Controlling Creditor Opportunism

Jonathan C. Lipson
CONTROLLING CREDITOR OPPORTUNISM

JONATHAN C. LIPSON*

This paper addresses problems of creditor opportunism. “Distress investors” such as hedge funds, private equity funds, and investment banks are opportunistic when they use debt to obtain control of a financially troubled firm and extract improper gains at the expense of the firm and its other stakeholders. Examples include the mis-use of private information to short-sell a borrower’s securities and creditor self-dealing.

Creditors can act opportunistically because legal doctrines that historically checked such behavior—e.g., “lender liability”—have not kept pace with fundamental changes in the market for control of distressed firms. The recent Dodd-Frank financial reform is not likely to change this. Thus, creditor opportunism will remain a problem for courts to solve.

This article makes three basic contributions. First, it develops a tractable definition of creditor opportunism and offers examples of its destructive capacity; second, it explains why existing doctrine cannot adequately identify or remedy such behavior; third, it develops a new and more robust model of good faith review that will enable courts to manage problems of creditor opportunism.

* Foley & Lardner Professor of Law, University of Wisconsin School of Law. This paper has benefited from comments and discussions with Craig Green, Michelle Harner, Dave Hoffman, Darian Ibrahim, Harwell Wells and []. Maryellen Fields, Paris Glazer, Erica Maier, and Ryan Moore provided helpful research assistance. I thank Deans Ken Davis, of the University of Wisconsin Law School, and Joanne Epps, of Temple Law School, for supporting this work. An earlier version was presented at a faculty workshop at Temple Law School. Errors and omissions are mine, alone. © 2010 Jonathan C. Lipson, all rights reserved.
# TABLE OF CONTENTS

## I. OPPORTUNITIES FOR OPPORTUNISM ................................................................. 1
   A. *THE OLD MODEL—THE WORKOUT* ................................................................ 5
   B. *THE NEW MODEL—SHADOW BANKRUPTCY* .................................................. 6
   C. OPPORTUNISM V. ACTIVISM .......................................................................... 7
   D. OPPORTUNISM AND CONTROL ..................................................................... 9
      1. Negative De Jure Control—Holding Out & Short Sales .............................. 10
      2. De Facto Control—Firm and Reorganization Governance—Repelling Shark Repellants .......................................................... 13
         (a) CIT and Carl Icahn ............................................................................... 13
         (b) CIT’s Antitakeover Devices—Charter and Bylaws ................................. 15
         (c) CIT’s Plan—Icahn’s Control ................................................................ 18
         (d) The Meaning of CIT .......................................................................... 20
      3. De Facto Control—Heterogeneity and Conflict Transactions ..................... 21

## II. CURRENT APPROACHES TO REGULATING CREDITOR OPPORTUNISM ........ 23
   A. COMMUNITARIANISM—LENDER LIABILITY .................................................. 23
      1. Lender Liability ....................................................................................... 23
      2. Good Faith as Community Norms ........................................................... 27
   B. CONTRACTUALISM ...................................................................................... 28
      1. The Birth ofContractualism—The Gap Filling of Fischel and Easterbrook ... 28
      2. Blinkered Contractualism ....................................................................... 31

## III. THREE DIMENSIONS OF GOOD FAITH .......................................................... 34
   A. BILATERAL GOOD FAITH—GOOD FAITH IN TRADITIONAL CONTRACT DOCTRINE—THE ONTOLOGICAL QUESTION ......................................................... 34
   B. MULTILATERAL GOOD FAITH—GOOD FAITH IN CORPORATE GOVERNANCE—REREADING CREDIT LYONNAIS ................................................................. 37
   C. INSTITUTIONAL GOOD FAITH—GOOD FAITH BANKRUPTCY FILINGS .......... 42

## IV. NEW WORK OF GOOD FAITH: CONTROLLING CREDITOR OPPORTUNISM .... 44
   A. SUBSTANTIVE GOOD FAITH ........................................................................ 45
      1. Good Faith and Disclosure ..................................................................... 45
      2. Good Faith and Choice .......................................................................... 45
      3. Good Faith and the “Community of Interests” ......................................... 46
   B. PROCEDURAL GOOD FAITH ...................................................................... 47

## V. OBJECTIONS AND FURTHER INQUIRY ................................................................ 50
   A. OBJECTIONS .............................................................................................. 50
      1. Good Faith as Independent Cause of Action .......................................... 50
      2. Remedial Redundancy .......................................................................... 51
   B. FURTHER INQUIRY ................................................................................... 53
      1. Standing .................................................................................................. 53
      2. Remedy .................................................................................................. 54
      3. Relationship to Other Doctrine ............................................................... 54

CONCLUSION ......................................................................................................... 54
CONTROLLING CREDITOR OPPORTUNISM

Whatever else the recent Dodd-Frank financial reform may do, it will not solve the growing problem of creditor opportunism.

Although touted as “the biggest financial reform legislation since the Great Depression,” Dodd-Frank will not stop “distress investors” such as hedge funds, private equity funds, and investment banks from using debt to obtain control of a financially troubled firm before bankruptcy and, with that control, to extract at the expense of the firm and its other stakeholders “a benefit not contemplated by the initial agreement, either explicitly or implicitly”—that is, to be opportunistic.

