lenders in Corporate Governance*, 57 UCLA L. REV. 115, 178–79 (2009).

29. Michelle M. Harner, *Corporate Control and the Need for Meaningful Board Accountability*, 94 MINN. L. REV. 541, 547 (2010) (arguing that courts should subject directors who approve “stakeholder transactions,” such as with creditors, to “fairness” review).

30. The leading claim that good faith checks opportunism comes from the work of Steve Burton. *See* Steven J. Burton, *Breach of Contract and the Common Law Duty To Perform in Good Faith*, 94 HARV. L. REV. 369, 373 (1980) [hereinafter Burton, *Good Faith*] (“Bad faith performance occurs precisely when discretion is used to recapture opportunities forgone upon contracting—when the discretion-exercising party refuses to pay the expected cost of performance.”). *See also* Steven J. Burton, *Good Faith Performance of a Contract Within Article 2 of the Uniform Commercial Code*, 67 IOWA L. REV. 1, 1 (1981) (“The obligation to perform a contract in good faith is central to Article 2 of the Uniform Commercial Code . . . .”) (footnote omitted). Although an imperfect definition for our purposes, the Uniform Commercial Code (“U.C.C.”) defines good faith as “honesty in fact in the conduct or transaction concerned and the observance of reasonable commercial standards of fair dealing.” U.C.C. § 1-201(a)(20) (2009). As discussed in Part V, this dual subjective-objective expression of bilateral good faith in contract doctrine is inadequate when applied to distress investors.

31. *See, e.g.*, Marietta Auer, *The Structure of Good Faith: A Comparative Study of Good Faith Arguments* 6 (Nov. 17, 2006) (unpublished manuscript), available at <http://ssrn.com/abstract=945594>

“gap filler” that helps courts solve, among others, problems of opportunism.<sup>32</sup> Modern distress investing presents two classes of gaps.

First, there are “micro-gaps.” In the zone of distress, a firm will usually try to renegotiate its obligations. The very fact of renegotiation means that the contracts as originally executed did not acceptably speak to all states (or at least *this* state) of the world. Restructuring is the way parties involved with a distressed firm fill those micro-gaps between the parties’ ex ante contractual expressions of expectation and their ex post desire to rewrite the deal in response to financial distress. Although good faith plays a special role in filling the micro-gaps of contract renegotiation generally,<sup>33</sup> literature on financial distress has ignored this entirely.

Second, and perhaps most important, are “macro-gaps” in positive law that arise from disruptive market or technological changes. Thus, courts have often used good faith to address disputes that were unforeseen at the time of contracting, such as fights about the right to royalties from the cinematic version of a work before the invention of movies.<sup>34</sup> That is, courts have used good faith to fill large-scale gaps between law and social norms when technological change outpaces conventional legal rules and standards. Today, problems of creditor opportunism arise and persist in part because current legal standards respond to problems of a different era.

While good faith is not the only way to fill these gaps, it is likely to be the best we can do. Courts will do a better job than markets or legislatures of making the difficult, context-dependent determination that a creditor was (or was not) opportunistic. Good faith is, in turn, an evaluation that courts—in particular specialized business courts—are especially well suited to undertake. Good faith is, in Robert Thompson’s words, a “fail-safe mechanism” to remedy private behavior that is “sufficiently beyond the pale, even if not covered by the usual rules.”<sup>35</sup>

---

(discussing structural and semantic problems in debates about good faith).

32. For a discussion of gap filling in contract law, see, for example, Mariana Pargendler, *Modes of Gap Filling: Good Faith and Fiduciary Duties Reconsidered*, 82 TUL. L. REV. 1315, 1316 (2008) (citing Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87 (1989)).

33. See Robert Braucher, *The Legislative History of the Uniform Commercial Code*, 58 COLUM. L. REV. 798, 812 (1958) (discussing the good faith standard’s requirement that parties meet reasonable commercial standards).

34. This paraphrases the result in one of the foundational good faith cases. *Kirke La Shelle Co. v. Paul Armstrong Co.*, 188 N.E. 163 (N.Y. 1933) (“[I]n every contract there is an implied covenant that neither party shall do anything which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract, which means that in every contract there exists an implied covenant of good faith and fair dealing.”).

35. Robert B. Thompson, *The Short, but Interesting Life of Good Faith as an Independent*

Thus, the title of this Article: the breach of a lending agreement creates micro-gaps in which private investors may seek to govern distressed firms; changes in market structure and dynamics have created macro-gaps through which they can do so opportunistically, with little fear of liability. This Article develops a new understanding of good faith in the distress context that will help courts fill these gaps by correcting two important mistakes in prior attempts to use good faith to control creditor opportunism: one institutional, the other conceptual.

The institutional mistake has been a tendency to permit the wrong institutions (in particular, lay juries) to determine whether creditors have acted in good faith.<sup>36</sup> Courts in the past developed a variety of doctrines, known loosely as “lender liability” (and which I call “lender liability 1.0”), that have produced inconsistent results.<sup>37</sup> The unpredictability of these decisions has led courts and commentators to become understandably wary of the doctrine. Yet, it has been well understood since Lord Mansfield’s time that disputes involving specialized business knowledge—for example, commercial lending—should be resolved by those with some relevant expertise.<sup>38</sup> While we do not have merchant juries, we do have a large and growing body of expert business courts—including the Delaware Chancery Court, specialized state business courts, and perhaps United States Bankruptcy Courts<sup>39</sup>—that can adapt good faith to modern distress investing more effectively than lay decisionmakers of the past.

The conceptual mistake has been to treat creditor opportunism as a problem of contractual or “bilateral” good faith. This is the sense of good faith found in cases addressing disputes between contract parties, for example, debtor versus creditor; landlord versus tenant; buyer versus seller. The problem, however, is that financial distress rarely involves bilateral disputes. Rather, when a firm is distressed, actions by the firm and creditors

---

*Liability Rule*, 55 N.Y.L. SCH. L. REV. 543, 545 (2010/2011).

36. Whether courts are the best choice is, itself, an important question. As Neil Komesar has observed, there may be sound reasons to believe that other institutions—in particular the political or regulatory institutions—might be better able to solve a large range of problems than courts. See NEIL K. KOMESAR, IMPERFECT ALTERNATIVES 3–13 (1994) (developing a general model of comparative institutional analysis). I have, in this vein, argued elsewhere that greater transparency forced by improved regulation would lead to better market-based solutions to problems of creditor opportunism. See Lipson, *Shadow Bankruptcy*, *supra* note 5.

37. The rise and fall of lender liability as a basis for reviewing claims of creditor opportunism is discussed in Part IV.

38. See generally Note, *The Case for Special Juries in Complex Civil Litigation*, 89 YALE L.J. 1155 (1980) (making the case for special juries as a solution to the increasing difficulty of trying complex cases).

39. See discussion *supra* note 26.

with potential or actual control will affect not only those parties, but all or most of the borrower's other stakeholders, including employees, other creditors, and other investors. Indeed, it is the opportunity to externalize losses onto unwitting firm stakeholders that can make distress investing lucrative. Moreover, bilateral good faith tends to focus only on a single contract—for example, the debt contract between the borrower and lender—and ignores other rights the creditor might have against or affecting the firm, such as preferred stock, derivative rights, and so forth.

Creditor opportunism today presents problems of “multilateral” or “institutional” good faith, which are different but related species of good faith. Doctrinally, multilateral good faith arises from corporate governance law.<sup>40</sup> In the *Gheewalla* case, for example, the Delaware Supreme Court held that directors of distressed firms are not typically fiduciaries for creditors because “creditors’ existing protections [include] . . . the implied covenant of good faith and fair dealing.”<sup>41</sup> This duty, the Delaware Chancery Court has suggested, runs not bilaterally, but multilaterally—to the debtor’s “community of interests.”<sup>42</sup> Institutional good faith involves relationships between private and public actors, such as investors and courts. It should forbid the misuse of public institutions for private gain, such as running distressed firms through a prenegotiated bankruptcy that benefits a few controlling distress investors at the expense of the debtor’s

---

40. In corporate law, good faith has had a peripatetic life. Commentators currently believe that good faith is a subspecies of the duty of loyalty, and has no independent force of its own. *See, e.g.*, Leo S. Strine et al., *Loyalty’s Core Demand: The Defining Role of Good Faith in Corporation Law*, 98 GEO. L. REV. 629, 633 (2010) (“The concept of good faith long been a vital one in Delaware’s corporate law but not as a fiduciary duty separate from the fundamental duty of loyalty. Rather, we demonstrate that the term good faith has long been used as the key element in defining the state of mind that must motivate a loyal fiduciary.”). *See* Thompson, *supra* note 35, at 553 (“Any development of good faith as a basis for liability will likely be in the violation of law aspects or the subjective lack of bad faith, or new categories that future generations of lawyers and judges develop as new meltdowns occur.”). These papers are responding to two Delaware cases in the acquisitions context, both of which concluded that Delaware law did not recognize good faith as an independent, liability-creating standard of conduct. *See* Lyondell Chem. Co. v. Ryan, 970 A.2d 235 (Del. 2009); Stone v. Ritter, 911 A.2d 362, 369–70 (Del. 2006). While that may be true in the acquisitions context, it may not be the case when a firm is in the zone of distress.

41. *See* N. Am. Catholic Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 100 (Del. 2007) (“‘Creditors are often protected by strong covenants, liens on assets, and other negotiated contractual protections,’ [which] . . . render the imposition of an additional, unique layer of protection through direct claims for breach of fiduciary duty unnecessary.”) (quoting Prod. Res. Grp. L.L. v. NCT Grp., Inc., 863 A.2d 772, 790 (Del. Ch. 2004)).

42. I take this phrase from the *Credit Lyonnais* opinion, discussed further in Part IV. *Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc’ns Corp.*, No. 12150, 1991 Del. Ch. LEXIS 215, at \*109 (Del. Ch. Dec. 30, 1991) (explaining that the directors of a distressed corporation “had an obligation to the community of interest that sustained the corporation, to exercise judgment in an informed, good faith effort to maximize the corporation’s long-term wealth creating capacity”).

other stakeholders.

This Article proceeds in seven subsequent parts. Part II defines creditor opportunism and explains why it has become a problem. Part III illustrates with three examples. Part IV explains the institutional and conceptual failures of current attempts to address creditor opportunism, lender liability 1.0. Part V elaborates on the conceptual failure, describing three different but related models of good faith—bilateral, multilateral, and institutional—and explains why the latter two are better devices than the first to assess claims of creditor opportunism. Part VI describes what a better understanding of good faith in the distress context—which we can call “lender liability 2.0”—would mean substantively and procedurally. Part VII considers objections and areas of further inquiry. Lastly, Part VIII concludes.

## II. THE ROOTS AND DEFINITION OF CREDITOR OPPORTUNISM

In order to define and better manage problems of creditor opportunism, it is first helpful to understand patterns in the resolution of business distress, and how those patterns have changed since the late 1980s.

### A. THE OLD MODEL—THE WORKOUT AND MICRO-GAPS

Historically, financial distress rarely resulted immediately in bankruptcy. Instead, it usually resulted in talk—between a troubled borrower and its lenders. This talk was known colloquially as the “workout.”<sup>43</sup> Workouts were meant to avoid either of two other, more dire events. On one hand, lenders may not have wanted to exercise their full panoply of rights—loan acceleration and foreclosure—because that would effectively shut the borrower down, impairing collateral and loan values. On the other hand, the lenders (usually) wanted to keep the company out of bankruptcy, as that process was thought to be costly and unruly. The workout—“capital restructuring” in fancier terms—would almost always be the first response because it held the promise of preserving the greatest value at lowest cost. Bankruptcy was a last resort, used only if the talk failed to produce a better agreement for all (or most) stakeholders.

Workouts in the past were usually a loss-avoiding—not a profit-

---

43. See, e.g., Gilson, *supra* note 5, at 358 (“[F]irms can (and usually do) attempt to restructure their debt privately before filing for bankruptcy . . . .”); Nini, Smith & Sufi, *supra* note 3, at 8 (“In practice, creditors rarely accelerate the loan, opting instead to use the right to accelerate to initiate a renegotiation of the credit agreement.”).

making—project. They might have involved the cancellation or dilution of existing shares, and the issuance of new shares to senior classes; they might have involved the issuance of new debt or extended payment terms for existing debt; they might have required new collateral or third-party guarantees; they might have required the borrower to sell assets or change business plans. And so on. The variations were limited only by the will and skill of the parties involved and the realities of the firm's balance sheet.

Workouts reflected micro-gaps between the parties' ex ante expectations as expressed in their agreements and the ex post exigencies of financial distress. Significant portions of most credit contracts reflect a creditor's enforcement rights, including provisions permitting the creditor to accelerate debt in the event of a default, and (if the loan is secured) to seize collateral.<sup>44</sup> Yet, creditors would appear rarely to act immediately on these contractual rights. Rather, they talk. This talk—and the renegotiation that it may produce—evidences a gap between the rights the initial contract gave the creditor and what the creditor realistically wants when distress actually occurs.

Workouts have long been characterized by a certain amount of gamesmanship. One attorney I worked with in 1990 said that the business of restructuring distressed firms—in or out of bankruptcy—was “New York's largest floating craps game.” Prebankruptcy restructuring negotiations are replete with posturing, table pounding, empty threats, puffery, head fakes, and the occasional “desperate gamble.”<sup>45</sup>

Although workouts historically saw more than their fair share of shenanigans, they were in the past comparatively simpler affairs. In 1978, when the current Bankruptcy Code was enacted, it would appear that

---

44. See AM. BAR ASS'N TASK FORCE ON FORMS UNDER REVISED ARTICLE 9, FORMS UNDER REVISED ARTICLE 9, Form 3.15 (Jonathan C. Lipson ed., 2002).

45. See LoPucki & Whitford, *supra* note 5, at 672 (describing Continental Airlines bankruptcy). Tom Wolfe's novel, *A Man in Full*, contains a vivid, and only slightly exaggerated, depiction of workout negotiations of the past.

Harry [the bank's workout officer] began speaking in a softer, lower voice. “Listen, Mr. Croker [owner of the debtor], don't get me wrong. We're on your side here. We don't want this to turn into a free-for-all with nine lenders, either. And we wouldn't particularly look forward to the press coverage.” He paused to let that terrorist threat, the press, stalk the room. “We're the agent bank in this setup, and that gives us the privilege of looking out for Plannersbanc first of all. But we gotta come up with something *concrete*.” He extended his right fist up in the air as high as it would go and said, “Where's the money gonna come from? It ain't gonna come . . . *poof!*”—he sprung his fist open—“from outta the air! Mr. Stroock assures us you got a lot of sound assets. Okay . . . good. The time has come to make them liquid. The time has come to pay us back. The time has come to sell something. I'm with you—the tailgate has dropped.

TOM WOLFE, *A MAN IN FULL*, 49–50 (1998).

corporate structures and commercial financing techniques were generally simpler.<sup>46</sup> It was implicitly assumed that in the mill-run case, a firm would have senior secured debt held by a bank or group of banks, unsecured debt held by public bondholders or trade creditors, or both, and one or maybe two layers of equity.<sup>47</sup> Similarly, it was assumed that in most cases, a debtor's creditors would, for better or worse, be stuck with whatever process the debtor and its major lenders chose to resolve the firm's distress. Because the Bankruptcy Code was designed, in large part, to make the bankruptcy process more appealing and transparent for corporate borrowers, the operating expectation through the early 1990s was that this process would either be a prebankruptcy workout or a Chapter 11 reorganization.

#### B. THE NEW MODEL—SHADOW BANKRUPTCY AND MACRO-GAPS

Beginning in the late 1980s, basic workout dynamics began to change in at least three fundamental ways. First, as noted in the Introduction, unregulated, professional distress investors increasingly displaced traditional lenders.<sup>48</sup> Second, because these investors—unlike lenders of the past—are largely unregulated, they can (and often do) hold multiple positions against (or affecting) a single firm, including debt, equity, and derivative positions, such as equity short sales or credit default swaps.<sup>49</sup> A credit default swap is essentially a form of insurance that a creditor may purchase against the risk that a debtor defaults; if the debtor fails to pay, the insurer will.<sup>50</sup> While they can perform legitimate market-signaling functions, they can also invite market manipulation.<sup>51</sup> Third, distress investors often acquire their rights against (or affecting) troubled firms in a secondary market. Because this secondary market is, like distressed investors, largely unregulated, it is difficult to police.

---

46. Steven L. Schwarcz, *Rethinking the Disclosure Paradigm in a World of Complexity*, 2004 U. ILL. L. REV. 1, 7–8 (2004).

47. To be sure, Congress articulated no vision of a particular sort of capital structure for firms in Chapter 11. Indeed, it appears Congress wanted Chapter 11 to incorporate a fair amount of flexibility, anticipating the possibility of financial and structural changes in the way we do business. Yet, it is unlikely that Congress anticipated the kinds of changes that have in fact occurred since the late 1980s, which have fundamentally altered the dynamics and outcomes of Chapter 11 reorganizations. See Lipson, *Shadow Bankruptcy*, *supra* note 5 at 1633–34 (discussing history).

48. To be sure, claims traded before the late 1980s, and so-called “vulture” investors were not unknown in the railroad receiverships of the early 20th century. See *id.* (discussing history).

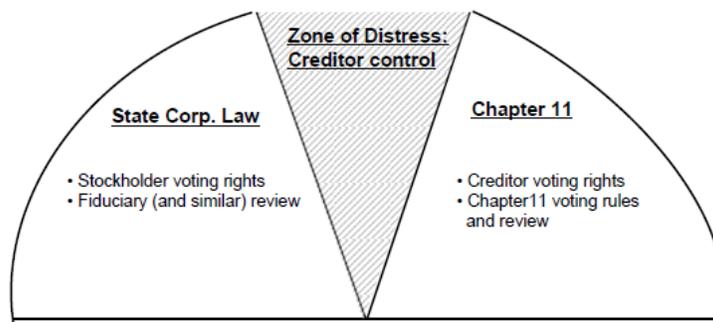
49. *Id.* at 1654.