Creditor opportunism can take many forms. Two especially troubling examples involve insider trading with derivative securities affecting distressed borrowers and creditor self-dealing. In the case of derivatives, there is growing evidence that investors use their leverage and inside information about a firm’s distress to purchase credit default swaps or equity short sales. These transactions can push down the value of a firm’s debt or shares,


2 See Douglas J. Elliot, Brookings, The Dodd-Frank Financial Reform Bill is a Valuable Step Forward, available at http://www.brookings.edu/opinions/2010/0625_financial_reform_elliott.aspx (last visited July 27, 2010). See also Eric Dash and Andrew Martin, New Rules Hit Every Corner of JPMorgan, N.Y. TIMES, B1, Jun. 26, 2010 “Not since the Great Depression, when the mighty House of Morgan was cleaved in two, have Washington lawmakers rewritten the rules for Wall Street as extensively as they did [when enacting Dodd-Frank].”


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. See, e.g., Stephen J. Lubben, Credit Derivatives and the Future of Chapter 11, 81 AM. BANKR. L. J. 405, 427-30 (2007); Mark J. Roe, Bankruptcy’s Financial Crisis Accelerator: The Derivatives’ Players’ Priorities in Chapter 11, __ STAN. L. REV. ___ (forthcoming 2010); 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); Frank Parmeau & 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).

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 cover of covering will be less than the proceeds received earlier from the sale and the short seller will make money.”

making recovery even more difficult. In the case of self-dealing, creditors may extract improper benefits by forcing a debtor to enter into a contract of questionable value. All are examples of opportunism because the gains come outside the lending contract, and at the expense of the distressed firm.

Creditor opportunism makes the reorganization of troubled firms more costly which, in turn, imperils going concerns and the jobs and communities that depend on them. Concerns about creditor opportunism were one reason the federal government asserted itself in the General Motors bankruptcy.6

Creditor opportunism is possible because market behavior has outstripped legal doctrine. Unlike banks and institutional lenders of the past, modern creditors are professional “distress investors.”7 They are often not a firm’s original lenders, but instead purchase debt claims at a discount on a secondary market.8 Today’s distress investors have heterogeneous portfolios reflecting multiple positions affecting the same debtor, including debt and equity of various tranches, as well as derivative securities. Although Dodd-Frank will regulate these firms and transactions in certain ways, it is unlikely to alter core opportunities for opportunistic behavior in distress investing.9

Distress investors are often lauded as “activists” for the liquidity and expertise they can bring to troubled firms.10 Yet, because they obtain control before bankruptcy, they operate in an environment that is—and will remain—remarkably free from scrutiny. Traditional financial regulation, such as the federal securities laws, has little reach here. The secondary debt market is essentially an unregulated securities market, which Dodd-Frank does not change.11 Although Dodd-Frank may put some derivatives on exchanges,12 nothing

5 Key examples—the CIT and MarketXT cases—are discussed in Part I.D, infra.


7 See Lipson, id. See also Greg Nini et al., Creditor Control Rights, Corporate Governance, and Firm Value, 92(3) J. F. ECON. 400 (2009).

8 Finance scholars have noted that, for publicly traded companies, 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 Nini, et al., id; Michelle M. Harner, Trends in Distressed Debt Investing: An Empirical Study of Investors’ Objectives, 16 AM. BANKR. INST. L. REV. 69 passim (2008).

9 As discussed further below, Dodd-Frank may regulate around creditor opportunism, by requiring registration of (some) hedge funds and exchange trading of (some) derivatives. See CONFERENCE REPORT, available at http://financialservices.house.gov/Key_Issues/Financial_Regulatory_Reform/conferece_report_FINAL.pdf (last visited July 13, 2010). However, there appears to be nothing in the legislation that requires holders of derivative instruments to disclose those holdings to distressed firms affected by them. Moreover, much of this re-regulation would be subject to exemptions and administrative rulemaking, which distress investors will seek to capture.

10 See, e.g., Douglas G. Baird, Robert K. Rasmussen, Antikbankruptcy, 119 YALE L.J. 648, 661 (2010) (discussing liquidity and expertise that private investors may bring to distressed firms);

11 See Lipson, supra note 6, at 1653-1655.

12 Dodd-Frank § Section 3203 amends the Securities Exchange Act of 1934 to prescribe requirements for clearing procedures and execution of security-based swaps, including requirements for: (1) swap execution facilities; (2) segregation of assets held as collateral in security-based swap transactions; (3) position limits and accountability for security-based swaps and large trader reporting; (4) registration and regulation of security-based swap dealers and major security-based swap participants; and (5) reporting and recordkeeping for certain security-based swaps. H.R.4173, 111th Cong. § 3203 (2010) (enacted).
will force a distressed investor to disclose to a troubled borrower—or its other stakeholders—that it simultaneously holds debt and a short, a combination that creates obviously perverse incentives.\textsuperscript{13}

Common law doctrines that might constrain creditors, such as lender liability, have been weakened by two decades of contractualism. Cases from the 1970s and ‘80s, in which juries sometimes held lenders liable for enforcing their rights too aggressively were cast aside as unpredictable and (therefore) inefficient assaults on the stability of contract. According to Judge Frank Easterbrook, a leading contractualist, lender liability is a contradiction in terms: creditors may enforce their agreements “to the letter, even to the great discomfort of their trading partners, without being mulcted for lack of ‘good faith.’”\textsuperscript{14}

Commentators recognize the problems presented by modern forms of creditor opportunism, yet none has proposed realistic solutions. Some scholars are equivocal, suggesting that the “antibankruptcy” of creditor opportunism may be an inevitable and insoluble feature of an increasingly complex world.\textsuperscript{15} Others think the market will correct itself.\textsuperscript{16} Still others hope that adjustments to fiduciary review will lead directors to make better decisions on behalf of troubled firms.\textsuperscript{17} Unfortunately, these efforts tend to underestimate the problem or to overestimate the likelihood that market actors will correct their behavior. They give courts few new tools to address creditor opportunism.

Courts and commentators recognize that “good faith” is the classic response to claims of opportunism. Yet, their key mistake has been a failure to see that good faith has three different but related dimensions: bilateral, multilateral, and institutional. Conventional wisdom treats claims of creditor opportunism as problems of “bilateral” good faith and, as suggested by Judge Easterbrook, largely ignores them. Bilateral good faith, however, is concerned chiefly with simple forms of opportunism in simple contracts, such as landlord versus tenant. It is, in many respects, too simple and strong for the complex and cutthroat world of distress investing. It would forbid too many practices considered normatively routine in this context, and ignores the fact that the fate of a distressed firm affects all of its stakeholders, not just a single creditor.

In fact, financial distress will typically involve problems of “multilateral” or “institutional” good faith (or both). Multilateral good faith is the province of corporate

\textsuperscript{13} See Lipson, Shadow Bankruptcy, supra note 6, at 1618.

\textsuperscript{14} Kham & Nate’s Shoes No. 2, Inc. v. First Bank of Whiting, 908 F.2d 1351, 1357 (7th Cir. 1990).

\textsuperscript{15} See Baird & Rasmussen, supra note 10, 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”).


\textsuperscript{17} See 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 as potential violations of the duty of loyalty).
governance law, where courts—in particular the Delaware Chancery Court—have recognized that when a firm is in distress, those in control (including creditors) must consider the effect of their actions on the debtor’s “community of interests.” Institutional good faith involves relationships between private and public actors, such as investors and courts. It forbids the misuse of public institutions for private gain, such as running distressed firms through a pre-negotiated bankruptcy that benefits a few controlling distress investors at the expense of the debtor’s other stakeholders.

This paper shows that courts and commentators have made a categorical mistake in their (mis)use of good faith to assess claims of creditor opportunism. Modern distress investing creates problems of multilateral and institutional—not bilateral—good faith, and common law doctrine must adjust accordingly. To do so, courts must make both substantive and procedural changes to their conception and use of good faith in this context.

Substantively, the article argues that courts should recognize a new and independent duty of good faith in distress investing. This duty would, among other things, require distress investors to disclose or avoid material conflict transactions, and would assure that investors’ control does not completely paralyze a debtor’s restructuring. As a procedural matter, the multilateral character of business failure renders good faith determinations inherently equitable in nature. Thus, these determinations should be made by expert business courts, such as the Delaware Chancery Court or other specialized state business courts, and not by lay civil juries, who have historically misunderstood the nature and norms of financial distress.

Although there is an enormous body of literature on good faith and the role that it plays in policing opportunism, no effort has been made to connect that canon to modern problems of creditor opportunism. This paper fills that gap. While good faith is—like all common law doctrines—an imperfect tool, properly understood it offers our best hope for managing and limiting the opportunism of controlling creditors.

The paper has five parts. Part I defines and illustrates problems of creditor opportunism, and includes a detailed case study of investor Carl Icahn’s role as a distress investor in the recent CIT reorganization. Part II summarizes current thinking on creditor opportunism, and shows why it cannot solve this growing problem. Part III unbraids the bilateral, multilateral, and institutional strands of good faith, and explains why distress investing and creditor opportunism are best understood as presenting problems of multilateral and institutional good faith. Part IV applies the model to specific problems of creditor opportunism. Part V addresses important objections and identifies areas of further inquiry.

I. OPPORTUNITIES FOR OPPORTUNISM

In order to understand how opportunities for creditor opportunism arise, it is first necessary to understand patterns in the resolution of business distress, and how those patterns have changed over the last 20 years.

---

A. **The Old Model—The Workout**

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.”\(^{19}\) Workouts were meant to avoid either of two other extreme events. On the 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 were usually a loss-avoiding—not a profit-making—proposition. They might involve the cancellation or dilution of existing shares, and the issuance of new shares to senior classes; they might involve new debt or extended payment terms for existing debt; they may require new collateral or third-party guarantees; they may require the borrower to sell assets or change business plans. The variations on a workout were limited only by the will and skill of the parties involved and the realities of the firm’s balance sheet.

Workouts have also 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.”\(^{20}\)

---

\(^{19}\) See, e.g., Stuart Gilson, *Bankruptcy, boards, banks, and blackholders: Evidence on changes in corporate ownership and control when firms default*, 27 JOURNAL OF FINANCIAL ECONOMICS 355, 358 (1990) (“[F]irms can (and usually do) attempt to restructure their debt privately before filing for bankruptcy . . .”); Nini et al., supra note 7, at 7 (“In practice, creditors rarely accelerate the loan, opting instead to use the right of repayment to initiate a renegotiation of the credit agreement.”).


> "Everybody, not just the senior loan officer Raymond Peepgass, knew this breakfast meeting was an elaborate practical joke, starting with the word "breakfast." . . . Nobody was even looking at the "breakfast." They were all settling back and eyeing the mark, the quarry, the prey, or whatever you would call the butt of a practical joke involving half a billion dollars. It was the old man at the other end of the table, the [debtor’s] end . . . ."