50. See the authorities at *supra* note 10. *But cf. generally* M. Todd Henderson, *Credit Derivatives Are Not “Insurance,”* 16 CONN. INS. L.J. 1 (2009) (questioning proposals to subject credit derivatives to insurance regulation).

51. See, e.g., Lubben, *supra* note 10.

These changes have converged to create what I have characterized elsewhere as a “shadow bankruptcy” system that permits “sophisticated and aggressive . . . stakeholders to manipulate the outcomes of reorganization.”<sup>52</sup> As with its namesake, “shadow banking,” shadow bankruptcy thrives in regulatory gaps and ambiguities, “macro-gaps.” For purposes of this Article, and as depicted in figure 1, the key gaps will be between state corporate law, which sets boundaries on control of a firm before bankruptcy, by channeling the actions of shareholders and directors, and the Bankruptcy Code, which provides (some) analogous limits on creditors if a firm is in Chapter 11.

FIGURE 1. Gap Between State Corporate Law and Chapter 11



Both sets of laws—state corporate law and the Bankruptcy Code—try, among other things, to create incentives that limit the ability of those in ultimate control (shareholders and directors, when the firm is solvent, and creditors and managers when the firm is in bankruptcy) to act opportunistically. Yet, as illustrated in figure 1, there is a gap in both time and law between the onset of distress and bankruptcy. In this macro-gap, opportunities for creditor opportunism arise.

### C. DEFINING CREDITOR OPPORTUNISM

Before providing examples of creditor opportunism, it is important to define terms: What does it mean to say that a creditor behaves opportunistically? Oliver Williamson has famously described opportunism as “self-interest seeking with guile.”<sup>53</sup> The problems here are that creditors

52. Lipson, *Shadow Bankruptcy*, *supra* note 5, at 1618.

53. OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM* 47 (1985). *See also*

are axiomatically self-interested, and who knows what “guile” is? Daniel Fischel’s view, referenced in the Introduction, may be somewhat more helpful: “Opportunistic behavior occurs whenever one party attempts to obtain, at the expense of the other, a benefit not contemplated by the initial agreement, either explicitly or implicitly.”<sup>54</sup>

Today, at least in the case of distress investing, this definition proves too much. The work of Greg Nini, David Smith, and Amir Sufi (“Nini”) shows that creditors of distressed firms routinely obtain benefits not contemplated by their debt contracts.<sup>55</sup> In their study of debt covenant defaults among 7600 firms, they found that creditors of distressed firms “use covenant violations to apply non-contractual control over the governance of firms [in the form of] a statistically and economically significant increase in CEO turnover following the announcement of a covenant violation.”<sup>56</sup> They found that “[t]he impact of CEO turnover is particularly strong for those turnover events classified as forced.”<sup>57</sup>

This is an extraordinary finding, because at least in theory creditors should have no power to control the selection of management whatsoever. Rather, that is a decision that corporate law gives to directors, who are, in turn, usually elected by shareholders. Moreover, as they acknowledge, the ability to exert this control comes not from enforcing the lending agreement, but instead from what they characterize as “non-contractual” control, presumably the threats and theatrics typically found in workouts when the firm is in the zone of distress.

It is unlikely that creditors are routinely opportunistic. Thus, we must tailor Fischel’s definition of opportunism to reflect modern distress investing. For purposes of this Article, creditors are opportunistic when they (1) seek or exert control of a distressed firm or its reorganization; (2) to obtain a better deal than the debt contract, express or implied, would

---

Timothy J. Muris, *Opportunistic Behavior and the Law of Contracts*, 65 MINN. L. REV. 521, 521 (1981) (“[W]hen a performing party behaves contrary to the other party’s understanding of their contract, but not necessarily contrary to the agreement’s explicit terms, leading to a transfer of wealth from the other party to the performer [you have] a phenomenon that has come to be known as opportunistic behavior.”).

54. Fischel, *supra* note 21, at 138. As discussed below, while there is much to commend in this definition, it creates its own problems.

55. Nini, Smith & Sufi, *supra* note 3, at 11–13. Nini studied over 7600 nonfinancial U.S. firms from the second quarter of 1997 to the fourth quarter of 2008, comparing the stock performance of those that did and did not report a financial covenant violation. *Id.* In their sample, about 3700 firms reported a new covenant violation during the relevant period. *Id.* at 13.

56. *Id.* at 3.

57. *Id.*

have provided; (3) in a way that materially harms the debtor or its other stakeholders.

This definition adds “control” (actual or sought) and “harm” to the substance of Fischel’s definition. Without control—or efforts to obtain it—opportunism is much less likely (although not impossible). Without harm, it does not matter. Instead, aggressive behavior by a lender who lacks control, or whose self-serving actions cause no harm, would simply appear in most cases to be the ordinary enforcement of a debt contract.

### III. OPPORTUNITIES FOR OPPORTUNISM

Armed with this definition, consider three recent examples of creditor opportunism: (i) self-dealing beyond the ordinary enforcement of a debt contract; (ii) holding out in negotiations in a way that is needlessly destructive to the borrower; and (iii) using information obtained as a creditor to trade against the firm (that is, by shorting its securities).

#### A. SELF-DEALING

Self-dealing is the classic form of opportunism. Yet, not all self-dealing is the same. In the corporate context, those that might be said to self-deal—controlling shareholders or directors on both sides of a deal—can do so if they show the transaction to be “fair.”<sup>58</sup> The problem is that creditors enforcing their rights as creditors are at some level always engaged in self-dealing: they are trying to collect debts due them. For this reason, among others, creditors as such cannot realistically be viewed as fiduciaries, and so are not appropriately subject to “fairness” review.<sup>59</sup>

That said, modern distress investing makes possible opportunistic self-dealing through the complex, but very real, control that creditors can exert through heterogeneous holdings against or affecting a debtor. Consider, for

---

58. As Lynn Stout and Iman Anabtawi explain, [C]orporate law modifies the strict rule against self-dealing by allowing corporate officers and directors to use their corporate powers to pursue business transactions that benefit themselves as long as they are prepared to prove to a disinterested party—in particular, to a court—that the transaction, although self-interested, was nevertheless intrinsically “fair” to the corporation. Thus, a corporate officer or director can be found liable for breach of the duty of loyalty only if (1) she uses her corporate office to promote a corporate transaction that provides her with material personal benefits *and* (2) the transaction is “unfair.” It is not fiduciary self-dealing alone that is improper. Instead, it is *unfair* fiduciary self-dealing that is improper.

Anabtawi & Stout, *supra* note 15, at 1264.

59. *Accord* Harner, *supra* note 13, at 575–76 (discussing controlling creditor’s role as beneficiary vis-à-vis corporation, rather than as fiduciary). *Cf.* sources cited *supra* note 6.

example, the *MarketXT* case.<sup>60</sup> Here, Softbank was not only a major creditor of debtor MarketXT, an electronic securities trading firm, but also controlled the debtor through shares of common and preferred stock as well as two seats on the debtor's board of directors.<sup>61</sup> While there were many allegations of misconduct by the bank, the most extraordinary was that the bank essentially forced the debtor to sell its only viable operating subsidiary, Momentum, to a competitor, E\*Trade, for consideration that was basically worthless.<sup>62</sup> At the time, Softbank also had a substantial investment in E\*Trade. It was thus on both sides of, and benefitted from, the deal. Although the court entertained the possibility that Softbank's claim should be equitably subordinated,<sup>63</sup> it refused to hold the bank affirmatively liable.

The central question was whether Softbank controlled the debtor. The court recognized that,

There may be circumstances where the holding of contractual rights, coupled with a significant equity position and other factors, will support the finding that a particular shareholder is, indeed, a 'controlling shareholder,' especially if those contractual rights are used to induce or to coerce the board of directors to approve (or refrain from approving) certain actions.<sup>64</sup>

But, the court reasoned, such a finding requires a "confluence of factors" that it believed was missing here.<sup>65</sup> "[T]he 'confluence of factors' relating to control and wrongdoing," the court explained, "involved, for the most part, Softbank's exercise of its rights as a lender, its refusal to give up those

60. *In re MarketXT Holdings Corp.*, 361 B.R. 369, 387 (Bankr. S.D.N.Y. 2007).

61. *Id.* at 376. Softbank also had the power to control whether the board could act at all, by providing that a quorum required the presence of at least one Softbank director. *Id.*

62. The debtor sold its subsidiary to E\*Trade for unregistered (and therefore illiquid) stock that proved to be significantly overvalued. *Id.* at 380. At the time the merger agreement was executed, E\*Trade's publicly held stock was trading in the \$8–12 range. After the merger, E\*Trade announced that, despite having had a poor year, it had awarded its CEO, Christos Cotsakos, \$90 million in compensation, a disclosure which immediately pushed the stock's value down. *Id.* On the day the sale of Momentum closed, the E\*Trade stock—which was the consideration for the Momentum subsidiary sale—dropped to about \$6 and continued to drop thereafter. Within two months, it was less than half that. *Id.*

63. *Id.* at 388 ("The Complaint contains allegations that raise core equitable subordination issues and that are sufficient to (i) make Defendants subject to a higher level of scrutiny for purposes of equitable subordination . . ."). Softbank later settled with MarketXT. As discussed in Part VII.A.2.b., equitable subordination is unlikely to be as effective against creditor opportunism as we might want. The doctrinal basics of equitable subordination are described *infra* note 137.

64. *Id.* at 391 (quoting *Superior Vision Servs., Inc. v. Reliastar Life Ins. Co.*, 2006 Del. Ch. LEXIS 160, at \*20 (Del. Ch. Aug. 25, 2006)).

65. *Id.*

rights or its collateral, and its demands for payment of overdue debt and its contractual liquidation preferences. Softbank cannot be subjected to control person liability for those actions alone.”<sup>66</sup>

[T]here is no claim in the Complaint that Softbank’s loans or liquidation preferences were usurious or illegal or that the Debtor could not have made a rational business decision to grant Softbank these rights . . . [T]here is no allegation in the Complaint that Softbank used its position on the board of directors to force itself on the Debtor as a preferred stockholder or lender.<sup>67</sup>

While the creditor in *MarketXT* used its influence outside the lending contract to self-deal, it would not be liable for the harm it caused to the debtor because, viewed in isolation, the bank’s conduct did not violate the credit contract itself. The court refused to recognize that the combination of rights that the bank had—as creditor, shareholder, and on the board—gave it power that it used in ways that are best understood as opportunistic.

What if Softbank had been only a creditor, or only a shareholder? Would its actions have passed muster? There is a good argument that they would not. If Softbank had exclusively been a creditor enforcing a secured loan, it would have had the right to foreclose the loan, and to take the collateral, assuming it could do so without breaching the peace.<sup>68</sup> But Article 9 of the Uniform Commercial Code (“U.C.C.”), which typically governs such enforcement actions when personal property secures the loan, generally requires the creditor to sell the collateral at a public sale or to waive the deficiency (unless the debtor otherwise agrees to pay it).<sup>69</sup> A secured creditor cannot, directly or indirectly, purchase the collateral at a private sale and hope to continue to pursue the debtor for the balance of its claim, for an obvious reason: the secured creditor would low-ball the collateral in order to get the collateral for less than its full value.

What if Softbank had merely been a controlling shareholder, and engaged in similar conduct? It should have been subject to “fairness” review under loyalty standards. Exercising control as a shareholder to the advantage of the shareholder, at the expense of the corporation, is a classic form of self-dealing on which fiduciary law frowns.<sup>70</sup> Unless the

---

66. *Id.*

67. *Id.* (footnote omitted).

68. U.C.C. § 9-609 (2006); N.Y. U.C.C. LAW § 9-609 (Consol. 2011).

69. U.C.C. §§ 9-610, 9-620(g).

70. As the Delaware Chancery Court reasoned in *Superior Vision Services*, “the focus of the inquiry has been on the *de facto* power of a significant (but less than majority) shareholder, which, when coupled with other factors, gives that shareholder the ability to dominate the corporate decision-

controlling shareholder can show the transaction's "fairness" to the company, it can be voided.<sup>71</sup>

Yet, somehow the fact that Softbank's control came not solely from its debt claim, or solely from its significant shareholders, appears to have changed the analysis entirely. Softbank was both creditor and shareholder and, according to the *MarketXT* analysis, not to be evaluated as either. Despite suggesting that it was looking for a "confluence of factors" that would confer control,<sup>72</sup> the court in fact ignored the reality that Softbank apparently did control this debtor, and did so for reasons that were plainly self-serving.

Was Softbank opportunistic? It appears so. It exercised control above and beyond that given it by the debt contract—in particular through its rights on the board—to profit at the expense of the debtor. Taking the debtor's sole valuable assets for consideration that was essentially worthless harmed the debtor. Yet, thanks apparently to the heterogeneity of its holdings—both debt and equity—it was subject to standards of review applicable to neither. It governed in the breach with impunity.

## B. HOLDING OUT

Forcing a debtor to do a deal that benefits the creditor at the debtor's expense is not the only harmful control a creditor can wield in the zone of distress. Perhaps more important—because more common and more subtle—is the power to block a workout that might otherwise salvage a firm.

Consider workouts involving bonds. Under the Trust Indenture Act of 1939, as amended,<sup>73</sup> provisions in a bond indenture relating to interest rate, principal amount, and maturity can be amended only by unanimous consent; however, all other provisions can be amended in accordance with the voting requirements specified in the governing indenture. Those who hold bonds subject to the Trust Indenture Act can always effectively thwart

---

making process." *Superior Vision Servs. v. Reliastar Life Ins. Co.*, C.A. No. 1668-N, 2006 Del. Ch. LEXIS 160, at \*16–17 (Del. Ch. Aug. 25, 2006) (emphasis added). *See also* *Thorpe v. CERBCO, Inc.*, 676 A.2d 436 (Del. 1996); *Rosener v. Majestic Mgmt., Inc. (In re OODC, LLC)* 321 B.R. 128, 142 (Bankr. D. Del. 2005) (finding sufficient facts pled to support claim against nonofficer, director or majority shareholder for breach of fiduciary duties of loyalty and good faith; defendant was allegedly in control of debtor through close ties with officer of debtor and preferred interest in debtor's parent).

71. *See* *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983) ("The requirement of fairness is unflinching in its demand that where one stands on both sides of a transaction, he has the burden of establishing its entire fairness, sufficient to pass the test of careful scrutiny by the courts.").

72. *MarketXT Holdings Corp.*, 361 B.R. at 391.

73. Trust Indenture Act of 1939 § 316(b), 15 U.S.C. § 77ppp(b) (2006).

a negotiated modification to the core provisions of the bond—maturity date, interest, principal amount—which would, in turn, impair a reorganization outside bankruptcy.<sup>74</sup>

For example, a firm's workout may involve an "exit consent" solicitation to remove bond covenants or to create an inducement to tender in conjunction with an offer to exchange existing bonds for new ones that make the reorganization possible. If the issuer is able to conduct a successful exit consent solicitation, holders who do not tender into the offer will continue to hold their old securities but may become effectively subordinated or entitled to fewer protections.

Companies may propose to exchange old bonds for new debt, with the understanding that the new debt will contain terms more favorable to the firm. Generally, however, exchange offers require the support of around 90 percent of holders.<sup>75</sup> Because bonds that are not tendered cannot change, issuers often seek a higher percentage of participation. Thus, when Six Flags held its exchange offer, it sought 95 percent bondholder participation.<sup>76</sup> A bondholder with seemingly small holdings—6 percent, for example—may hold more than enough to permit the exchange to be effective and will therefore be in a position to block the restructuring.<sup>77</sup> In 2008, IAC/InterActiveCorp, Tyco International, D.R. Horton, Thornburg Mortgage, and NRG Energy coupled consent solicitations with exchange or tender offers.<sup>78</sup>

---

74. See generally Mark J. Roe, *The Voting Prohibition in Bond Workouts*, 97 YALE L.J. 232 (1987) (urging repeal of the provision prohibiting modification of bond indenture terms except by unanimous consent).

75. Edward I. Altman & Brenda Karlin, *The Re-Emergence of Distressed Exchanges in Corporate Restructurings*, 5 J. CREDIT RISK 43, 43 (2009).

76. The tender offer would allow Six Flags creditors to exchange \$1000 in bond principal for approximately 19 shares of common stock following a 1-for-100 reverse stock split. See Press Release, Six Flags, Inc., Six Flags Announces Debt for Equity Exchange Offer for Certain of Its Debt Securities (Apr. 17, 2009), <http://www.prnewswire.com/news-releases/six-flags-announces-debt-for-equity-exchange-offer-for-certain-of-its-debt-securities-61857582.html>.

77. Loan participations, which may be acquired in the secondary market by private investors, often require unanimous consent to modification, and so present comparable hold-out problems. Amir Sufi, *Information Asymmetry and Financing Arrangements: Evidence From Syndicated Loans*, 62 J. FIN. 629, 633 (2007).

78. Press Release, InterActiveCorp, IAC Commences Cash Tender Offer and Consent Solicitation for its 7% Senior Notes Due 2013 (June 11, 2008), <http://iac.mediaroom.com/index.php?s=43&item=1537>; Press Release, Tyco International Ltd., Tyco Announces Tender Offers and Consent Solicitations (Apr. 27, 2007), <http://phx.corporate-ir.net/phoenix.zhtml?c=112348&p=irol-newsArticle&ID=992156&highlight=>; Press Release, D.R. Horton, Inc., D.R. Horton, Inc., America's Builder, Announces Exchange Offer and Consent Solicitation for its 9.75 Percent Senior Subordinated Notes Due 2010 (May 21, 2008), <http://business.highbeam.com/1816/article-1G1-179253587/dr-horton-inc-america-builder-announces-exchange-offer>; Bob Quick, *Thornburg Mortgage Upbeat*

Holding out in an exchange offer, or any proposed workout, is not of itself opportunistic. Distress investors may have legitimate reasons for refusing to support a restructuring. They may, for example, believe that in the game of “chicken” that is a workout, waiting will produce a better offer. They may disagree with management or other investors over the direction the firm should take. They may simply lack confidence and want nothing more than to liquidate the firm (and their debt).