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.”
Although workouts historically saw more than their fair share of shenanigans, they were in the past comparatively simpler affairs. Although the Bankruptcy Code—which certainly influences pre-bankruptcy negotiations—did not envision a particular type of capital structure, it was enacted in a world with slower and less complex markets and firm structures. In 1978, when the current Bankruptcy Code was enacted, there was little distressed debt trading. Business borrowers were viewed as having investors who held discrete and monotonic rights: debt or equity, but not both. Neither secondary debt markets nor investment heterogeneity were common or problematic.

B. The New Model—Shadow Bankruptcy

Beginning in the late 1980s, the basic workout model began to change in at least three fundamental ways. First, a fairly robust secondary market for claims against distressed firms developed. Through this market, distress investors acquire defaulted debt claims at a discount, hoping to maximize their value. Sometimes, they use these claims to obtain assets at fire-sale prices. Sometimes, they use these claims to obtain inside information that they can then use in other contexts.

Second, because these private investors—unlike lenders of the past—have been largely unregulated, they can (and often do) hold multiple positions against a single firm. The heterogeneity of private investors’ portfolios enables the investor to seek the “fulcrum” position, which is generally viewed as the set of claims that gives the holder the greatest control for the smallest investment.

Third, private investors can hold derivative positions. A credit default swap, for example, 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. As has been discussed elsewhere, these and similar derivative instruments can perform legitimate market-signaling functions. But, they can also lead to significant market manipulation. They are classic forms of moral hazard, and the opportunism that that implies.

These and other market changes have converged to create what I have characterized elsewhere as a “shadow bankruptcy” system, a system that permits “sophisticated and


22 See Lipson, supra note 6, at 1620.

23 Id. at 1639. To be sure, claims traded on a limited basis before the late 1980s. See id. at 1646. (discussing history).

24 Id. at 1654.

25 See materials cited in note 7, supra.
aggressive . . . stakeholders to manipulate the outcomes of reorganization.”

As with its namesake, “shadow banking,” shadow bankruptcy thrives in regulatory gaps and ambiguities.

Here, the gap arises between the time a firm first breaches a lending agreement and the time it either goes into bankruptcy or its distress is otherwise resolved. In this period, the firm's governance will be up for grabs. In theory, state corporate law gives directors the power and responsibility to manage the firm for the benefit of shareholders, subject to ordinary fiduciary review. 

In fact, however, real control shifts away from directors and shareholders to creditors. Yet, creditors are not generally viewed as fiduciaries, so their control is largely unchecked.

As illustrated in figure 1, while creditors of the distressed firm will exercise actual control, no set of laws controls their control. In that gap, opportunities for opportunism thrive.

Figure 1—gap between state corporate law and Chapter 11

C. Opportunism v. Activism

To target “opportunism” requires a distinction from “activism.” We know that opportunism is “bad” and that activism is (often considered) “good.” Yet, these terms are not self-defining. Indeed, one person’s activist may be another person’s opportunist. While distinguishing one from the other is critical to making judgments about socially acceptable investment activities, a bright line test applicable to all cases is unrealistic. This part briefly describes the terminology, so that later parts can explore when creditor opportunism arises and how courts can address it.

“Activism” is a term generally associated with the inter-branch struggle between corporate shareholders and directors.

26 See Lipson, supra note 6 at 1618.

27 See, e.g., DEL. CODE ANN. tit. 8, § 141(a) (2007) (“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)(“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 . . . .”).

28 As discussed in Part II, courts have, in the past 20 years, largely declined to police creditor opportunism out due to over-reliance on contract principles which are increasingly inapplicable to the new forms of creditor opportunism discussed in this paper.

29 Although this article is the first attempt to examine creditor opportunism in a serious way, I cannot take credit for the term "creditor activism." The earliest (and only other) reference to the term appears in Ethan S. Bernstein, All’s Fair in Love, War & Bankruptcy? Corporate Governance Implications of CEO Turnover in Financial 11 STAN. J.L. BUS. & FIN. 298, 324 (2006) ("corporate governance system functions through an intersection of multiple mechanisms, including bankruptcy, private restructuring, the market for corporate control,
Although many are skeptical of the benefits of shareholder activism, activists mount campaigns to change bylaws, limit executive compensation, or actualize social goals.10 Although many are skeptical of the benefits of shareholder activism, its democratic and energetic aspirations resonate for some observers. Some believe that greater shareholder activism might have constrained the credit crisis that began in 2008.33

“Opportunism” by contrast, is usually a dirty word. Oliver Williamson has famously described opportunism as “a condition of self-interest seeking with guile.”34 The problem here, of course, is that creditors are always self-interested, and who knows what “guile” is? More helpful may be Daniel Fischel’s view referenced in the Introduction: “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. Thus, whenever a lender attempts to renegotiate with the borrower for better terms when there is no basis for doing so, the lender is behaving opportunistically.”35

This definition envisions a bilateral relationship—debtor and creditor. Problems of distress rarely involve only two parties, however. Distress presents classic challenges of collective action, and the Bankruptcy Code is thought to provide a way to channel group activity in a reasonably acceptable way.36 Prior to bankruptcy, however—when creditor opportunism is most likely—the Bankruptcy Code will have little reach. Thus, Fischel’s...
definition of opportunism needs to be expanded to reflect the multilateral character of distress:

1. Opportunistic investors will have control of, or affecting, a distressed firm or its reorganization;
2. They will use this control to obtain a better deal than the contract, express or implied, would have provided; and
3. The debtor—or its other stakeholders—are materially harmed as a result.

This definition adds “control” to the substance of Fischel’s definition. Without control, opportunism would not be possible in this context. Instead, aggressive behavior by a creditor who lacks control in a workout would look more like activism. Activists may seek to influence a firm (or its reorganization), but not control it; they certainly want a better deal than their contract contemplates, but they may not get it; and, in any case, activism without more is unlikely to harm a firm.

D. Opportunism and Control

To say that control is the key added element in a tractable definition of opportunism in distress begs an obvious question: what is control? A classic—although often overlooked—description of control comes from Berle and Means. “Like sovereignty,” they told us:

control . . . is an elusive concept, for power can rarely be sharply segregated or clearly defined. Since direction over the activities of a corporation is exercised through the board of directors, we may say for practical purposes that control lies in the hands of the individual or group who have the actual power to select the board of directors, (or its majority), either by mobilizing the legal right to choose them--"controlling" a majority of the votes directly or through some legal device--or by exerting pressure which influences their choice."

Creditors, as such, are unlikely to have a mathematical majority of voting control of a company because creditors do not vote on matters of firm governance, such as the election of directors; shareholders do. Yet, a key feature of creditor control is the ability to capture the board of directors and management even if the firm’s charter purports to prevent hostile acquisitions (through anti-takeover devices such as shark repellants). Thus, as Berle and Means presciently observed, "[o]ccasionally a measure of control is exercised not through the selection of directors, but through dictation to the management, as where a bank determines the policy of a corporation seriously indebted to it." As figure 2 shows, in distress, creditors may form alliances with management that enable them to exercise control, direct and indirect, that they would not otherwise have.


39 BERLE & MEANS, supra note 37, at 66.
As discussed in the next sub-Parts, distress investors can exercise de jure or de facto control. De jure control reflects the mathematical control that a stakeholder with a voting right has to control an outcome. De facto control reflects the actual ability—through legal and extralegal means—to determine outcomes.\textsuperscript{40}

1. **Negative De Jure Control—Holding Out & Short Sales**

Although creditors do not vote on conventional corporate governance matters (e.g., director elections), they can nevertheless exercise a kind of negative de jure control of a distressed firm’s restructuring if they hold debt sufficient to block a workout that might otherwise salvage a firm.

Consider workouts involving bonds. Under the Trust Indenture Act of 1939, as amended,\textsuperscript{41} 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 a negotiated modification to the core provisions of the bond—maturity date, interest, principal amount—which would, in turn, impair a reorganization outside bankruptcy.\textsuperscript{42}

\textsuperscript{40} As the Delaware Chancery Court reasoned in Superior Vision Services, "the focus of the inquiry has been on the \textit{de facto} power of a significant (but less than majority) shareholder, which, \textit{when coupled with other factors}, gives that shareholder the ability to dominate the corporate decision-making process." Superior Vision Servs. v. Reliastar Life Ins. Co., 2006 WL 2521426, *4 (Del. Ch. Apr. 25, 2006) (emphasis supplied). \textit{See also} Thorpe v. CERBCO, Inc., 676 A.2d 436 (Del.1996); Rosener v. Majestic Management, Inc. (In re OODC, LLC,) 321 B.R. 128, 142 (Bankr.D.Del.2005) (sufficient facts pled to support claim against non-officer, 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).


\textsuperscript{42} \textit{See} Roe \textit{supra} note 36 (urging repeal of the provision prohibiting modification of bond indenture terms...
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. For example, a firm’s workout may involve an “exit consent” solicitation to alter 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 succeeds in inducing a sufficient number of bondholders to tender, holders who do not will continue to hold their old securities but may become effectively subordinated or entitled to fewer protections.

Generally, exchange offers require the support of around 90% of holders. 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% bondholder participation. A bondholder that holds more than enough to permit the exchange to be effective will therefore be in a position to block the restructuring. D.R. Horton, Thornburg Mortgage and NRG Energy are examples of companies who have coupled consent solicitations with exchange or tender offers in 2008.

Negative de jure control, therefore, will be the ability to filibuster the workout. Distress investors may have many reasons for refusing to support a workout. They may, for example, believe that in the game of “chicken” that is a workout, waiting will produce a better offer. They may simply lack confidence in management and want nothing more than liquidation of the firm (and their debt).

In some cases, however, the filibuster may be for uglier reasons. 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).

Consider the case of Kellwood Co. In July, 2009 Kellwood, one of the large U.S. 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. For example, a firm’s workout may involve an “exit consent” solicitation to alter 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 succeeds in inducing a sufficient number of bondholders to tender, holders who do not will continue to hold their old securities but may become effectively subordinated or entitled to fewer protections.

Generally, exchange offers require the support of around 90% of holders. 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% bondholder participation. A bondholder that holds more than enough to permit the exchange to be effective will therefore be in a position to block the restructuring. D.R. Horton, Thornburg Mortgage and NRG Energy are examples of companies who have coupled consent solicitations with exchange or tender offers in 2008.