Holding out becomes opportunistic, however, when done in the service of a strategy that benefits the creditor at the expense of the borrower in ways the lending agreement itself did not (or could not) have contemplated. There is, for example, evidence that the refusal may not be driven by the terms of the exchange offer itself, but instead by other claims or interests that the private investor holds, which are worth more if the exchange offer fails, in particular under credit default swaps (“CDS”).<sup>79</sup>

Consider the case of Kellwood Co. In July 2009, Kellwood, a large U.S. apparel supplier, was nearly forced into bankruptcy, apparently because its largest bondholder, Deutsche Bank, refused to participate in an exchange offer.<sup>80</sup> Although Deutsche Bank initially had agreed to restructure Kellwood’s debt, it unexpectedly withdrew its support for the workout, waiting until after the debt was in default for more than three days to agree to new debt repayment terms.<sup>81</sup>

Kellwood, which owns several clothing brands, including Phat Farm and Sag Harbor, said that bondholders, including Deutsche Bank, had agreed to exchange a \$140 million bond that came due in early July 2009 for new senior secured debt maturing in 2014.<sup>82</sup> Although Kellwood representatives said they had “no idea” why the bank changed its mind,

---

*Despite Reporting Big Loss*, SANTA FE NEW MEXICAN, June 12, 2008, <http://www.santafenewmexican.com/Business/Thornburg-Mortgage-stays-upbeat-despite-reporting-big-loss#>; Press Release, NRG Energy, Inc., NRG Energy, Inc., Commences \$2 Billion Private Debt Exchange Offers and Consent Solicitations for its 7.250% Senior Notes Due 2014, 7.375% Senior Notes Due 2016 and 7.375% Senior Notes Due 2017 (Sept. 4, 2008), [http://media.corporate-ir.net/media\\_files/irol/12/121544/releases/090408.pdf](http://media.corporate-ir.net/media_files/irol/12/121544/releases/090408.pdf).

79. Lipson, *Shadow Bankruptcy*, *supra* note 5, at 1617–18. See also Daniel Hemel, *Empty Creditors and Debt Exchanges*, 27 YALE J. REG. 159, 161–64 (2010).

80. See Karen Brettell, *CDS May Have Prompted Deutsche Delay on Kellwood-Traders*, REUTERS, July 24, 2009, available at <http://www.reuters.com/article/idUSN2447969420090724>; Peter Lattman, *Corporate News: Kellwood Faces Debt Deadline—Apparel Maker Considers Bankruptcy Filing in Blow to Buyout Firm*, WALL ST. J., July 11, 2009, at B5.

81. See Brettell, *supra* note 80; Brad Dorfman & Caroline Humer, *Kellwood Could Face Bankruptcy—WSJ*, REUTERS, July 10, 2009, available at <http://www.reuters.com/article/idUSN1033402820090710>; Lattman, *supra* note 80.

82. See Brettell, *supra* note 80; Dorfman & Humer, *supra* note 81; Lattman, *supra* note 80.

there was “widespread speculation” that Deutsche Bank owned CDS linked to Kellwood debt.<sup>83</sup> The CDS apparently would pay after a three-day grace period lapsed.

Traders have speculated that the bank may have held so-called negative basis trades, in which they owned the bonds and also owned CDS protection.

In this case, the bank would have profited from payments from the CDS contracts, which are expected to stand at around 80 percent of the insurance bought.

The company would also have gained from exchanging its bonds, which traded at 23 cents on the dollar on Thursday, for new debt that is expected to trade at its full value, traders said.<sup>84</sup>

Holding out in restructuring is not new. Indeed, it is one reason the Bankruptcy Code exists in its current form. It permits a bankruptcy court to confirm a reorganization plan with less creditor support than would be required outside bankruptcy.<sup>85</sup> Thus, while private investors may be able to hold up out-of-court restructurings, they do so in the shadow of bankruptcy, and the prospect that they cannot stall forever. If, however, the private investors’ goal is to cash in on distress by shorting the debtor’s securities, then the threat (or promise) of bankruptcy may not mean much. Indeed, bankruptcy may be a credit event that triggers the investor’s rights under the swap, and so advances the investor’s real (if secret) agenda.<sup>86</sup>

How do we know when holding out crosses the line from merely aggressive negotiating to opportunistic behavior? As the definition of opportunism suggests, the creditor must be in a position to prevent a workout from occurring, and thus to control it. There are a variety of reasons why the creditor may lack that power—for example, it may hold insufficient debt—in which event shorting the borrower’s debt may hurt the debtor, but is unlikely to be opportunistic. Indeed, it may be an appropriate wealth-preserving strategy for the creditor.

Yet, when a debt contract gives a creditor the power to preclude a

---

83. Dorfman & Humer, *supra* note 81. See also Brettell, *supra* note 80; Lattman, *supra* note 80.

84. Brettell, *supra* note 80.

85. 11 U.S.C. § 1126 (2006). In highly simplified terms, plans require the support of two-thirds in amount and more than half in number of creditors entitled to vote. *Id.* Interestingly, there is some evidence that nonbankruptcy restructurings produce suboptimal results. See *Distressed Exchanges May Hurt Firms’ Financial Outcomes*, WALL ST. J., Mar. 18, 2011, <http://blogs.wsj.com/bankruptcy/2011/03/18/distressed-exchanges-may-hurt-firms-financial-outcomes/tab/print/> (discussing study by Moody’s Investors Service showing that “a substantial number of companies which turned to distressed-debt exchanges during 2009 and 2010 still languish with low credit ratings”).

86. Lubben, *supra* note 10, at 411.

workout, and the creditor has also taken short positions, courts should worry about whether the behavior was opportunistic. In the case of Kellwood Co., and giving Deutsch Bank the benefit of the doubt, the answer is unclear. The opacity of the CDS market makes it difficult to know whether CDS created the motive and ability to profit from a delay in the debtor's restructuring. Harm is also difficult to measure, although delay is likely to raise borrowing costs with no clear benefit to the company. The structure and dynamics of these markets create opportunities for opportunism that are difficult to detect, albeit understandably attractive to distress investors.<sup>87</sup>

### C. INSIDER TRADING

The rise of credit derivatives creates a third opportunity for creditor opportunism. Private investors might use inside information obtained during a workout to short a debtor's shares. Recent research by Nadia Massoud et al. finds evidence that hedge funds as lenders may do just this, by short selling borrower equity before the announcement of a hedge fund loan.<sup>88</sup> They will do this because they know that shares of borrowers decline in value when they announce a loan (or loan amendment) with a hedge fund. As lenders, they will be "privity to private information about the performance of borrowing firms around both loan originations and loan renegotiations" and are thus "quasi-insiders."<sup>89</sup> Armed with this information, they will short the borrower's equity before the announcement, betting in essence that the firm's share price will decline—

---

87. These combinations are examples of "asset correlations," which have been characterized as contributing to overly aggressive behavior that led to the credit crisis of 2008. See Richard Squire, *Shareholder Opportunism in a World of Risky Debt*, 123 HARV. L. REV. 1151, 1153 (2010) ("If a firm's contingent debts are especially likely to be triggered when the firm is insolvent, the debt contracts transfer value from the firm's unsecured creditors to its shareholders. This transfer creates an incentive for a firm's managers to sell contingent claims against their firm that correlate—or that through asset purchases can be made to correlate—with the firm's insolvency risk."). Other examples—in particular the especially pernicious combination of senior secured debt and an equity short position—are discussed in Lipson, *Shadow Bankruptcy*, *supra* note 5, at 1678.

88. Massoud et al., *supra* note 24 (finding companies borrowing from hedge fund lenders experience aggressive short-selling of equity prior to public announcement of loans, suggesting abuses of insider information). There has also been speculation and concern about insider trading by private investors during bankruptcy, as well. See Lipson, *Shadow Bankruptcy*, *supra* note 5, at 1654–55 (discussing allegations of insider trading in the Adelphia bankruptcy case); Peg Brickley, *Hedge-Fund Lawyers Still on Washington Mutual's Pay List*, WALL ST. J., Mar. 23, 2011, <http://blogs.wsj.com/bankruptcy/2011/03/23/hedge-fund-lawyers-still-on-washington-mutuals-pay-list/tab/print/> (discussing allegations of insider trading by hedge funds in Washington Mutual bankruptcy).

89. Massoud et al., *supra* note 24, at 1.

which it will do on the announcement.<sup>90</sup> This information asymmetry may create or magnify perverse incentives to see prebankruptcy workouts fail.<sup>91</sup>

Shorting a firm under these conditions is certainly behavior outside the debt contract, but does it reflect control that harms the debtor? Some may argue that it does not because the investor exercises no direct control of the debtor: it does not vote its shares or debt, appoint the debtor's directors or managers, and so forth. The response is obvious: if the short strategy is effective, it reduces the market value of the firm's securities, which indirectly constrains the company's options. That, in turn, drives up its cost of capital, or reduces its universe of potential lenders, or both. It in effect controls the price of restructuring.

It is also harmful. Shorting on inside information about debt and distress extracts rents—from the company or others in the market (for example, those who hold shares that have been shorted on inside information)—for no gain to the company (or its other stakeholders). Short activity engineered around distress investing would seem to have the potential to create the sort of death spiral that destroys value for most firm stakeholders, even as it may enrich the investor savvy or lucky enough to have purchased the short position.

#### IV. THE RISE AND DEMISE OF LENDER LIABILITY 1.0

Courts have long struggled to manage overreaching by creditors through a variety of doctrinal clusters, often lumped together loosely as “lender liability.” At the core of these doctrines lies the fundamental question of good faith. A lender that exercised its rights in good faith will,

---

90. See *id.* at 2 (“Overall, our results are consistent with the notion that the equity of the hedge fund borrowers are (sic) short-sold *prior to* public announcements of loan originations.”). See also Jenny Anderson, *As Lenders, Hedge Funds Draw Insider Scrutiny*, N.Y. TIMES, Oct. 16, 2006, at A1 (discussing SEC scrutiny of hedge funds poised to exploit confidential insider information as debt holders); Gregory Zuckerman, *Hedge-Fund Lending Draws Scrutiny*, WALL. ST. J., July 3, 2010, at B1 (“Traders say a fund might seek short-term gains from a potential tumble [in share prices] when word emerges that a company has turned to hedge funds for a high-rate loan, even if the fund is comfortable extending a loan because the company is likely to survive over the long haul. It also could be that some hedge funds are offered the chance to lend to a company, turn down the opportunity and then short the company's shares.”). Although activity of this sort might violate federal securities laws, the technical nature of the claims, and important questions about standing and privity of contract, make securities law an unlikely tool to police opportunism of this form.

91. See Acharya & Johnson, *supra* note 24, at 138 (summarizing concern over hedging by banks with access to privileged information). See also Lipson, *Shadow Bankruptcy*, *supra* note 5, at 1618 (discussing private investors' incentives to realize short-term value at the expense of debtor's reorganization); Marshall E. Tracht, *Insider Guaranties in Bankruptcy: A Framework for Analysis*, 54 U. MIAMI L. REV. 497, 520 (2000) (describing insider guaranty's mitigation of “perverse pre-bankruptcy incentives”).

in the vast majority of cases, have little to fear; if it did not, the lender may have liability. The challenge is thus to understand how good faith has been used in the past (discussed in this part) and how it should be used in light of the growing and changing market for investment in distressed firms (discussed in the next two parts).

A. THE RISE OF LENDER LIABILITY 1.0—COMMUNITARIAN VALUES AND THE CIVIL JURY

In its original incarnation, lender liability rose to prominence in the mid-1980s, when a series of high-profile cases subjected lenders' enforcement actions to the scrutiny of civil juries, which often awarded damages that some viewed as wildly inappropriate.<sup>92</sup> The rise of lender liability 1.0 reflected both a particular political-economic context—a period of mistrust of lenders—and a set of institutional choices, in particular vesting liability and remedial decisionmaking with civil juries, not more expert institutions, such as bankruptcy courts.

In *K.M.C. Co. v. Irving Trust*, for example, K.M.C., a grocery wholesaler, entered into a discretionary line of credit with Irving Trust secured by K.M.C.'s accounts receivable and inventory.<sup>93</sup> The line of credit was discretionary because Irving had the right to demand repayment at any time.<sup>94</sup> K.M.C. repaid the loan by having its customers remit payments owed to K.M.C. to a "lockbox" account for the benefit of Irving.<sup>95</sup> Although Irving conceded that the loans were at all times fully secured, in March 1982, it exercised its discretion to stop lending to K.M.C. Not surprisingly, K.M.C.'s checks began to bounce, and it soon went out of business.

In a different era, this might have been the end of the story. Instead, K.M.C. sued Irving, claiming that refusing to lend—effectively calling the loan—"without prior notice to advance the requested funds breached a duty of good faith performance implied in the agreement and ultimately resulted

---

92. The leading cases included *Sahadi v. Continental Illinois National Bank & Trust Co.*, 706 F.2d 193 (7th Cir. 1983); *K.M.C. Co. v. Irving Trust Co.*, 757 F.2d 752 (6th Cir. 1985); *Barrett v. Bank of America*, 229 Cal. Rptr. 16 (Cal. Ct. App. 1986); and *State National Bank of El Paso v. Farah Manufacturing Co.*, 678 S.W.2d 661 (Tex. Ct. App. 1984). See also Fischel, *supra* note 21, at 132 n.6 (collecting cases involving civil jury awards in lender liability and similar cases).

93. *K.M.C.*, 757 F.2d at 754.

94. *Id.* at 760 ("The demand provision," in the loan agreement, the Court of Appeals explained, "is a kind of acceleration clause"). Commercial lawyers blanch at this conflation of a demand obligation and an acceleration clause, but that is a technicality beyond the scope of this Article.

95. *Id.* at 761.

in the collapse of the company.”<sup>96</sup> There appeared to be no question that the language of the contract gave Irving discretion to call the loan when it did. K.M.C. argued that this did not matter, because Irving had an implied duty to act in good faith, which prohibited it from calling the loan without prior notice or evidence that K.M.C. was otherwise in breach of the loan agreement.

By stipulation, the matter was tried before a magistrate, and the magistrate ordered a jury trial over defendant’s objection.<sup>97</sup> The magistrate instructed the jury that its job was to consider whether

there is implied in every contract an obligation of good faith; that this obligation may have imposed on Irving a duty to give notice to K.M.C. before refusing to advance funds under the agreement up to the \$3.5 million limit; and that such notice would be required if necessary to the proper execution of the contract, unless Irving’s decision to refuse to advance funds without prior notice was made in good faith and in the reasonable exercise of its discretion.<sup>98</sup>

On these instructions, the jury awarded \$7.5 million to K.M.C., measured as the difference between K.M.C.’s going concern value before and after the loan was called.<sup>99</sup> The Sixth Circuit Court of Appeals affirmed, largely on the grounds that the jury instruction was appropriate. “We agree with the Magistrate that just as Irving’s discretion whether or not to advance funds is limited by an obligation of good faith performance, so too would be its power to demand repayment.”<sup>100</sup>

Cases such as *K.M.C.* “inspired fear and mystery in bankers, borrowers, and lawyers”<sup>101</sup> because they were so difficult to predict, and so harsh in their results. *K.M.C.* was, according to Fischel, “wrongly decided” because the lenders “acted pursuant to contractual provisions best understood as bonding mechanisms used by borrowers to obtain more favorable credit terms.”<sup>102</sup> They were troubling because the case law lacked “a coherent theoretical framework establishing the rights of lenders and their duties to their borrowers.”<sup>103</sup> It was very difficult for a lender to know *ex ante* whether attempting to enforce its rights or participate in a workout

---

96. *Id.* at 754.

97. *Id.* at 755.

98. *Id.* at 759.

99. *Id.* at 764.

100. *Id.* at 760.

101. Werner F. Ebke & James R. Griffin, *Lender Liability to Debtors: Toward a Conceptual Framework*, 40 Sw. L.J. 775, 776 (1986).

102. Fischel, *supra* note 21, at 146.

103. *Id.* at 133.

would help or hurt its position.

Perhaps the strongest evidence of the lack of a “theoretical framework” supporting these decisions were the damages awarded. In Fischel’s view, they were “outrageous”<sup>104</sup> and “fundamentally flawed”<sup>105</sup> because they did not appear to reflect any economic or contractual theory of loss. In some cases, punitive damages were awarded reflecting a firm valuation beyond any realistic measure.<sup>106</sup> If, Fischel observed, the borrowers were viable but for the lenders’ actions, why did they not simply borrow from others? If they could not borrow from others, then perhaps the firms were not worth so much in the first place.<sup>107</sup>

Yet, these cases also had their (cautious) defenders. Some observed that they reflected an appropriate use of “good faith” to impose “communitarian” or “populist” norms on lenders.<sup>108</sup> They were communitarian because they were literally decided by representatives of the community at large: lay juries.<sup>109</sup> Dennis Patterson has argued that giving lay juries (communities) the power to impose this expanded interpretation of the duty of good faith in lender liability cases was not necessarily problematic, provided that jurors understood the norms of the

---

104. *Id.* at 152.

105. *Id.* at 154.

106. *Id.* at 147, 149 (discussing cases in which punitive damages were awarded and noting that damage awards implied a “rate of return in excess of 3000%”).

107. *Id.* at 148–49. “If a business is really that valuable,” Fischel argued, “market participants would be willing to invest in it—they are leaving money on the table if they don’t. Conversely, if nobody is willing to invest, a strong presumption arises that the business was not that valuable in the first place.” *Id.* at 149. The problem here is that this assumes, among other things, that market participants know about the investment opportunity and have the resources to act on it. In a world with imperfect information and transaction costs, neither is assured, or necessarily realistic. Moreover, it ignores the reputational cost to the borrower of having had a dispute with its lender. While the borrower may be right, it will be costly to explain that inconvenient fact to future investors, who may understandably want to avoid “difficult” borrowers.