Negative de jure control, therefore, will be the ability to filibuster the workout. Distress investors may have many reasons for refusing to support a workout. They may, for example, believe that in the game of “chicken” that is a workout, waiting will produce a better offer. They may simply lack confidence in management and want nothing more than liquidation of the firm (and their debt).

In some cases, however, the filibuster may be for uglier reasons. 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).

Consider the case of Kellwood Co. In July, 2009 Kellwood, one of the large U.S.


45 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); see also supra note 6, at 1655.
apparel suppliers was nearly forced into bankruptcy apparently because its largest bondholder, Deutsch Bank, refused to participate in an exchange offer.\textsuperscript{51} Although Deutsche had initially agreed to restructure Kellwood's debt, it unexpectedly withdrew its support for a debt restructuring, waiting until after the debt was in default for more than three days to agree to new debt repayment terms.\textsuperscript{52}

Kellwood, which owns clothing brands 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. Although Kellwood representatives said they had "no idea" why the bank changed its mind, there was "widespread speculation" that Deutsche Bank owned credit default swaps linked to Kellwood debt.\textsuperscript{53} The CDS would apparently pay after a 3-day grace period lapsed.

Traders 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 were 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.\textsuperscript{54} In short, and as academics have observed with respect to other categories of lenders,\textsuperscript{55} negative de jure control may create or magnify perverse incentives to see workouts fail.

Private investors may also exert indirect control by using debt to drive down share prices. Recent research by Massoud, et al. finds evidence that hedge funds as lenders may be short-selling borrower equity before the announcement of a hedge fund loan.\textsuperscript{56} 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 "privy to private information about the performance of borrower firms around both loan originations and loan renegotiations" and thus "quasi-insiders."\textsuperscript{57} 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—which it will do on the announcement.\textsuperscript{58}


\textsuperscript{53} Id.

\textsuperscript{54} Id.

\textsuperscript{55} See Acharya & Johnson, supra note 4.

\textsuperscript{56} See Massoud, et al., supra note 4.

\textsuperscript{57} Massoud et al., supra note 4, at 1.

\textsuperscript{58} Massoud, et al., supra note 4, at 2 ("Overall, our results are consistent with the notion that the equity of the hedge fund borrowers is short-sold prior to public announcements of loan originations.") (emphasis in original). See Zuckerman, supra, at B3 ("Traders say a fund might seek short-term gains from a potential tumble in share prices when emerges that a company has turned to hedge funds for a high-rate loan, even if the fund is comfortable extending the loan because the company is likely to survive over the long haul. It also could be
Some may quibble with the view that these are examples of control. It is true that it is not traditional control in the sense that it results directly in a fundamental change in corporate direction. But control can be indirect, and the ability to hold out and short a distressed firm’s securities effects a kind of control of that firm. It impairs, or at least increases the costs of, a workout. It 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. In the process it controls the company’s ability to reorganize. It indirectly constrains the company’s options by driving up the cost of capital, reducing the universe of potential lenders, or both.

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 a much a lower level of creditor support than would be required outside bankruptcy.\footnote{11 U.S.C. § 1126. In highly simplified terms, plans require the support of two-thirds in amount and more than half in number of creditors entitled to vote. \textit{Id}.} 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 filibuster 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.

2. **De Facto Control—Firm and Reorganization Governance—Repelling Shark Repellants**

Distress investors may also try to control a firm or its reorganization even though they lack the votes to do so. In particular, they may use distress investing in debt as a way to circumvent anti-takeover devices in organic documents. In so doing, they may realize the dreams of those who support investor activism generally. But, they may also create other problems, including opportunities for self-dealing.

(a) **CIT and Carl Icahn**

Consider the example of CIT and self-proclaimed investor activist Carl Icahn. Formed in 1908, CIT was, until it went into bankruptcy in October 2009, one of the nation’s largest non-bank commercial lenders.\footnote{\textit{The CIT Story, A New Venture}, \url{http://www.cit.com/about-cit/centennial/the-cit-story/a-new-venture/index.htm} (last visited Feb. 22, 2010). The company was originally named Commercial Credit & Investment Company. CIT Centennial, \url{http://www.cit.com/about-cit/centennial/index.htm} (last visited Feb. 22, 2010). In 1915 the company changed it’s name to Commercial Investment Trust and began using the initials “C.I.T.” \textit{Christopher Menkin, CIT to Be Sold?}, \textit{LEASING NEWS}, Aug. 15, 2007, \url{http://www.leasingnews.org/archives/August%202007/08-15-07.htm#cit}. The name was again changed, to The CIT Group, in 1986. \textit{Id}.} Weakened by real-estate-related losses,\footnote{\textit{CIT’s 10-K for the 2007 fiscal year shows the effects of the early stages of the home mortgage crisis. Due to the deteriorating condition of the home mortgage industry, CIT management decided to exit the home lending business completely. \textit{CIT Group Inc., Annual Report (Form 10-K)}, at 6 (Feb. 29, 2008) [hereinafter 2007 Annual Report] (“The Home Lending segment consists primarily of a liquidating portfolio of home mortgage receivables and manufactured housing receivables. In July of 2007, we announced our intent to exit this business and closed the home lending origination platform in August 2007.”). \textit{See also id. at 9-10} (citing rapid deterioration of home lending industry in second and third quarters of 2007).} CIT

that some hedge funds are offered the chance to lend to a company, turn down the opportunity and then short the company’s shares.