108. DENNIS M. PATTERSON, GOOD FAITH AND LENDER LIABILITY: TOWARD A UNIFIED THEORY 110 (1990) (“[C]ommunity standards of decency, fairness, and reasonableness [] have an important role to play in any evaluation of secured creditor misconduct.”). The related “populist” view comes from Julian McDonnell. *See id.* at 127 (citing Julian B. McDonnell, *Handling Distress Loans: New Liabilities for Secured Lenders*, in SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE 11-4 (P. Coogan et al. eds., 1987)).

109. Indeed, the use of the jury was one of the central issues in *K.M.C.*, since the loan agreement apparently contained a jury waiver, which the bank declined to enforce. *K.M.C. Co. v. Irving Trust Co.*, 757 F.2d 752, 757 (6th Cir. 1985). As Dennis Patterson explained, this may have resulted from a mistaken understanding of the function of the jury waiver clause. PATTERSON, *supra* note 108, at 136 n.56 (explaining that the magistrate judge granted *K.M.C.*’s request for a jury because “Irving’s representatives had told [K.M.C.’s president] that a jury-waiver clause in the loan documentation only applied in the case of fraud”).

commercial community in question.<sup>110</sup> “[C]ommunity standards of decency, fairness, and reasonableness,” he argued, “have an important role to play in any evaluation of secured creditor misconduct.”

Take the purpose of “community standards.” The word “community” should not be read to mean only the “community at large” when we speak of “community standards of reasonableness.” Whether or not it is “reasonable” for a secured creditor to accelerate on default after having consistently accepted late payments should be determined by reference to the ‘community’ of which the secured party is a member: the financial community. In other words, whether a behavioral norm of the financial community has been violated is a judgment as to whether the [challenged action] is consistent (reasonable) with the behavior of lenders similarly situated.<sup>111</sup>

Patterson’s principal goal was not to defend the results in the early lender liability 1.0 cases, but instead to argue that properly constrained, civil juries could be appropriate institutions to perform *ex post* good faith review of lender behavior.

Patterson recognized that questions about the good faith of lenders in commercial transactions presented special challenges to lay juries. This recognition built on the work of Karl Llewellyn, who hoped that inherently vague terms such as “good faith” would be interpreted and resolved by experts, and not the community at large. According to Patterson, in designing the Uniform Commercial Code, Llewellyn “advocated a central role for merchant juries”—not lay juries—“in judging the merits of commercial disputes.”<sup>112</sup> The “special commercial court or factfinder was essential to the orderly development and critique of commercial practices,” Llewellyn believed.<sup>113</sup> The “specialized knowledge and competence” of merchant juries was, for Llewellyn, a pragmatic recognition that the acceptable resolution of normatively volatile commercial disputes required “*some* adequate tribunal to determine competently and reckonably all questions of fact which rest *in special knowledge of the trade*.”<sup>114</sup> For Llewellyn, that tribunal would not be the community at large, but juries composed of merchant-experts, after the fashion of Mansfield.<sup>115</sup>

---

110. PATTERSON, *supra* note 108, at 110.

111. *Id.* at 110–11 (footnotes omitted).

112. *Id.* at 36.

113. *Id.*

114. *Id.* at 40–41 (quoting 1941 Revised Act (2d Draft), at Comment on Secs. 59-59-D, at 253, in I. U.C.C. Drafts 533).

115. See Ingrid Michelsen Hillinger, *The Article 2 Merchant Rules: Karl Llewellyn’s Attempt to Achieve the Good, the True, the Beautiful in Commercial Law*, 73 GEO. L.J. 1141, 1160 (1985)

While the U.C.C. did retain and impose concepts such as “good faith,” it jettisoned Llewellyn’s institutional choice: merchant juries were not incorporated into the enactment of the Uniform Commercial Code.<sup>116</sup> Interpreting that statute and concepts on which it rests, such as “good faith,” would be left to the much less predictable norms and values of civil lay juries.

B. THE DEMISE OF LENDER LIABILITY 1.0—CONTRACTS, NOT COMMUNITIES

As Fischel observed, this institution—the lay jury—was malleable in the hands of good trial lawyers, frequently hostile to lenders, and therefore susceptible to awarding excessive damages to borrowers. Although Fischel did not characterize his strong critique of lender liability 1.0 in this way, he was in part making an institutional claim: the civil lay jury was the wrong institution to decide these cases. The community at large could not be trusted to conduct ex post good faith review of lender enforcement actions.

Fischel developed his brief against cases like *K.M.C.* in a 1989 *Yale Law Journal* article, which (perhaps ironically) has also given us the basis for a serviceable definition of creditor opportunism.<sup>117</sup> Fischel focused not on the specific institutional question (lay versus expert juries), but instead on the scope and content of the term “good faith.” The only important question, he argued, was whether “courts should look beyond the contract itself and the usual tools of contract interpretation to some other body of authority in order to define the rights and duties between the parties.”<sup>118</sup> In his view, courts should not, for three reasons.

First, as was fashionable among law-and-economics scholars of the time, Fischel argued that good faith should be treated as a “gap filler” of a particular sort. Courts should not introduce extracontractual rights and remedies contrary to the parties’ express or implied agreement because they believed (in hindsight) that the lender violated (perceived) community norms. Rather, good faith should fill in blanks the parties may have left, so long as they were consistent with what a court believed hypothetically rational parties would have chosen, not what these particular parties

---

(discussing Llewellyn’s views on merchant tribunals); Amy J. Schmitz, *Embracing Unconscionability’s Safety Net Function*, 58 ALA. L. REV. 73, 86 (2006) (same).

116. See PATTERSON, *supra* note 108, at 42 (“The merchant jury idea did not survive past the Second Revised Sales Act (1941).”).

117. See Fischel, *supra* note 21. I say “ironically,” because it is unlikely Fischel would sympathize with the use to which I put his definition of “opportunism.”

118. *Id.* at 140.

(subjectively) would have chosen.<sup>119</sup>

Second, deviating from an interpretation of the contract that favored the lender would increase the cost of capital, he believed. “[T]he more expansive the interpretation of the duty of good faith to control opportunistic behavior by the lender, the weaker is the bond of the borrower and the less able the borrower is to use the bond to obtain more favorable credit terms.”<sup>120</sup>

Third, Fischel believed that three sets of legal and market forces already prevented lenders from behaving opportunistically.

First, if the lender’s actions constitute a breach of contract, the lender can be forced to pay damages. Second, the lender must be concerned about the effect of opportunistic behavior on its reputation. Most lenders are typically larger than borrowers and more likely to be repeat players. Reputation will be a more effective deterrent to lender misbehavior, therefore, than to debtor misbehavior. Finally, the market for substitute performance or, more specifically, the availability of other sources of credit, limits lenders’ ability to extract concessions from debtors. The size of any concessions must be smaller than the costs to the debtor of negotiating with a new lender.<sup>121</sup>

Fischel’s occasional coauthor, Frank Easterbrook, soon had a chance to apply this approach from his post as a judge on the United States Court of Appeals for the Seventh Circuit, in the 1990 *Kham & Nate’s* case.<sup>122</sup> Here, the First Bank of Whiting extended credit to a troubled retailer before it went into bankruptcy, both directly and via letters of credit on which the debtor’s suppliers could draw. The bank made the loan based in part on a requirement that the debtor commence a Chapter 11 case and obtain super-priority status for the bank’s loans, which it did.<sup>123</sup> Although the bank permitted trade creditors to draw on the letters of credit (essentially establishing a first-priority collateral position), it informed the debtor that it would make no further extensions of credit after the debtor had borrowed about \$75,000.

Although the lending facility had been approved by the bankruptcy

---

119. Fischel later elaborated on his theory of good faith and gap filling. See Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425, 446 (1993). For discussions of gap filling in contract law, see, for example, Pargendler, *supra* note 32, at 1316 (citing Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87 (1989)).

120. Fischel, *supra* note 21, at 142.

121. *Id.* at 138 (footnotes omitted).

122. *Kham & Nate’s Shoes No. 2, Inc. v. First Bank of Whiting*, 908 F.2d 1351 (7th Cir. 1990).

123. *Id.* at 1353–54.

court, it appears that neither the debtor nor the bank took any action with respect to the facility. The debtor did not seek to borrow, and the bank did seek to foreclose the loan. Instead, the debtor proposed a series of reorganization plans, all but the last of which would have paid the bank in full, consistent with its priority status.<sup>124</sup> At the hearing on the last plan, however, the bankruptcy judge concluded that, by refusing to lend any more than the \$75,000 directly (plus the amounts honored under the letters of credit), the bank had acted “inequitably.”<sup>125</sup> In confirming this plan, the bankruptcy court concluded that the appropriate remedy for the bank’s inequitable conduct was to vacate the original order approving the bank’s financing and subordinating the bank’s claim, effectively leaving the bank unpaid.

The Seventh Circuit reversed the bankruptcy court. Judge Easterbrook recognized that, even following an era in which equitable claims against lenders expanded significantly, “[c]ases subordinating the claims of creditors that dealt at arm’s length with the debtor are few and far between.”<sup>126</sup> “[U]sually,” he reasoned, equitable subordination “is a response to efforts by corporate insiders to convert their equity interests into secured debt in anticipation of bankruptcy.”<sup>127</sup> Here, the bank was not an insider. According to Judge Easterbrook, “It contributed new value under a contract, and it wants no more than the priority Judge Toles promised as the lure.”<sup>128</sup>

The debtor had argued that the bank’s conduct was “unfair” and “inequitable” even though permitted by the language of the contract.<sup>129</sup> Judge Easterbrook rejected this position: “[W]e are not willing to embrace a rule that requires participants in commercial transactions not only to keep their contracts but also do ‘more’—just how much more resting in the discretion of a bankruptcy judge assessing the situation years later.”<sup>130</sup> Permitting this sort of ex post review would increase the cost of capital, he believed.<sup>131</sup> “Unless pacts are enforced according to their terms, the institution of contract, with all the advantages private negotiation and

---

124. *Id.* at 1354.

125. *Id.*

126. *Id.* at 1356.

127. *Id.*

128. *Id.*

129. *Id.*

130. *Id.* This is obviously an exaggeration. In *Kham & Nate*’s, the bankruptcy judge had approved the financing, and had jurisdiction to resolve disputes over it more or less contemporaneously.

131. *Id.* at 1356–57 (“Courts may not convert one form of contract into the other after the fact, without raising the cost of credit or jeopardizing its availability.”).

agreement brings, is jeopardized.”<sup>132</sup>

Judge Easterbrook recognized that some conduct might be inequitable. But, the bank’s conduct here was not. “‘Inequitable conduct’ in commercial life,” he observed, “means breach *plus* some advantage-taking, such as the star who agrees to act in a motion picture and then, after \$20 million has been spent, sulks in his dressing room until the contract has been renegotiated.”<sup>133</sup> Treating good faith as a “gap filler,” he reasoned that “principles of good faith—such as the U.C.C.’s standard of honesty in fact” and “the reasonable expectations of the trade”<sup>134</sup>—would apply only “[w]hen the contract is silent.”<sup>135</sup> Creditors are not, however, their borrower’s fiduciaries: “they are not bound to treat [borrowers] with the same consideration reserved for their families.”<sup>136</sup> Thus, the bank won.

Strictly speaking, *Kham & Nates* concerned “equitable subordination,” a subspecies of lender liability with its own jurisprudence.<sup>137</sup> While fine doctrinal distinctions may matter in other contexts, the real contribution of *Kham & Nate’s* goes to the institutional questions at the heart of these cases: How should we go about deciding whether a lender has gone too far? In the view of Fischel and Easterbrook, contracts—not communities—should define the boundaries of acceptable creditor conduct.

### C. SUMMARY

The doctrinal arc from *K.M.C.* through *Kham & Nate’s* is usually thought to describe the rise and demise of lender liability 1.0.<sup>138</sup>

---

132. *Id.* at 1357.

133. *Id.*

134. *Id.*

135. *Id.*

136. *Id.*

137. *Id.* at 1354. As discussed below, equitable subordination is a remedy used by bankruptcy courts to punish “inequitable” conduct by creditors of a debtor. Section 510(c) of the Bankruptcy Code provides, in relevant part, that a court may “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.” 11 U.S.C. § 510(c) (2006). The doctrine grew out of a series of Supreme Court cases, *Taylor v. Standard Gas & Electric Co.*, 306 U.S. 307 (1939); *Pepper v. Litton*, 308 U.S. 295 (1939); and *Comstock v. Group of Institutional Investors*, 335 U.S. 211 (1948). Generally, a claim will be equitably subordinated if (1) the creditor engaged in some type of inequitable conduct; (2) the misconduct resulted in injury to other creditors or conferred an unfair advantage on the creditor to be subordinated; and (3) equitable subordination is not inconsistent with other provisions of the bankruptcy laws. See *Benjamin v. Diamond (In re Mobile Steel Co.)*, 563 F.2d 692, 700 (5th Cir.1977) (enumerating the three conditions that must be satisfied before equitable subordination is appropriate).

138. See Claire Moore Dickerson, *From Behind the Looking Glass: Good Faith, Fiduciary Duty & Permitted Harm*, 22 FLA. ST. U. L. REV. 955, 1011 (1995) (“[W]e are left with uncertainty as to the

Superficially, it would appear that *K.M.C.* and *Kham & Nate's* are polar opposites, and that the latter contractually rebottled the communitarian genie set loose by the former. While courts may sometimes continue to punish lenders for overreaching,<sup>139</sup> they will do so only rarely, preferring (like the *MarketXT* court) the contractarian certainty of Fischel and Easterbrook to the communitarian unpredictability of lay juries. Yet, it would seem more accurate to describe the difference as one of institutional choice: the *K.M.C.* court believed that the judicial branch (and the substitution of the civil jury) could perform appropriate ex post review of the good faith of a lender's enforcement actions, while the *Kham & Nate's* court did not.

Perhaps most important—and yet ignored by commentators—is what *K.M.C.* and *Kham & Nate's* share: a bilateral conception of good faith. Both courts view the essential question of good faith as being about the behavior of the contract parties toward one another. *K.M.C.*'s (permissible) jury instruction asked jurors to focus on the lender's (Irving's) duties to the borrower: Did the duty of good faith “impose[] on Irving a duty to give notice to K.M.C. . . . ?”<sup>140</sup> *Kham & Nate's* exonerated the creditor because “[g]ood faith” is about what was or was not contemplated “explicitly by the parties” with respect to one another.<sup>141</sup>

The problem, as will be developed below, is that these are not the only (or necessarily the appropriate) parties from whose perspective we should judge good faith. In the context of financial distress, good faith requires us to consider a broader group of stakeholders, because they are the ones who will be affected by the behavior of the debtor and controlling creditors.

---

extent of the good faith obligation in lender liability.”); A. Brooke Overby, *Bondage, Domination, and the Art of the Deal: An Assessment of Judicial Strategies in Lender Liability Good Faith Litigation*, 61 *FORDHAM L. REV.* 963, 1013–15 (1993) (“[T]he passive judicial strategy toward good faith in lender liability cases is beginning to achieve substantial acceptance in the courts.”).

139. Some modern courts and juries have punished lenders who have defrauded their borrowers, e.g., *Corestates Bank, N.A. v. Levy Bros. Co.*, No. 98 CV 1158, 2006 WL 3478942 (Pa. C.P. Sept. 29, 2006); committed torts, e.g., *Busy Bee, Inc. v. Wachovia Bank, N.A.*, No. 97 CV 5078, 2006 Pa. Dist. & Cnty. Dec. LEXIS 238 (Pa. C.P. Feb. 28, 2006); or were grossly negligent, e.g., *In re Yellowstone Mountain Club, LLC*, 2009 Bankr. LEXIS 2047 (Bankr. D. Mont. May 13, 2009). Others have declined to do so for conduct that appears equally egregious. See *Famm Steel, Inc. v. Sovereign Bank*, 571 F.3d 93, 102 (1st Cir. 2009) (holding that “the relationship between a lender and a borrower, without more, does not establish a fiduciary relationship” despite lender's breach of promises and actual control by installing officers who managed debtor ineffectively).

140. *K.M.C. Co. v. Irving Trust Co.*, 757 F.2d 752, 759 (6th Cir. 1985).

141. *Kham & Nate's*, 908 F.2d at 1357 (internal quotation marks omitted) (“‘Good faith’ is a compact reference to an implied undertaking not to take opportunistic advantage in a way that could not have been contemplated at the time of drafting, and which therefore was not resolved explicitly by the parties.”).

Distress investing, especially as it appears to be developing, requires a different understanding and application of good faith than contract law alone would provide.

## V. THREE MODELS OF GOOD FAITH

To say that creditor opportunism challenges good faith begs the obvious question: what do we mean by good faith? While good faith has long been the way that courts police opportunistic behavior in contractual relations, the reality is that contract—as such—is only one of many potential doctrinal constructs through which we might give content to the term “good faith.” After developing contract doctrine’s bilateral approach to good faith, and explaining why it, by itself, will not solve problems of modern creditor opportunism, this part argues that good faith as understood in the law of corporations and bankruptcy may be more apt.

### A. BILATERAL GOOD FAITH—GOOD FAITH IN TRADITIONAL CONTRACT DOCTRINE—THE EXISTENTIAL QUESTION

Good faith is the Zelig of private law,<sup>142</sup> appearing chameleon-like in many different contexts. Academics disagree about virtually everything involving good faith, including whether it even exists<sup>143</sup> or is an obligation distinct from fiduciary duty.<sup>144</sup> Doctrinally, courts have long treated good

---

142. The Woody Allen movie *Zelig* is a fictional documentary “about the life of human chameleon Leonard Zelig, a man who becomes a celebrity in the 1920s due to his ability to look and act like whoever is around him.” *Plot Summary for Zelig* (1983), INTERNET MOVIE DATABASE, <http://www.imdb.com/title/tt0086637/plotsummary> (last visited Aug. 2, 2011).

143. Auer, *supra* note 31, at 5 (“It has almost become a trademark of writings in this genre to begin by emphasizing the unsatisfactory state of the debate, which mostly seems to be concerned with the insurmountable difficulty of defining a concept such as ‘good faith.’”). See also Emily M.S. Houh, *The Doctrine of Good Faith in Contract Law: A (Nearly) Empty Vessel?*, 2005 UTAH L. REV. 1, 1 (2005) (questioning whether good faith should exist). But cf. Robert S. Summers, “Good Faith” in *General Contract Law and the Sales Provisions of the Uniform Commercial Code*, 54 VA. L. REV. 195, 199 (1968) (“[G]ood faith is both a pervasively relevant and an independently significant doctrine in the fields of contracts and sales.”); Robert S. Summers, *The General Duty of Good Faith—Its Recognition and Conceptualization*, 67 CORNELL L. REV. 810, 810 (1982) (discussing section 205 of the Restatement (Second) of Contracts, which represents a “major advance[.]” in good faith doctrine) [hereinafter Summers, *General Duty*].

144. Some think fiduciary review and good faith are just different points on the contractual continuum. As Easterbrook and Fischel claim,

When transactions costs reach a particularly high level, some persons start calling some contractual relations “fiduciary,” but this should not mask the continuum. Contract law includes a principle of good faith in implementation—honesty in fact under the Uniform Commercial Code, plus an obligation to avoid (some) opportunistic advantage taking. Good faith in contract merges into fiduciary duties, with a blur and not a line.

Easterbrook & Fischel, *supra* note 119, at 438 (footnotes omitted). See also Andrew S. Gold, *On the Elimination of Fiduciary Duties: A Theory of Good Faith for Unincorporated Firms*, 41 WAKE FOREST

faith as the antidote for bilateral opportunism. This means that one party cannot use the contract to “harm” the other party<sup>145</sup> or use discretion in the contract to frustrate its purpose.<sup>146</sup> Even Judge Easterbrook, in *Kham & Nate’s*, paid lip service to the idea that good faith checks opportunism.<sup>147</sup>

The central scholarly debate about contractual good faith is, in a sense, existential: Is there any “there there”?<sup>148</sup> Do the words “good faith” impute some affirmative duties, and if so, what are they? Or, does the term merely exclude a variety of forms of misconduct that courts can identify in more or less ad hoc fashion? Similarly, is good faith instrumental, having economic consequences (as was the case in *K.M.C.*) or is it merely expressive (as in *Kham & Nate’s*), aspirational but unlikely to require an offender to pay damages?

Robert Summers famously argued the latter—there was no “there there” in good faith jurisprudence.<sup>149</sup> Restatement (Second) Section 205

---

L. REV. 123, 134 (2006) (“Fiduciary duties exist along the same continuum as contractual duties of good faith and fair dealing.”). Others, however, have a different view. *See, e.g.*, Dickerson, *supra* note 138, at 993 (“[T]he current view [is] that fiduciary duty and good faith are wholly separate concepts.”). Of course, it is important to remember that good faith has deep roots in confusion. Its modern progenitor, *Kirke La Shelle*, appeared to collapse good faith and fiduciary duty, and we have struggled with the distinction ever since.

Indeed, the court in *Kirke La Shelle* characterized [the] restraint [on alleged opportunistic behavior] as stemming from “the duty of utmost good faith” that arose from the “fiduciary relationship” established by the parties in their contract. Perhaps the court was using the term “fiduciary” more metaphorically than analytically. If the licensor-licensee relationship in *Kirke La Shelle* created a fiduciary obligation, the consequences of that obligation diverge significantly from the consequences of other fiduciary obligations.

Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879, 896–97 (quoting *Kirke La Shelle Co. v. Paul Armstrong Co.*, 188 N.E. 163, 166 (N.Y. 1933)).

145. *See, e.g.*, *Conoco Inc. v. Inman Oil Co.*, 774 F.2d 895, 908 (8th Cir. 1985) (finding good faith imposed a duty to do nothing destructive of another party’s right to the fruits of the contract); *Lloyd Noland Found., Inc. v. City of Fairfield Healthcare Auth.*, 837 So. 2d 253, 267 (Ala. 2002) (same); *Anthony’s Pier Four, Inc. v. HBC Assocs.*, 583 N.E.2d 806, 820–21 (Mass. 1991) (same).

146. *See, e.g.*, *Seidenberg v. Summit Bank*, 791 A.2d 1068, 1077 (N.J. 2002) (“The guiding principle in the application of the implied covenant of good faith and fair dealing emanates from the fundamental notion that a party to a contract may not unreasonably frustrate its purpose . . . . [Thus,] the defendant [may] not exercise . . . discretion . . . under the literal terms of the contract to thwart plaintiff’s expectation or purpose.” (quoting *Emerson Radio Corp. v. Orion Sales Inc.*, 80 F. Supp. 2d 307, 314 (D.N.J. 2000), *rev’d in part on other grounds*, 253 F.3d 159 (3d Cir. 2001))).

147. *Kham & Nate’s Shoes No. 2, Inc. v. First Bank of Whiting*, 908 F.2d 1351, 1357 (7th Cir. 1990) (“‘Good faith’ is a compact reference to an implied undertaking not to take opportunistic advantage in a way that could not have been contemplated at the time of drafting, and which therefore was not resolved explicitly by the parties.”).

148. *Cf.* GERTRUDE STEIN, EVERYBODY’S AUTOBIOGRAPHY 289 (1993) (referring to visit to childhood home, “there is no there there”).

149. Summers, *General Duty*, *supra* note 143, at 819. Summers relied heavily on the work of John Langshaw Austin (March 28, 1911 – February 8, 1960), an English philosopher of language and speech theorist. *See id.* (quoting JOHN AUSTIN, SENSE AND SENSIBILIA 70–71 (G. Warnock ed. 1962))

and the common law of good faith generally simply forbade a variety of potentially bad acts, but imposed no positive duty. Quoting Restatement reporter Robert Braucher, Summers argued that “good faith ‘excludes a variety of types of conduct characterized as involving bad faith,’” including evasion of the spirit of the bargain, lack of diligence and slacking off, abuse of a power to specify terms, conjuring up a dispute to force a settlement or modification, willfully failing to mitigate damages, and so on.<sup>150</sup>

Steven Burton took the former position—good faith has positive content—because it prohibited opportunism. Burton argued that bad faith captured two essential ideas: (1) discretion to act within the contract, and (2) the misuse of that discretion to recapture an opportunity foregone in the contract.<sup>151</sup> By a parity of reasoning, Burton observed, “Good faith performance . . . occurs when a party’s discretion is exercised for any purpose within the reasonable contemplation of the parties at the time of formation—to capture opportunities that were preserved upon entering the contract, interpreted objectively.”<sup>152</sup>

At first blush, these depictions of good faith—although substantive antagonists—would both seem to proscribe the sorts of creditor opportunism we have seen. Surely, short sales may “evade the spirit” of any direct rights a distress investor holds against a firm. The kind of holding out we increasingly see sounds like “slacking off,” akin to Judge Easterbrook’s hypothetical “sulking star.”<sup>153</sup> The way lenders like Softbank in the *MarketXT* case use their “confluence” of rights certainly seems like an “abuse of discretion to define terms.”

Why, then, have courts shown little interest in treating these forms of behavior as opportunistic violations of the duty of good faith? The answer may be that this conception of good faith is too strong. These examples do

---

(describing Austin’s description of the term “real” as “illuminating”).

150. *Id.* at 820 (quoting RESTATEMENT (SECOND) OF CONTRACTS § 205 cmts. a, d, e (1981)). “Subterfuge and evasions violate the obligation of good faith in performance,” the Restatement comments indicate. RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. d. But, the Restatement continues, the obligation to act in good faith “goes further.”

[B]ad faith may be overt or may consist of inaction, and fair dealing may require more than honesty. A complete catalogue of types of bad faith is impossible, but the following types are among those which have been recognized in judicial decisions: evasion of the spirit of the bargain, lack of diligence and slacking off, willful rendering of imperfect performance, abuse of a power to specify terms, and interference with or failure to cooperate in the other party’s performance.

*Id.*

151. See sources cited *supra* note 30.

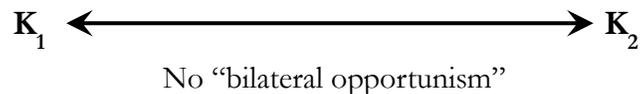
152. Burton, *Good Faith*, *supra* note 30, at 373.

153. *Kham & Nate’s Shoes No. 2, Inc. v. First Bank of Whiting*, 908 F.2d 1351, 1357 (7th Cir. 1990).

not just challenge modern examples of opportunism: they would impugn almost all workouts. Even in simpler times, restructuring negotiations involved “piling up damages.” The exigencies of distress often result in a “lack of diligence.” Buying debt in the distress context is, in a sense, always capturing a foregone opportunity: distress investors forego the “opportunity” to buy equity because they believe that the debt they purchase instead will convert to new equity, which would either dilute or cancel the old equity. And, if a distress investor buys debt, whose “spirit” of the deal determines the boundaries of good faith—the original lender or the investor? Is the “spirit” of good faith assignable?

Classical contract doctrine’s understanding of good faith proves too much because, as shown in figure 2, it is essentially concerned with bilateral relationships: The tenant who rearranges his shop to avoid paying percentage rent to the landlord;<sup>154</sup> the commodity buyer who locks in a low price and uses it to compete with his supplier when prices rise.<sup>155</sup> Restructurings, by contrast, will almost always be multilateral, involving multiple contracts, parties, positions and types of rights.

FIGURE 2. Bilateral Good Faith (Contract)



Viewing good faith in bilateral terms is obviously somewhat stylized, a “highly ordered structure in the form of [a] pair-wise, symmetrical opposition,” in the words of one observer of debates about good faith.<sup>156</sup> The structure of debates about good faith are self-consciously conceptual, and thus antiseptic, devoid, in Dennis Patterson’s terms, of the “purposiveness” that should inform our understanding of institutionally vital terms like “good faith.”<sup>157</sup>

154. Cf. *Mutual Life Ins. Co. v. Tailored Woman, Inc.*, 128 N.E.2d 401, 403 (N.Y. 1955).

155. *New York Cent. Iron Works Co. v. U.S. Radiator Co.*, 66 N.E. 967, 968 (N.Y. 1903).

156. See Auer, *supra* note 31, at 6.

157. PATTERSON, *supra* note 108, at 99–100 (“The purposive analysis of legal concepts provides what is most useful in discourse methodology, and marks a significant advance over the excluder analysis. By identifying the role and function of good faith in the discourse of commercial law, we have a means of unifying the many contexts in which good faith has meaning. The meaning of good faith never can be exhausted in any one of its instances, nor is any particular instance uniquely illustrative or

Yet, the basic point—the one that has escaped courts and commentators alike—is that while the context in which creditors invest has changed dramatically in the last twenty years, the structure of our doctrinal response has not. Courts remain wedded to a bilateral conception of good faith that they apply to claims of creditor opportunism. This new context—the modern distress investing market—renders the bilateral vision of good faith incomplete because it rests on a series of faulty structural assumptions about the rights and relationships involved.

B. MULTILATERAL GOOD FAITH—GOOD FAITH IN CORPORATE GOVERNANCE—REREADING *CREDIT LYONNAIS*

As examples in Part III show, the central structural problem created by opportunistic distress investing is its complexity, its heterogeneous and multilateral character. Distress investors may hold multiple types of claims against a distressed firm (heterogeneity). Due to the debtor's financial distress, opportunism will have multilateral consequences because it will harm not only the debtor—with whom an investor may have a bilateral relationship—but also the debtor's many other stakeholders, including employees, trade creditors, involuntary creditors, and others generally not in a position to protect themselves contractually.<sup>158</sup>

1. Good Faith in Corporate Governance Generally

This multilateral conception of good faith is foreign to contract doctrine and the approach represented by lender liability 1.0. But it captures important aspects of how good faith is understood in corporate governance law, where good faith has long played an important role in policing opportunism by those who control firms.

The key question about good faith in the corporate context is not existential (as with contract doctrine), but instead logistic. Most take for granted that a duty of good faith exists in the corporate governance context. The important questions are what that means, and where that duty lies in relation to (and interacts with) other, more traditional governance duties, such as care and loyalty.

The statutory pattern gives good faith a prominent role in corporate governance. The Model Business Corporations Act provides that directors shall act “in good faith,” “in a manner the director reasonably believes to

---

paradigmatic.” (footnotes omitted).

158. That is, “low VCE” creditors. See Lipson, *Directors' Duties*, *supra* note 25, at 1245–49 (discussing four categories of low VCE creditors).

be in the best interests of the corporation,” and “with the care that a person in a like position would reasonably believe appropriate under similar circumstances.”<sup>159</sup> Delaware’s General Corporation Law provides that protections such as exculpation and indemnification are available only to those who have acted in “good faith.”<sup>160</sup>

Good faith was thus traditionally assumed to be part of the background of corporate law. In 1993, however, it came briefly to the foreground, when the Delaware Supreme Court announced in *Cede & Co. v. Technicolor, Inc.* that good faith enjoyed equal dignity with the duties of care and loyalty, that there were, in other words, three duties, not two.<sup>161</sup> This announcement was followed by the *Disney*<sup>162</sup> and *Stone*<sup>163</sup> cases, which whipsawed back and forth, *Disney* suggesting that corporate directors are bound by an independent duty of good faith, *Stone* holding that good faith is nothing more than a species of loyalty, having no independent doctrinal stature in the world of corporate governance.

Today, leading authorities seem to view the debate as having come to rest at the latter point: good faith in the corporate governance context is not a separate class of fiduciary duty, but instead is a subspecies of the duty of loyalty. “The concept of good faith has long been a vital one in Delaware’s corporate law,” several prominent Delaware corporations law authorities recently explained, “but not as a fiduciary duty separate from the fundamental duty of loyalty.”<sup>164</sup> Rather, drawing on cases such as *Stone v. Ritter*, they argue that “good faith has long been used as the key element in defining the state of mind that must motivate a loyal fiduciary.”<sup>165</sup> Good faith is not an independent duty, they argue, but is instead “at the core of

159. MODEL BUS. CORP. ACT. § 8.30(a)–(b) (2007).

160. See, e.g., DEL. CODE ANN. tit. 8, §§ 102(b)(7), 141(e), 144, 145(a)–(b) (2001). See also *Ryan v. Lyondell Chem. Co.*, 970 A.2d 235, 239 (Del. 2009) (discussing good faith in connection with exculpation clause).

161. *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993) (“[A] shareholder plaintiff assumes the burden of providing evidence that directors, in reaching their challenged decision, breached any one of the *triads* of their fiduciary duty—good faith, loyalty or due care.”). Earlier cases such as *Perrine v. Pennroad Corp.*, seemed to assume that corporate actors owed the firm a duty of good faith. *Perrine v. Pennroad Corp.*, 47 A.2d 479, 489 (Del. 1946) (bad faith includes conduct that is “reckless and indifferent as to the rights of the stockholders”). See also *In re J.P. Stevens & Co. S’holders Litig.*, 542 A.2d 770, 780–81 (Del. Ch. 1988) (evaluating whether directorial conduct was “so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith”).

162. *In re The Walt Disney Co. Derivative Litigation*, 906 A.2d 27 (Del. 2006); *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693 (Del. Ch. 2005).

163. *Stone v. Ritter*, 911 A.2d 362 (Del. 2006).

164. See, e.g., Strine et al., *supra* note 40, at 633.

165. *Id.*

the duty of loyalty.”<sup>166</sup>

The classic example of bad faith in corporate governance law involves not self-dealing, *per se*—as that will already violate the duty of loyalty—but instead nonconflict acts or omissions that may have the effect of harming the corporation, such as causing the corporation to engage in an illegal course of conduct or failing to detect and interdict such illegality. Strictly speaking, that is not a product of self-interest, and indeed in the short run may appear to help the corporation. Rather, as articulated by Chancellor Allen in *Caremark*, the absence of good faith may be shown by directors’ “sustained or systematic failure . . . to exercise oversight.”<sup>167</sup> As *Caremark* suggested, a board’s failure to detect corporate fraud may not have been due to self-interest, but it nevertheless potentially offended the duty of good faith, whether as a species of loyalty or a standalone duty.

Good faith in corporate governance doctrine generally thus appears to have two features that distinguish it from good faith in contract doctrine. First, it is multilateral in character. Corporate good faith is concerned chiefly with harm to the corporation—the entity, and indirectly its stakeholders—not the benefits enjoyed by conflicted fiduciaries. Second, it is largely about subjective—not objective—bad faith. Good faith here does not focus on the reasonableness of directors’ behavior measured by “community” standards of directorial conduct. That might be part of the duty of care, not good faith.<sup>168</sup> Rather, as Chancellor Allen reasoned in the *RJR* takeover case, good faith requires “a review of the board’s subjective motivation.”<sup>169</sup>

---

166. *Id.* at 632 (citing *Stone v. Ritter*, 911 A.2d 362 (Del. 2006)). They attribute brief interludes to the contrary—driven chiefly by *Cede & Co.*—as resulting from a series of mistaken understandings of the relationship between good faith and loyalty. Although *Cede & Co.* denominated good faith a separate duty, it arguably did not actually treat it that way. Instead, *Cede & Co.*, which upheld a challenge to MacAndrews & Forbes’s two-step acquisition of Technicolor, Inc., was in reality best understood as a loyalty case. According to Vice Chancellor Strine and coauthors, *Cede & Co.* “actually framed the issue of loyalty in a broad way that subsumes the proposition that a director must act in good faith to advance corporate, not personal, interests.” *Id.* at 682 (citing *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 365 (Del. 1993)).

167. *In re Caremark Int’l Inc. Derivative Litig.*, 698 A.2d 959, 971 (Del. 1996). Of course, everything about good faith in *Caremark* may have been dicta, since the opinion merely approved the settlement of a shareholder lawsuit stemming from a board’s failure to detect and stop fraud by corporate managers. *Id.* at 972.

168. *In re RJR Nabisco, Inc. S’holders Litig.*, No. 10389, 1989 Del. Ch. LEXIS 9, at \*39 (Del. Ch. Jan. 31, 1989).