\footnote{11 U.S.C. § 1126. In highly simplified terms, plans require the support of two-thirds in amount and more than half in number of creditors entitled to vote. \textit{Id}.} Although activity of this sort may violate federal securities laws, the technical nature of the claims, and important questions about standing and privity of contract, make it an unlikely tool to police opportunism of this form.
announced October 1, 2009, that it was soliciting support for an out-of-court restructuring (the “Out-of-Court Restructuring”) and, simultaneously, a prepackaged bankruptcy plan (the “Prepackaged Plan”) (collectively, the “Board Proposals”). The Out-of-Court Restructuring initially sought to exchange roughly $29 billion worth of debt to reduce CIT’s total debt load by $5.7 billion.

On Monday, October 19, ten days before the exchange offer was set to expire, Icahn sent a letter to CIT’s board, in which he claimed to be the company’s largest creditor. Icahn blasted the board for “reign[ing] over [CIT’s] ruin,” and offered a $6 billion loan, which he claimed was superior to the Board Proposals because it did not require bondholder support and would not allow the board to entrench itself, as would the Board Proposals, according to Icahn. Four days later, Icahn sent an open letter to CIT bondholders, urging them to reject the Out-of-Court Restructuring, vote against the Prepackaged Plan, and unite to show the board that “the company now belongs to the bondholders.” In his letter to the bondholders, Icahn proposed the immediate replacement of a majority of the directors, arguing that replacement of the board could not wait until CIT’s regular annual meeting in May 2010 because it would be “nearly impossible” by then.

Then, on Tuesday, October 27, Icahn announced a competing offer to buy CIT bonds from any bondholder who voted against the Board’s Proposals. The CIT board saw the writing on the wall. The next day, the Board agreed to bondholder control over accelerated replacement of board members in the event of bankruptcy. In response, Icahn agreed to support the company’s Prepackaged Plan and to provide a $1 billion dollar loan to aid the company in bankruptcy. On the same day, CIT reached an agreement with existing term lenders to provide an additional $4.5 billion in financing. By Friday, October 30, 2009, CIT was ready to file a Chapter 11 case.

---

62 Id. at Ex. 99.1.
65 Id.
67 Id. See Part III.B, infra, for discussion of Icahn’s argument.
69 CIT Group Inc., Current Report (Form 8-K), at Ex. 99.1 (Oct. 30, 2009) (press release announcing “Immediately upon effectiveness of CIT’s plan of reorganization, a majority of the Directors will be individuals who were identified by bondholders.”).
Icahn is the paradigm activist investor. His Facebook profile lists his personal interests as “[r]aiding corporations, breaking up airlines, [and] making money.”

He has had significant roles in many corporate takeovers. He also owns a majority stake in, and is the chairman of, American Railcar Industries Inc. Perhaps it is no coincidence that American Railcar depended on CIT for over 50% of its production orders and 31% of its revenue in the first half of 2009.

Thus, Icahn likely had two interests in CIT’s fate beyond merely ensuring that he would receive the largest payment possible for CIT debt he owned. First, Icahn’s purchase of CIT bonds and eagerness to extend additional credit to the company suggest a traditional “loan-to-own” strategy used by many private equity firms. Icahn bought CIT’s distressed knowing it was likely to convert to equity in the workout or bankruptcy. Second, Icahn would have wanted to make sure CIT would maintain its relationship with American Railcar. Both of these interests are implicated by Icahn’s goal to gain control CIT and its reorganization process.

(b) CIT’s Antitakeover Devices--Charter and Bylaws

If CIT had been a healthy firm, and Icahn an actual or aspiring shareholder, it would have been difficult for him to take control. Certain charter provisions effectively delayed shareholder votes, including those that would change the board. CIT’s charter and

76 Id.
77 See Mike Spector & Jeffrey McCracken, Distressed Takeovers Soar: Deals Reach $84.4 Billion as M&A Bankers Flock to Bankruptcy Court, WALL ST. J., Aug 11, 2009 (“The new cliché among restructuring professionals: Bankruptcy is the new M&A’), http://online.wsj.com/article/SB124994892736221145.html.
78 Linda Shen, Icahn’s American Railcar Bet May Be Tied to CIT Fate, BLOOMBERG, Aug. 12, 2009, http://preview.bloomberg.com/apps/news?pid=newsarchive_en10&sid=aQV5i5qvB6.M. In bankruptcy, CIT would have the right to "reject" executory contracts, such as those with American Railcar, if, in its business judgment, it believed doing so was appropriate. 11 U.S.C. § 365. If the contracts were rejected, American Railcar would not only lose future business with CIT; its claims under those contracts would be paid as general unsecured claims.
80 See CIT Group Inc., Quarterly Report (Form 10-Q), at Ex. 3.1 (Aug. 12, 2003) [hereinafter CIT Charter],
bylaws\textsuperscript{81} did not have such traditional anti-takeover devices as a staggered board,\textsuperscript{82} multi-tiered voting structure, supermajority merger approval provision, fair price provision, compulsory redemption provision, or poison pill.\textsuperscript{83}

There were, however, several restrictions on shareholders’ ability to appoint and to remove directors, and to otherwise influence the board. For example, shareholders were required to give notice of shareholder proposals and director nominations,\textsuperscript{84} could not act by written consent,\textsuperscript{85} and could not call special meetings.\textsuperscript{86} Shareholders had the power to remove directors, but only by an affirmative vote of a 66 2/3% supermajority of the voting power of the outstanding shares.\textsuperscript{87}