169. *Id.* at \*39.

## 2. Good Faith and Governance of the Distressed Firm

The debate about the status of good faith in corporate governance law almost never considers the role that the doctrine might play in the context of distressed corporations. This is both surprising and unfortunate, as the Delaware courts have used good faith as a way of defining and delimiting duty and liability in that context as well. Arguably, they do so in a way that treats good faith as an independent duty. But whether freestanding or collapsed into loyalty, Delaware's corporate-governance good faith may be a more apt way to assess the conduct and of controlling creditors of a distressed firm than is the good faith of contract doctrine or lender liability 1.0.

In cases such as *Credit Lyonnais* and *Gheewalla*, the Delaware courts carved out an important and controversial niche for themselves in the distress context when considering whether, or to what extent, directors of distressed firms owe fiduciary duties to corporate creditors. The logic of the cases is fairly straightforward, although it reflects a somewhat crude understanding of priority doctrine: Having priority over shareholders, unsecured creditors of a firm in the zone of distress are its "residual claimants"; directors should act for the benefit of the residual claimants: ergo, directors should act for the benefit of creditors when the corporation is in financial distress.<sup>170</sup>

These cases are often thought to be about directors' fiduciary duties to creditors, and indeed they often invoke such terminology.<sup>171</sup> Yet, a careful reading suggests that another—perhaps better—way to understand them is as being about good faith.

---

170. See Lipson, *Expressive Function*, *supra* note 25, at 246–55 (describing priority-duty model).

171. Those who have argued that *Credit Lyonnais* created fiduciary risk for corporate directors include Royce de R. Barondes, *Fiduciary Duties of Officers and Directors of Distressed Corporations*, 7 GEO. MASON L. REV. 45, 66–71 (1998) (arguing that *Credit Lyonnais* should be read to create rights that are "affirmatively enforceable" by creditors against directors of companies in the vicinity of insolvency); James Gadsden, *Enforcement of Directors' Fiduciary Duties in the Vicinity of Insolvency*, 24 AM. BANKR. INST. L. REV. 16 (2005); Ramesh K.S. Rao, David Simon Sokolow & Derek White, *Fiduciary Duty à la Lyonnais: An Economic Perspective on Corporate Governance in a Financially-Distressed Firm*, 22 J. CORP. L. 53, 64–76 (1996); Andrew D. Shaffer, *Corporate Fiduciary—Insolvent: The Fiduciary Relationship Your Corporate Law Professor (Should Have) Warned You About*, 8 AM. BANKR. INST. L. REV. 479 (2000); Myron M. Sheinfeld & Judy Harris Pippitt, *Fiduciary Duties of Directors of a Corporation in the Vicinity of Insolvency and After Initiation of a Bankruptcy Case*, 60 BUS. LAW. 79 (2004); and John M. Sjovall, *What Duty Do Company Directors Owe to Banks and Other Creditors?*, 121 BANKING L.J. 4 (2004). I have argued elsewhere that Delaware case law on directors' duties creditors—to the extent it is about fiduciary review—is expressive, not instrumental, in design and effect. See Lipson, *Expressive Function*, *supra* note 25, at 255–61.

Consider *Credit Lyonnais*.<sup>172</sup> *Credit Lyonnais* arose out of the failed leveraged buyout (“LBO”) of MGM, which had been financed by Credit Lyonnais Bank Nederland (“CLBN”).<sup>173</sup> As part of a strategy to have MGM’s bankruptcy case dismissed, MGM’s controlling shareholder, Giancarlo Parretti entered into a restructuring agreement with the bank whereby he ceded most of his power as shareholder to CLBN.<sup>174</sup> Despite the restructuring agreement, it appears that Parretti persisted in attempting to control MGM.<sup>175</sup> Believing that Parretti was in breach of the restructuring agreement, CLBN exercised its right to take control of Parretti’s stock, removed him and his designees from the board, and replaced them with directors selected by CLBN.<sup>176</sup> CLBN then asked the Delaware Chancery Court to confirm its appointments and enforce the restructuring agreement.<sup>177</sup>

Parretti asserted a variety of counterclaims against CLBN, including two alleging that CLBN and Ladd had breached duties to Parretti by creating “golden parachutes” for the bank-appointed managers and refusing to sell certain assets.<sup>178</sup> Chancellor Allen summarily disposed of the claims. “It is,” he observed “an oddity of these facts that the change in control that the contracts contemplated is one that would return control back to an existing controlling shareholder, but I don’t see that circumstance as necessarily material.”<sup>179</sup> There was, according to Chancellor Allen, no basis for claiming the breach of any duty to Parretti as there was “persuasive evidence that the [CLBN] management group acted prudently with respect to these transactions from the point of view of MGM.”<sup>180</sup>

If Chancellor Allen had said no more than this, *Credit Lyonnais* would probably not have been a terribly important or controversial decision. Parretti had, after all, conditionally ceded control to creditor CLBN under the restructuring agreement. But Chancellor Allen went on to announce what appeared to have been a new, and ill-defined, set of duties owed by

---

172. *Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc’ns Corp.*, No. 12150, 1991 Del. Ch. LEXIS 215 (Del. Ch. Dec. 30, 1991).

173. *See id.* at \*7–8.

174. *See id.* at \*33 (discussing bank’s control under restructuring agreement).

175. *See id.* at \*35–70.

176. *See id.* at \*70.

177. *See id.* at \*3.

178. *See id.* at \*97–98. Technically, Parretti claimed that the duty ran to PCC, which was the 98.5 percent shareholder of MGM. Since Parretti controlled PCC, I will refer to the owner of MGM’s shares as Parretti.

179. *Id.* at \*107.

180. *Id.* at \*108.

directors to or for the benefit of corporate creditors: “At least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise.”<sup>181</sup>

What did this mean? In an elaborate footnote, Chancellor Allen explained that CLBN’s directors and managers had no duty to act for Parretti, or any particular constituency, because they instead were to “conceiv[e] of the corporation as a legal and economic entity.”<sup>182</sup> Most analysis of *Credit Lyonnais* has focused on whether this footnote created affirmative causes of action that creditors or a bankruptcy trustee could pursue against directors and what effect such risk would have on directors.<sup>183</sup> Others have observed that the meaning of the opinion is, for a variety of reasons, indeterminate<sup>184</sup> or “much ado about nothing.”<sup>185</sup>

In fact, the case may not really be about directors’ fiduciary duties to creditors at all. Instead, it may really be about duties that parties in distress negotiations owe to one another generally—including creditors who may seek or exert control of the borrower. What duty would that be? According to Chancellor Allen, good faith. Citing, among other things, Restatement (Second) Contracts § 205, Chancellor Allen held that—

Giancarlo Parretti *did not act with that degree of good faith that contracting parties are entitled to expect and demand. . . .* More specifically, I conclude that he breached the foundational obligation implicit in every contract, to refrain from acting with respect to the subject matter of his contract so as to deny or materially impair the value bargained for by his promisee. From the outset Mr. Parretti adopted a course of conduct that insistently and continually breached the obligation to act with respect to the subject matter of the contract *in good faith and to deal fairly, so that the bargain for which the other gave value should not, by his action, be defeated or materially impaired.*<sup>186</sup>

---

181. *Id.*

182. *Id.*

183. See Lipson, *Expression Function*, *supra* note 25, at 229–30 & n.17 (collecting citations).

184. See Lipson, *Directors’ Duties*, *supra* note 25, at 1211.

185. See, e.g., Stephen M. Bainbridge, *Much Ado About Little? Directors’ Fiduciary Duties in the Vicinity of Insolvency*, 1 J. BUS. & TECH. L. 335, 338 (2007).

186. *Credit Lyonnais*, 1991 Del. Ch. LEXIS 215, at \*72 (emphasis added). This perhaps lends support to Vice Chancellor Strine’s thoughtful analysis of *Credit Lyonnais* in the *Production Resources* opinion. Here, the Vice Chancellor explained that the “spirit” of *Credit Lyonnais* was that the business-judgment rule protected directors acting in good faith, who pursue a less risky business strategy in the light of potential insolvency because the directors fear a riskier strategy would cause the corporation to default on its legal obligations to creditors. *Prod. Res. Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d 772, 787–88 (Del. Ch. 2004).

In other words, Parretti was acting opportunistically—seeking extra-contractual benefits that harmed the other party (CLBN)—and the antidote for opportunism is good faith review.

This sounds like the bilateral good faith of contract doctrine, which, we have seen, may be too strong to yield acceptable results in cases involving creditor opportunism. Yet, Chancellor Allen did not stop there. His dicta about directors' duties to creditors reflects a multilateral approach to good faith in corporate governance doctrine generally. Directors of the distressed firm, Chancellor Allen explained elsewhere in *Credit Lyonnais*, must be

*capable of conceiving of the corporation as a legal and economic entity. Such directors will recognize that in managing the business affairs of a solvent corporation in the vicinity of insolvency, circumstances may arise when the right (both the efficient and the fair) course to follow for the corporation may diverge from the choice that the stockholders (or the creditors, or the employees, or any single group interested in the corporation) would make if given the opportunity to act.*<sup>187</sup>

*Credit Lyonnais* offers three lessons about the role that good faith can play in policing creditor opportunism. First, it signals that those in control of a distressed firm should be judged not necessarily as fiduciaries, but instead under a good faith standard. This was a point the Delaware Supreme Court recently affirmed in the *Gheewalla* case, its only major decision on directors' duties to creditors. Here, the Delaware high court reasoned that directors owed creditors of firms in the zone of distress no fiduciary duties because “creditors’ existing protections [including] . . . the implied covenant of good faith and fair dealing . . . render the imposition of an additional, unique layer of protection though direct claims for breach of fiduciary duty unnecessary.”<sup>188</sup>

Second, we should understand that good faith in this context, as with good faith in corporate law generally, is multilateral in character. *Credit Lyonnais* means that to the extent that the bank-appointed directors owed duties to anyone, they ran to the corporation, and not to Parretti, per se. The corporation, however, is an entity that merely channels the collective claims of its various stakeholders. It is by definition a multilateral construct whose social and legal value derives importantly from its capacity to sort

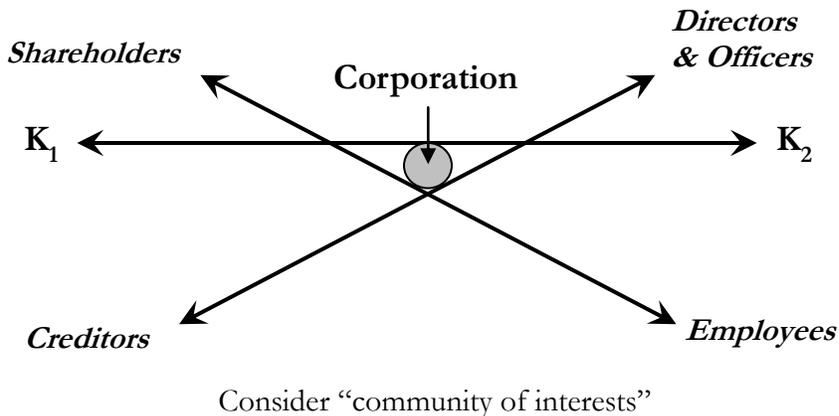
187. *Credit Lyonnais*, 1991 Del. Ch. LEXIS 215, at \*108 (emphasis added).

188. *N. Am. Catholic Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 100 (Del. 2007) (emphasis added). *See id.* (“Creditors are often protected by strong covenants, liens on assets, and other negotiated contractual protections.” (quoting *Prod. Res.*, 863 A.2d at 790)). Note that this implies that, at least in the distress context, good faith may be a standalone duty.

and direct those claims.

As depicted in figure 3, creditors, shareholders, directors, officers, and others all jockey for control of the distressed corporation, and all are affected by the outcome of that contest. There is no reason to discourage the contest, so long as it occurs with at least the modest level of good faith expected of corporate law. Yet, their good faith (or not) will surely affect the debtor “as a legal and economic entity.” Bilateral contract alone is not a reliable mechanism by which to measure good faith, however, because the distress investor may have multiple rights (involving multiple contracts) against or affecting the debtor. The debtor may not even be party to some of those contracts, as is the case in short sales. Yet, subjecting controlling creditors to no extra-contractual review seems only to encourage the sort of opportunism that destroys going concerns and value for the firms’ other stakeholders.

FIGURE 3. Multilateral Good Faith (Corporate Governance)



Third, the good faith that matters is the subjective intent of those in control. Delaware’s application of good faith would appear to focus on the state of mind of those in control, and not to measure their conduct against others in similar positions. Among other things, this means that mere self-seeking will not of itself violate the duty of good faith. Rather, good faith constrains action that knowingly harms the debtor. “[W]hile contracting parties are not fiduciaries for each other,” Chancellor Allen observed in *Creditor Lyonnais*, “there are outer limits to the self-seeking actions they may take under a contract.”<sup>189</sup> Those outer limits are, at least in the distress context, better policed by good faith as developed in the law of corporate governance than exclusively by contract’s good faith.

### C. INSTITUTIONAL GOOD FAITH—GOOD FAITH BANKRUPTCY FILINGS

A third way to understand good faith, which tends to supplement the foregoing, involves not the conduct of parties toward one another, but instead toward institutions, in particular bankruptcy courts. Distress investing is often prelude to, or proxy for, a bankruptcy proceeding. As such, it will indirectly be concerned with the way that bankruptcy courts treat good faith.

189. *Credit Lyonnais*, 1991 Del. Ch. LEXIS 215, at \*76–77. Note that Chancellor Allen used the rhetoric of bilateral good faith. This is not surprising, but it does not mean that principles of bilateral good faith necessarily map neatly onto the multilateral context of distress investing. In fact, we know they should not. As discussed below, some will; others will be too strong or otherwise inappropriate.

Good faith appears at various points in the Chapter 11 process. For example, a buyer of assets out of bankruptcy will succeed notwithstanding an appeal of the sale order if the purchase was in “good faith.”<sup>190</sup> A bankruptcy court can confirm a reorganization plan only if, among other things, it was proposed in “good faith.”<sup>191</sup> Although not stated in the statute, bankruptcy courts usually require that a Chapter 11 case be commenced in “good faith.”<sup>192</sup>

The Bankruptcy Code does not define good faith, and it is not clear that the term has (or should have) the same meaning across the bankruptcy spectrum. Not surprisingly, and as in other contexts, determining whether a case is commenced in good faith is fact specific, and thus prone to few generalizations.<sup>193</sup> Courts have been concerned with debtors who file bankruptcy in an attempt to gain an advantage in litigation strategies,<sup>194</sup> or to buy themselves time to get out of foreclosure proceedings.<sup>195</sup> Important factors in assessing whether a petition has been filed in “bad faith,” include whether there is a “valid reorganization[al] purpose,”<sup>196</sup> or evidence of “subjective bad faith” practices.<sup>197</sup> Among other things, bad faith may be

---

190. 11 U.S.C. § 363(m) (2006) (“The reversal or modification on appeal of an authorization [to sell assets not in ordinary course] does not affect the validity of a sale . . . under such authorization to an entity that purchased . . . such property in good faith . . .”).

191. *Id.* § 1129(a)(3) (stating that, among other things, a plan may be confirmed only if a court finds that “[t]he plan has been proposed in good faith and not by any means forbidden by law”).

192. Section 1112 permits a bankruptcy court to dismiss a case if the party moving for such dismissal establishes “cause.” 11 U.S.C. § 1112(b) (2006). While § 1112(b)(4)(A)–(P) lists various forms of “cause,” the list is not limited because the statute provides that it is inclusive. Courts have interpreted the list to include lack of good faith in the commencement of the case as a basis for dismissal. *See, e.g., In re SGL Carbon Corp.*, 200 F.3d 154 (3d Cir. 1999); *In re Little Creek Dev. Co.*, 779 F.2d 1068 (5th Cir. 1986).

193. *See In re Greenwood Supply Co.*, 295 B.R. 787, 793 (Bankr. S.D.S.C. 2002) (enumerating eleven fact-specific factors for determining subjective bad faith). *See also Carolin Corp. v. Miller*, 886 F.2d 693, 701 (4th Cir. 1989) (noting that, as other courts have ruled, “a totality of the circumstances inquiry is required” and that there is no set list or one pinnacle factor that will result in a finding of “bad faith”).

194. *See, e.g., SGL Carbon*, 200 F.3d at 166–67 (ruling dismissal of the Chapter 11 petition in light of evidence that the company filed bankruptcy as a litigation tactic against a pending antitrust suit). *See also In re Marsch*, 36 F.3d 825, 828 (9th Cir. 1994).

195. *See, e.g., In re Phoenix Piccadilly, Ltd.*, 849 F.2d 1393, 1395 (11th Cir. 1988).

196. *Marsch*, 36 F.3d at 828. That is, that the corporation filing for Chapter 11 relief is objectively able to reorganize and continue its operations. This is also referred to as “objective futility,” and usually involves a question as to whether reorganization is necessary or realistic for the company at the time of filing. *Carolin*, 886 F.2d at 701 (quoting *In re Coastal Cable T.V., Inc.*, 709 F.2d 762, 765 (1st Cir. 1983)) (reasoning that there must be a relationship between the petition in question and the objective of the Bankruptcy Code to provide equitable relief to a troubled debtor). *See also In re Liberate Techs.*, 314 B.R. 206 (Bankr. N.D. Cal. 2004); *Greenwood Supply*, 295 B.R. at 787.

197. *E.g., Phoenix Piccadilly*, 849 F.2d at 1393–94 (holding that a company’s ability to successfully reorganize does not “override, as a matter of law, the finding of bad faith

shown if the debtor is subject to “new debtor syndrome”;<sup>198</sup> there is no realistic possibility of reorganization; or the reorganization is really a two-party dispute.<sup>199</sup>

Bankruptcy courts thus use “good faith” as a way to preserve their integrity, and the integrity of the bankruptcy process.<sup>200</sup> Viewed this way, good faith is really a way that courts (or, for that matter, other institutions) can channel behavior to conform to established policy goals. Congress enacted Chapter 11 to promote negotiated loss reallocation, reasoning that “it is more economically efficient to reorganize than liquidate [a debtor], because [reorganization] preserves jobs and assets.”<sup>201</sup> A case that offends this policy goal lacks institutional good faith, and should be dismissed.

The point here is not to suggest that prebankruptcy behavior should be governed exclusively by the rules and standards of the bankruptcy process. The goal of distress investing is often to keep debtors out of bankruptcy, for good or for ill. Moreover, until a case is commenced, a bankruptcy court has no jurisdiction. If Congress wanted to impose the norms

---

or . . . compel . . . a contrary finding”). More recent cases combine these two elements into a single inquiry. *In re Harmony Holdings, LLC*, 393 B.R. 409, 418 (Bankr. S.D.S.C. 2008) (citing *Greenwood Supply*, 295 B.R. at 787). *See also Miller*, 709 F.2d at 700–01. *Cf. Little Creek*, 779 F.2d at 1072 (“[G]ood faith depends largely upon the bankruptcy court’s on-the-spot evaluation of the debtor’s financial condition, motives, and the local financial realities.”).

198. A case will be dismissed for lack of good faith where “a one-asset entity has been created or revitalized on the eve of foreclosure to isolate the insolvent property and its creditors . . .” *Little Creek*, 779 F.2d at 1073.

199. *See Harmony Holdings*, 393 B.R. at 418 (citing *Greenwood Supply*, 295 B.R. at 793). These factors have been enumerated over time, and have been compiled from various courts. *Compare Little Creek*, 779 F.2d at 1073 (listing several of the *Harmony* factors), with *In re Strug-Division, LLC*, 375 B.R. 445, 448 (Bankr. N.D. Ill. 2007), and *In re Trident Assocs. Ltd. P’ship*, 52 F.3d 127, 131 (6th Cir. 1995), and *In re Natural Land Corp.*, 825 F.2d 296, 298 (11th Cir. 1987). *See also* 7 COLLIER ON BANKRUPTCY § 1112.07 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2010) (discussing several specific circumstances where “good faith” was found to be lacking); 2 COLLIER ON BANKRUPTCY § 302; 2 COLLIER ON BANKRUPTCY § 303.16.

200. *Little Creek*, 779 F.2d at 1072. Good faith prevents abuse of the bankruptcy process by debtors whose overriding motive is to delay creditors without benefiting them in any way or to achieve reprehensible purposes. Moreover, a good faith standard protects the jurisdictional integrity of the bankruptcy courts by rendering their powerful equitable weapons (i.e., avoidance of liens, discharge of debts, marshalling and turnover of assets) available only to those debtors and creditors with “clean hands.”

*Id.*

201. *See* H.R. REP. NO. 595, at 220 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6179 (“The premise of a business reorganization is that assets that are used for production in the industry for which they were designed are more valuable than those same assets sold for scrap.”); 123 CONG. REC. H35,444 (daily ed. Oct. 27, 1977) (statement of Rep. Rodino) (“For businesses, the bill facilitates reorganization, protecting investments and jobs.”). *See also* MARTIN J. BIENENSTOCK, BANKRUPTCY REORGANIZATION 6–10 (1987).

embedded in that system on distressed firms in the absence of a formal bankruptcy case, it probably knew how to do so.

Nevertheless, the role that good faith plays in maintaining institutional integrity has two important implications for modern distress investing. First, there is the expressive effect of these norms. As I (and others) have observed elsewhere, legal standards articulated in this context often have rhetorical value far beyond the juridical confines of a particular case or controversy.<sup>202</sup> For example, in cases involving claims of directors' breach of fiduciary duties to creditors, I have argued that published opinions reveal a strong desire by the Delaware judiciary to exhort directors to behave in certain ways, without actually imposing liability on them if they fail to do so.<sup>203</sup> By parity of reasoning, the posture we take toward the principal institution designated to manage corporate financial distress should signal something about behavior toward distressed firms even if that particular institution is not involved. This seems especially important given the fact that distress investors will often be in the position to decide whether a firm ever reaches that institution (bankruptcy court) and if so, under what conditions.

Second, and perhaps more important because it is instrumental, the reality of distress investing appears to be that bankruptcy courts are sometimes recruited into supporting "reorganizations" that may, on greater inspection, advance not Congress' remedial policy goals as reflected in Chapter 11, but instead the interests of a particular stakeholder. There are, for example, claims that the sale of Lehman Brothers' brokerage division to Barclays Bank in the *Lehman Brothers Holdings* bankruptcy, and the automaker bankruptcies, offended bankruptcy policy by enabling particular creditors in a position to control the process to profit at the expense of others.<sup>204</sup> More generally, there is ample anecdotal evidence that sophisticated private investors seek to manipulate the Chapter 11 process, and sometimes succeed, to their opportunistic advantage.<sup>205</sup>

Whether or not a bankruptcy case is commenced, as depicted in figure 4, the bankruptcy process, as an institution, casts a shadow over workouts that distress investors cannot and should not ignore. Part of that shadow will be the ways that this institution defines good faith.

---

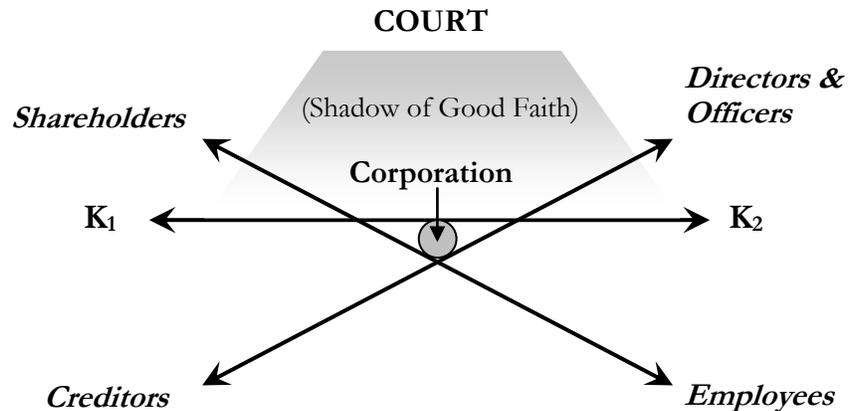
202. Lipson, *Expressive Function*, *supra* note 25, at 261–62.

203. *Id.* at 269 ("Exhortation preserves a zone of discretion that liability would constrict.").

204. See Daniel J. Bussel & Kenneth N. Klee, *Recalibrating Consent in Bankruptcy*, 83 AM. BANKR. L.J. 663, 732 n.320 (2009); Mark J. Roe & David Skeel, *Assessing the Chrysler Bankruptcy*, 108 MICH. L. REV. 727 (2010).

205. See Lipson, *Shadow Bankruptcy*, *supra* note 5.

FIGURE 4. Institutional Good Faith (Courts)



Respect institutional policy goals (e.g., collective renegotiation)

## VI. CONTROLLING CREDITOR OPPORTUNISM—LENDER LIABILITY 2.0

We have seen thus far that creditors can behave opportunistically in the zone of distress, that good faith review as currently understood has done little about it, and that this may be because courts make both conceptual and institutional mistakes about the way good faith should work in this context. Conceptually, courts tend to treat good faith in the zone of distress as a problem of bilateral or contractual good faith, when in fact it (also) involves problems of multilateral and institutional good faith. The institutional mistake has been to ignore the role that expert decisionmakers should play in assessing good faith. This part offers concrete suggestions to correct both mistakes. Doing so will help courts build a better lender liability jurisprudence, lender liability 2.0.

### A. CONCEPTUAL CORRECTIONS

Although it is a mistake to view creditor opportunism exclusively as a problem of bilateral good faith, traditional contract doctrine offers lessons that, by analogy, show the work that good faith can do in the distress context.

## 1. Good Faith and Disclosure

Good faith requires some disclosure that distress investors may not want to make. In *Market Street Associates v. Frey*, for example, Judge Posner famously concluded that good faith required disclosure of important information to avoid opportunism.<sup>206</sup>

[I]t is one thing to say that you can exploit your superior knowledge of the market—for if you cannot, you will not be able to recoup the investment you made in obtaining that knowledge—or that you are not required to spend money bailing out a contract partner who has gotten into trouble. It is another thing to say that you can take deliberate advantage of an oversight by your contract partner concerning his rights under the contract. Such taking advantage is not the exploitation of superior knowledge or the avoidance of unbargained-for expense; it is sharp dealing.<sup>207</sup>

If we apply *Market Street Associates* to the world of distress investing, it becomes clear that some tactics may go too far. It is unlikely that a court would require parties to disclose their strategies or proprietary information in workout negotiations. However, if a distress investor acquires debt knowing that it will then obtain inside information in the workout and, relying on that information, purchases an equity short that drives down the firm's share price, there is a problem. Distress investors that hold positions that are antithetical to the workout should, at minimum, disclose this to the debtor and the other parties involved in the workout. Similarly, good faith would appear to require that distress investors actually hold the positions they claim to hold. While puffing about the value of a firm in a workout is likely to be par for the course, claiming to hold a blocking percentage of a firm's debt—when you in fact hold less or none—might be bad faith.

If the distressed firm does land in bankruptcy, disclosure is likely to be an even greater issue. Bankruptcy Rules 2019 and 3001 require public disclosures that private investors seem especially reluctant to make.<sup>208</sup> Courts have struggled with the textual nuances, and have come to no clear resolution. This is partly because the statutory structure was simply not

206. *Mkt. St. Assocs. Ltd. P'ship v. Frey*, 941 F.2d 588, 595 (7th Cir. 1991).

207. *Id.* at 594 (citing Burton, *Good Faith*, *supra* note 30, at 393).

208. See Lipson, *Shadow Bankruptcy*, *supra* note 5; Lipson & DiVirgilio, *supra* note 18. The Supreme Court recently proposed modest amendments to these rules which will become effective December 1, 2011, unless Congress acts to the contrary. See Letter from John G. Roberts, Jr., Chief Justice of the Supreme Court, to John A. Boehner, Speaker of the House of Representatives 4, 6 (Apr. 26, 2011), available at [http://www.uscourts.gov/uscourts/RulesAndPolicies/rules/Supreme%20Court%202011/SC\\_Letters\\_Orders.pdf](http://www.uscourts.gov/uscourts/RulesAndPolicies/rules/Supreme%20Court%202011/SC_Letters_Orders.pdf) (transmitting to Congress amendments to the Federal Rules of Bankruptcy Procedure adopted by the Supreme Court of the United States).

designed with modern distress investing in mind. Thus, an appropriate way to fill this gap, in order to preserve the institutional integrity of bankruptcy courts, is to consider whether private investors resist disclosure for opportunistic reasons. If they do, good faith review would be a way for bankruptcy courts to assess and address this behavior.

## 2. Good Faith and Choice

An important body of scholarship considers the role that good faith plays in contract modification.<sup>209</sup> Curiously, virtually none of it addresses what are perhaps the most important kinds of modifications: distress workouts. Historically, the central question in contract modification involved challenges to enforceability for want of consideration. Doctrines such as the pre-existing duty rule—and the many exceptions to it—ensnared courts in deciding whether a change to a contract should (or should not) be enforced.<sup>210</sup> The pre-existing duty rule was, in the words of Robert Hillman, “both too broad and too narrow,” often producing the “wrong result.”<sup>211</sup>

Hillman argued that the important question when assessing the enforceability of contract modifications was voluntariness. “Evaluation of the voluntariness of a contract modification . . . is crucial to determining whether or not it ought to be enforced. Literally hundreds of cases deciding the enforceability of contract modifications confirm that this is the paramount, although rarely articulated, concern of courts facing the question.”<sup>212</sup> According to Hillman, a better path would look to the rules on economic duress. “Economic duress exists,” he explained, “when a party’s assent results from an ‘improper threat’ that leaves the party with no reasonable alternative but to assent.”<sup>213</sup> Good faith in contract modifications, the court in the *Roth Steel* case explained, prohibits changes

---

209. See Robert A. Hillman, *Contract Modification Under the Restatement (Second) of Contracts*, 67 CORNELL L. REV. 680, 684–86 (1982) [hereinafter Hillman, *Restatement Modifications*]; Robert A. Hillman, *Policing Contract Modifications Under the U.C.C.: Good Faith and the Doctrine of Economic Duress*, 64 IOWA L. REV. 849 (1979). See also Eric L. Talley, Note, *Contract Renegotiation, Mechanism Design, and the Liquidated Damages Rule*, 46 STAN. L. REV. 1195 (1994).

210. See Hillman, *Restatement Modifications*, *supra* note 209, at 684–85 (“The common-law response to the problem of modification enforceability is the preexisting-duty doctrine. Under this doctrine, a promise of additional consideration, or acceptance of partial performance in return for a performance that is already a contractual obligation of the promisee, is unenforceable for want of additional consideration.”).

211. *Id.* at 685 (footnote omitted).

212. *Id.* at 682.

213. *Id.* at 683.

produced by “extortion or overreaching.”<sup>214</sup>

If good faith in contract modification requires some choice on the part of the other party, then certain behavior in workouts appears to be out of bounds. In particular, distress investors who use derivative contracts to depress a firm’s share or debt price may leave the firm in a position where it cannot workout its distress. Holding out, too, may violate the duty of good faith if it is so extreme as to deprive the borrower of meaningful choice in restructuring. Locking up a debtor’s board and assets, as happened in the *MarketXT* case, appears to have deprived the debtor of any meaningful choice in its contract renegotiations with its lender. At least from this vantage point, this appears to have been opportunistic, and to have violated a better understanding of good faith in the zone of distress.

#### B. PROCEDURAL GOOD FAITH—THE INSTITUTIONAL CHOICE

Good faith determinations are inherently normative and contextual. While some substantive standards appear possible today, the boundless creativity of distress investors and workout professionals make a definitive list implausible. Moreover, the excesses of lender liability 1.0 cases like *K.M.C.* suggest that more recent courts have had good reason to limit the use of good faith review in the debtor-creditor context. To assure that good faith review is, and remains, responsive to changing market conditions without producing extreme and unjustifiable results, it is important to understand that good faith in this context is a determination best made by experts.

Discussions about the duty of good faith usually focus on its conceptual aspects (Does it exist? What does it mean?). They rarely consider its procedural qualities. Yet, at least if we take seriously Llewellyn’s views about good faith, the term could have value only if applied in a certain procedural context. For Llewellyn, as discussed in Part IV above, that context was the merchant jury.

Today, we have no merchant juries. We do, however, have a large and growing number of courts with expertise in business law generally. These special courts will include the Delaware Chancery Court as well as the many business courts being organized around the nation. In the case of Delaware, “this nation’s arguably most important business court,”<sup>215</sup> there

214. Roth Steel Prods. v. Sharon Steel Corp., 705 F.2d 134, 146 (6th Cir. 1983).

215. Leo E. Strine, Jr., *If Corporate Action Is Lawful, Presumably There Are Circumstances in Which It Is Equitable to Take that Action: The Implicit Corollary to the Rule of Schnell v. Chris-Craft*, 60 BUS. LAW. 877, 878 (2005).

is little doubt that its bench contains the most sophisticated business jurists in the nation.<sup>216</sup> Given the centrality of corporate governance law to Delaware's economic and social stature,<sup>217</sup> its courts should be eager to expand upon the role of good faith as expressed in Chancellor Allen's opinion in *Credit Lyonnais*, and to interdict (or manage) creditor opportunism. Where Delaware lacks jurisdiction, other states have started to develop business courts that may have comparable expertise.<sup>218</sup>

There is, of course, a world of difference between a judge, even one with expertise, and a merchant. It is not clear whether Llewellyn would have considered judges any better suited to assess good faith than lay juries.<sup>219</sup> It is true that judges in courts of original jurisdiction—for example, United States District Courts—are not likely familiar with the norms and practices of specialized commercial enterprises (e.g., distress investing). But, judges on business courts are likely to have better insight into the nature of good faith in business contexts than lay juries.

Bankruptcy courts—especially the bankruptcy courts in the Southern District of New York and the District of Delaware—are likely also to have expertise of this sort. Some of these courts have been accused of industry capture, a serious claim.<sup>220</sup> There is thus reason to be concerned that they will not think as creatively and carefully about good faith as modern distress investing requires. Recall, for example, that the problematic opinion in the *MarketXT* case was authored by Judge Gropper, of the Southern District of New York.

The key procedural and institutional challenge in reconceiving the role of good faith in distress investing will be constraining the right to trial by jury on issues of creditor opportunism, which is guaranteed in nonequity matters by the Seventh Amendment.<sup>221</sup> Recall that the problematic lender

---

216. There is also evidence that the court may be looking for work. See John Armour, Bernard S. Black & Brian R. Cheffins, *Is Delaware Losing Its Cases?* (Northwestern Law & Econ. Research, Working Paper No. 10-03, 2010), available at <http://ssrn.com/abstract=1578404>.

217. See, e.g., Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225 (1985) (discussing state competition for corporate charters).

218. See *Business and Specialty Courts Resource Guide*, NAT'L CTR. FOR STATE COURTS, <http://www.ncsc.org/Topics/Specialty-Courts/Business-Specialty-Courts/Resource-Guide.aspx> (last visited Aug. 3, 2011).

219. See Imad D. Abyad, *Commercial Reasonableness in Karl Llewellyn's Uniform Commercial Code Jurisprudence*, 83 Va. L. Rev. 429, 458 (1997). See also Zipporah Batshaw Wiseman, *The Limits of Vision: Karl Llewellyn and the Merchant Rules*, 100 HARV. L. REV. 465, 529 (1987).

220. LOPUCKI, *supra* note 26.

221. U. S. CONST. Amend. VII guarantees the right to jury trial in civil cases in Federal courts; in civil cases in state court, the right to a jury trial is governed by the state's constitution and statutes. See also Jennifer F. Miller, *Should Juries Hear Complex Patent Cases?*, 2004 DUKE L. & TECH. REV. 4, 4

liability cases of the 1980s were decided by lay juries, not expert judges.<sup>222</sup> There is no question that specialized business courts—indeed, bankruptcy courts—have the power to conduct jury trials. The jurisdictional limit appears to be determined by the characterization of the claim, not the court. Thus, litigants claiming that a creditor behaved opportunistically will be entitled to a jury as a constitutional matter unless the claim is one in equity.<sup>223</sup>

The key to keeping questions of creditor opportunism in the hands of experts, therefore, will be to characterize these disputes as equitable in nature. Although no bright line distinguishes “equitable” proceedings from those “at law,” an important consideration appears to be the dimensions involved.<sup>224</sup> Thus, a claim of bilateral opportunism in a traditional contract dispute may well be a “legal” claim amenable to a jury trial because good faith is (or can be) a contract claim as to which the fact finder may be a jury.

Multilateral problems of distress, by contrast, have long been treated as equitable proceedings, even if the underlying causes of action were disputes at law involving contract, tort, and so forth.<sup>225</sup> There are a variety of reasons courts have made this determination in the distress context, but one is simply pragmatic: no one could realistically expect a jury to decide whether to approve a reorganization plan involving hundreds, if not thousands, of creditors. The number of parties and the specialized nature of the problems are simply beyond the expertise of a lay jury. The equity receiverships of the 19th and early 20th centuries—the main mechanism for resolving financial distress at the time—were equitable proceedings in part because they involved hundreds, perhaps thousands, of creditors and

---

(“Some commentators argue that a ‘complexity exception’ to the Seventh Amendment right to a jury trial should be invoked, which would give judges discretion to withhold cases from a jury where the complexity of the facts or the underlying legal issues make it impossible for a jury to render a fair and rational verdict. The constitutional support for the complexity exception is grounded in Seventh Amendment jurisprudence and on the Fifth Amendment right of due process.”).

222. See discussion *supra* Part III.

223. Tim Dibble and Geoff Gallas, *Best Practices in U.S. Business Courts*, COURT MANAGER 19, no. 2, 2004, available at [http://www.nacmnet.org/publications/Top10CourtMgrArticles/BestPractices\\_in\\_BusinessCts.pdf](http://www.nacmnet.org/publications/Top10CourtMgrArticles/BestPractices_in_BusinessCts.pdf) (last visited Aug. 2, 2011).

224. *Tull v. United States*, 481 U.S. 412, 417 (1987) (holding that while the Seventh Amendment requires “a jury trial on the merits in those actions that are analogous to ‘Suits at common law[,]’ . . . actions that are analogous to 18th-century cases tried in courts of equity or admiralty, do not require a jury trial.”). See also *Chauffeurs, Teamsters & Helpers Local No. 391 v. Terry*, 494 U.S. 558, 565–66 (1990) (holding that the right to a jury trial exists in causes of action unknown at common law that are analogous to eighteenth century forms of action).

225. Jonathan C. Lipson, *Debt and Democracy: Towards a Constitutional Theory of Bankruptcy*, 83 NOTRE DAME L. REV. 605 (2008).

shareholders of large, troubled firms such as railroads.<sup>226</sup>

Thus, claims of creditor opportunism in the distress context should be treated as problems of equity. This removes them from the province of lay juries which, at the dawn of lender liability 1.0, were apparently willing to judge creditor conduct by local norms that may have had little to do with commercially reasonable conduct as understood by those in the industry.

## VII. OBJECTIONS AND FURTHER INQUIRY

To argue that courts should test the good faith of distress investors is to argue for a different kind of good faith, one that is independent of other causes of action that may be brought against distress investors (e.g., breach of contract). This is a controversial claim, one to which some (e.g., distress investors) might object. This part briefly considers some objections, and areas of further inquiry.

### A. OBJECTIONS

#### 1. Good Faith as Independent Cause of Action

An important technical objection to the vision of good faith described above is that good faith creates no independent cause of action. Good faith does not, according to black letter contract analysis, constitute a claim “separate and distinct” from a breach of contract claim.<sup>227</sup> Thus, conduct falling outside the scope of “good faith and fair dealing,” without more, cannot in bilateral contract analysis serve as the sole basis for a suit; rather, a breach of the implied covenant of good faith often serves as a “vehicle for interpreting the contract.”<sup>228</sup>

While this doctrine may make sense in ordinary bilateral contract analysis, it is problematic when applied to distress investing. As we have seen, in many cases, there may not be an explicit contract to which the

226. See Lipson, *Shadow Bankruptcy*, *supra* note 5, at 1634 (discussing railroad receiverships).

227. See Teri J. Dobbins, *Losing Faith: Extracting the Implied Covenant of Good Faith from (Some) Contracts*, 84 OR. L. REV. 227, 265–69 (2005). See generally *AW Acquisition Corp. v. Sw. Bell Mobile Sys., LLC*, No. 04-C-1448, 2005 U.S. Dist. LEXIS 271, at \*9 (N.D. Ill. 2005) (“[W]hile there is a duty of good faith and fair dealing implied by law in every contract, that duty does not create an independent cause of action. According to [the defendant], the implied duty of good faith and fair dealing is an aid in the construction of contracts, and therefore any breach of the implied duty must be appurtenant to some other explicit contract provision.”); *Seiple v. Cmty. Hosp. of Lancaster*, No. 97-CV-8107, 1998 U.S. Dist. LEXIS 5093, at \*6 (E.D. Pa. 1998) (“Pennsylvania does not recognize a claim for breach of the covenant of good faith and fair dealing as an independent cause of action.”).

228. See Seth William Goren, *Looking for Law in All the Wrong Places: Problems in Applying the Implied Covenant of Good Faith Performance*, 37 U.S.F. L. REV. 257, 302–03 (2003).

debtor is a party, the breach of which creates the “host” doctrine that would house the good faith claim. For example, a creditor may obtain seats on a debtor’s board, or persuade management to hire the creditor’s preferred turnaround expert. There is no obvious reason why a contract would have to be executed for either event to occur; nor would it make sense to talk of “breach” by virtue of the debtor’s compliance. Yet, both may lead to control that the investor could use opportunistically. Moreover, debtors are not usually parties to short sale contracts affecting their securities. So, while those contracts may show opportunism when coupled with a debt claim, there would be no contract with the *debtor* under which the debtor or others asserting rights on behalf of the debtor (e.g., creditors or a bankruptcy trustee) could assert a primary breach of contract claim.<sup>229</sup>

These and other examples set forth above show why the objection lacks merit. If we recognize that distress investing can create problems of multilateral and institutional good faith, there may be good reason to relax this pleading requirement. It may be an appropriate constraint on bilateral contract litigation, but it has no place in the zone of distress.

## 2. Remedial Redundancy

A second, and related, objection is that claims of bad faith will overlap with other, better-established causes of action.

### a. Fiduciary Review

Consider, first, the view that fiduciary review might be a more appropriate way to deal with such behavior. Lynn Stout and Iman Anabtawi have argued that activist shareholders should be subject to fiduciary review: citing cases like *Kahn v. Lynch*, they argue that if a shareholder is in actual control, and uses its control in a disloyal way, it should be liable for breach of fiduciary duty.<sup>230</sup> By extension, one might argue that the same logic should apply to creditors, especially if (as we have seen) creditors of the distressed firm are its residual claimants.

The problem, as explained above, is that creditors are not like shareholders for this purpose. While distress investors may have shares and debt—or their debt may convert to shares in a reorganization—the underlying dynamics of the debtor-creditor relationship make it unrealistic to expect that distress investors would or should act as fiduciaries for their

---

229. Presumably, debtors could begin to ask lenders to warrant that they will not hold short claims against the debtors, although it is unlikely that borrowers would have the leverage to obtain such agreements.

230. See Anabtawi & Stout, *supra* note 15, at 1265, 1270.

borrowers. Like all creditors of a troubled debtor, their interests are adverse to those of the debtor and its other stakeholders in a way that is incompatible with any meaningful expression of fiduciary norms.

Michelle Harner has taken a different tack with a somewhat similar goal.<sup>231</sup> She has argued, in essence, that concerns about creditor opportunism should be managed at the board level, and not at the level of the distress investors who are actually in control. Thus, she has argued that a board should lose business judgment protection for having engaged in a transaction with a stakeholder, which she calls the “fairness proposal.”<sup>232</sup>

Harner has the right instincts, but it is not clear how her proposal would work. First, Harner argues that creditors should not be viewed as fiduciaries because they are “outsiders” to the firm, whereas shareholders and directors are “insiders.”<sup>233</sup> “Shareholders,” she claims, “commonly are viewed as part of a corporation’s inner circle, and their rights arise in part from a state’s corporate code and related common law.”<sup>234</sup> Given what we know about the ability of distress investors to obtain and exploit confidential information in workouts, however, creditors are more likely to be “insiders” than widely dispersed public shareholders. Moreover, distress investors appear often to hold debt and shares: It cannot be that they are both insiders and outsiders. Whether someone is an “insider” or “outsider”—just like whether someone is in “control”—is a conclusion determined by facts on the ground, not by labels such as “creditor” or “shareholder.”

Second, and more important, this ignores the real locus of control in the distress context: private investors appear in many cases to have the power to choose the board and management. If so, they—and not the board—will be the ones who exercise ultimate control. The directors they appoint may be the ones through whom conflict transactions are approved, as in *MarketXT*. Directors may well simply be instrumentalities of the distress investor.

Third, it is not clear why it would be appropriate to expose the entire board to fairness review, even members who were not appointed by the distress investors and thus not in a conflict position. As discussed above, conflict transactions can be shown to have been presumptively fair by establishing that they were approved by independent directors operating at

---

231. Harner, *supra* note 29, at 545 (rejecting fiduciary review as “not [a good fit]”).

232. *Id.* at 547.

233. *Id.* at 543.

234. *Id.*

arm's length in connection with the conflict transaction.<sup>235</sup> Independent director approval shows "fair process," which challengers must attempt to rebut by showing, in essence, that the price paid was nevertheless unfair.<sup>236</sup> This is viewed as virtually impossible to do.<sup>237</sup> Fights over price—as opposed to process—are notoriously difficult and expensive. Delaware courts want to avoid them for good reason: its judges may have a deeper understanding of business transactions and law than other judges, but they are not investment bankers. It is thus not clear who—besides Delaware litigators—benefits from a proposal that would, in effect, subject all stakeholder transactions to judicial price review.

Finally, and as demonstrated above, the most problematic expressions of creditor opportunism may not involve conflict transactions at all, in which case no adjustment to fiduciary review of board action matters. A firm engages in no transaction when its debt is traded in the secondary market or its securities are sold short. There is thus nothing for a board to approve or disapprove. Such transactions may ultimately lead to or enhance a creditor's control of the board but, as we have seen, that may or may not be expressed through board action. In short, creditor opportunism may include, but nevertheless goes well beyond, problems that judicial review of board conduct can hope to address.

#### b. Traditional Bankruptcy-Related Powers

Another concern might be that adjusting good faith as proposed here overlaps with existing doctrines, such as fraudulent transfer or equitable subordination, both of which in the past had greater capacity to constrain opportunistic behavior.

Fraudulent transfer doctrine voids a transaction by a debtor that transfers assets, or incurs debts, while insolvent for less than fair value.<sup>238</sup> As discussed in Part IV above, equitable subordination is a subspecies of lender liability 1.0 and essentially empowers a bankruptcy court to subordinate the claim of a creditor who has been found to have behaved "inequitably."<sup>239</sup>

---

235. See, e.g., *Emerald Partners v. Berlin*, 787 A.2d 85 (Del. 2001); *Kahn v. Lynch Comm'n Sys., Inc.*, 638 A.2d 1110 (Del. 1994). See also discussion *supra* Part III.A.

236. *Kahn*, 638 A.2d at 1117.

237. *Id.*

238. Every state has some form of fraudulent transfer law, see UNIF. FRAUDULENT TRANSFER ACT, 7A U.L.A. 2 (1984), or a predecessor statute with similar effect, UNIF. FRAUDULENT CONVEYANCE ACT, 7A U.L.A. 246 (1918). See, e.g., VA. CODE ANN., § 55-81 (1950). The Bankruptcy Code also contains similar remedies for fraudulent transfers. 11 U.S.C. § 548 (2006).

239. See discussion *supra* notes 63 and 125.

As with lender liability 1.0 generally, these doctrines have diminished capacity to police or remedy modern creditor opportunism. In the case of fraudulent transfer law, the Supreme Court has held that “procedurally regular” noncollusive foreclosures can almost never be treated as fraudulent conveyances, even if they have that economic effect.<sup>240</sup> Moreover, it is a doctrine that applies only if there is a transfer of property of the debtor. As we have seen, creditor opportunism is often chiefly about governance or transactions that may not directly involve property of the debtor. Fraudulent transfer law will not avoid a short sale or remedy a collapse that occurred due to excessive holding out in renegotiation.

Equitable subordination is equally problematic, but for different reasons. First, it appears to be a creature of bankruptcy courts.<sup>241</sup> The problem this Article confronts is behavior that may never be subject to bankruptcy court review because it occurs before bankruptcy, or controlling creditors keep the distressed firm out of bankruptcy. Even if a bankruptcy case is commenced, the current fight in the *Chicago Tribune*’s bankruptcy suggests that private investors may seek to control litigation over such claims, in order to insure that they are exonerated.<sup>242</sup>

Second, equitable subordination creates no basis for affirmative recovery, so is unlikely to provide a remedy for those harmed by opportunistic behavior. Indeed, if we take seriously the logic of credit derivatives, it might be profitable for a creditor to short debt and behave outrageously actually hoping that the debt will be subordinated, thus triggering counterparty liability to the creditor under the credit derivative. Equitable subordination may not only fail to be a remedy—it may inadvertently encourage inequitable conduct.

In short, the modern distress investing market has simply created problems that other doctrines developed under lender liability 1.0 can no longer effectively address. Good faith as developed in this Article would help to solve those problems.

---

240. *BFP v. Resolution Trust Corp.*, 511 U.S. 531, 549 (1994) (Souter, J., dissenting).

241. The doctrinal basics of equitable subordination are discussed *supra* note 137.

242. The *Chicago Tribune* case does not involve an obvious controlling creditor or group, but instead a classic fight for control between two groups. One group has proposed a plan that would effectively exonerate its members from avoidance claims that arose in connection with the *Tribune*’s failed buyout. See Michael Liedtke, *Judge to Weigh Rival Plans in Trib Bankruptcy Case*, CHICAGO SUN TIMES (Apr. 8, 2011), <http://www.suntimes.com/business/4174738-420/judge-to-weigh-rival-plans-in-trib-bankruptcy-case.html>.

## B. FURTHER INQUIRY

This Article has identified a new way to conceive of an old doctrine, good faith, in order to address fundamental changes in the market place. Good faith has a long history of helping courts adapt to changing environments,<sup>243</sup> and there is no reason to think current market changes are somehow different. But identifying a new way to characterize an old doctrine hardly answers all questions that might arise. Consider a few.

### 1. Standing

Who should be able to assert claims of creditor opportunism? The debtor? Other creditors, who may lack contractual privity with one another? A bankruptcy trustee? Questions of standing are important precisely because distress investing presents multilateral problems. Who in the lawsuit speaks for stakeholders harmed by a creditor's opportunism will say something about how the claim is prosecuted.

The general rule about standing, of course, is that a party can sue only if the plaintiff suffered an injury in fact; the plaintiff's injury is fairly traceable to the actions of the defendant; and the relief requested redresses the plaintiff's injury.<sup>244</sup> The multilateral nature of distress led Congress to enact the Bankruptcy Code, which gives specialized courts special jurisdiction and some clarity on standing for these sorts of complex, collective problems.

Our problem, of course, is that important creditor misconduct may occur before bankruptcy and may prevent a bankruptcy case from ever being commenced. So, we must look to state courts (for example, the business courts discussed above). If we take seriously the nature of opportunism and the way it works in distress, it seems clear that stakeholders of a debtor harmed by a controlling creditor should have standing under traditional principles. But this is a question that will doubtless warrant further consideration.

### 2. Remedy

To treat good faith as an independent and equitable cause of action creates a variety of questions about remedy. May courts nevertheless award money damages? In general, equity is an alternative to money damages, but Delaware's courts award money damages despite this. Not all courts may

243. See Braucher, *supra* note 33, at 812 (discussing the development of the good faith standard).

244. Heather Elliott, *The Functions of Standing*, 61 STAN. L. REV. 459, 465 (2008).

be comfortable following suit, however. If not, what specific or other equitable remedies would be appropriate? Disgorgement on an unjust enrichment theory? Subordination? As discussed above, subordination alone may not always be an effective deterrent to creditor opportunism.

Courts have been understandably concerned about awarding money damages for claims that there has been a breach of the duty of good faith, especially if asserted as an independent cause of action. Nevertheless, it would appear that if we take seriously the definition of creditor opportunism—control that produces extracontractual benefits to the harm of the debtor and its other stakeholders—we may need some measure of monetary damages, both as remedy and as deterrent.

What should that measure be? In contract, it is traditionally “expectation.” We have seen that an important, perhaps the principal, problem with the lender liability 1.0 cases involved outsized damages awarded by arguably inappropriate institutions (lay juries). If, as argued above, that is the real problem, then perhaps the chief value of channeling creditor opportunism disputes to specialized courts and away from lay juries is their ability to provide more tempered and appropriate monetary awards in cases where creditors are found to have behaved opportunistically.

### 3. Relationship to Other Doctrine

Although this Article argues that good faith should be treated as an independent and actionable standard of review of distress investor conduct in workouts, I recognize that other doctrines have long been relevant in this context as well. While I believe that good faith will do a better job than other doctrines for reasons described above, that does not mean other doctrines play no role. Thus, courts will have to continue to unthread multiple causes of action alleged in connection with creditor opportunism.

## VIII. CONCLUSION

Governance in the breach is likely here to stay. The new realities of distress investing will require a new judicial response. This Article has shown that one such response is to make more creative and nuanced use of the doctrine of good faith. Good faith has long been a way to constrain opportunism in contract. It can also do so in the more complex and volatile world of distress investing.