Moreover, the board had the exclusive power to engage in “board packing.” Only the board could set the number of directors, within the range authorized by the CIT By-Laws,\textsuperscript{88} and only the board could fill vacancies, including when the vacancy was the result of
an increase in the size of the board. 89 If shareholders modified the number of directors authorized by the CIT By-Laws, no directors would be removed by such modification. 90 The board could adopt, amend, or repeal the CIT By-Laws with a majority vote but an affirmative vote of a 66 2/3% supermajority of the voting power of the outstanding shares was required for the shareholders to do so. 91 Board approval and an affirmative vote of a 66 2/3% supermajority of the voting power of the outstanding shares was required to modify every CIT Charter provision—and only those CIT Charter provisions—implicated by this paragraph. 92

These “shark repellents” are designed, among other things, to deter unwanted share tender offers. 93 The merits of these sorts of provisions have been debated, in ways that tend to mirror debates about the virtues of shareholder activism generally. 94 Those who would permit such provisions to withstand judicial scrutiny argue that directors are in a better position than shareholders (or other investors) to make informed decisions about the benefits of a hostile acquisition to the firm. 95 Those who do not argue that they merely permit management to entrench itself, immune from the competitive pressures of the marketplace. 96

The enormous literature on anti-takeover devices tends to ignore their effectiveness when a firm is in distress. Perhaps this is because they apply to shareholders, not creditors. As Icahn’s tactics demonstrate, once a firm is in distress, bondholders—and management (directors and officers)—will act as if the bondholders are the “owners” of the firm.

from time to time by resolution adopted by the affirmative vote of a majority of the entire Board of Directors.

89 See CIT Charter art. 6, para. c (providing that “vacancies resulting from death, resignation, retirement, disqualification, removal from office or other cause, and newly created directorships resulting from any increase in the authorized number of directors, may be filled only by the affirmative vote of a majority of the remaining directors”); CIT By-Laws art. 3, sec. 3.06 (using identical language).

90 See CIT Charter art. 6, para. c (“No decrease in the number of authorized directors constituting the Board of Directors shall shorten the term of any incumbent director.”); CIT By-Laws art. 3, sec. 3.06 (using identical language).

91 See CIT Charter art. 5, para. 1 (authorizing board to adopt, amend, or repeal by-laws and authorizing shareholders to do same but “in the case of the stockholders, the affirmative vote of the holders of at least 66 2/3% of the voting power of the then outstanding Voting Stock, voting as a single class, shall be required”); CIT By-Laws art. 11 (same).

92 See CIT Charter art. 10, para. b (“[I]n addition to the approval of the Board of Directors, the affirmative vote of the holders of at least 66 2/3% of the voting power of the outstanding Voting Stock, voting together as a single class, shall be required to amend, repeal or adopt any provision inconsistent with (i) paragraph (1) of Article FIFTH, (ii) Article SIXTH, (iii) Article SEVENTH or (iv) paragraph (b) of this Article TENTH.”).

93 It is open to debate whether shark repellents actually do deter hostile takeover attempts. See Coates, supra note 83, at 318. (discussing empirical study of effectiveness of repellents).


95 See, e.g., Bainbridge, supra note 32.

96 See Bebchuk, supra note 30.
Moreover, even though firm failure may actually result in a change of control, historically, that change occurred through a bankruptcy process, with its own rules. Increasingly, however, private investors such as Icahn can use their leverage as creditors before bankruptcy to control the outcome in the event a bankruptcy case is commenced.

(c)  **CIT’s Plan— Icahn’s Control**

Which is exactly what happened. With Icahn’s support, CIT’s reorganization plan was confirmed on December 8, 2009. The plan was, in effect, an end-run around CIT’s anti-takeover devices. When the CIT bankruptcy plan converted company debt to equity, Icahn filed SEC Form 13-G to declare his acquisition of beneficial ownership. This indicates that Icahn’s beneficial ownership, through all entities under his control, is approximately 6.07% of the reorganized company. Icahn’s 6% should have been worth about $11.5 billion, given a valuation of $69. And reports describe Icahn as “one of [the reorganized CIT’s] largest shareholders.”

The other prize was seats on the board. Shortly after CIT’s plan of reorganization became effective, the senior creditors appointed seven new directors in an accelerated process; three were designated by the Lenders’ Steering Committee, one was designated by Icahn, and three were chosen by the board from recommendations made by “any holder of more than 1% of CIT’s debt” (excluding the Lenders’ Steering Committee and Icahn). The new board consisted of thirteen directors—five who remained from the pre-bankruptcy board, John A. Thain, CIT’s Chairman and CEO since February 2010, and seven appointed by the senior creditors.

Icahn’s director was Daniel A. Ninivaggi. Prior to a short stint as Of Counsel at

---

97 See Findings of Fact, Conclusions of Law and Order (I) Approving (A) The Disclosure Statement Pursuant to Sections 1125 and 1126(c) of the Bankruptcy Code, (B) Solicitation of Votes and Voting Procedures, and (C) Forms of Ballots, and (II) Confirming the Modified Second Amended Prepackaged Reorganization Plan of CIT Group Inc. and CIT Group Funding Company of Delaware LLC, In re CIT Group Inc., No. 09-16565 (Bankr. S.D.N.Y. Nov. 25, 2009) (Docket No. 193).

98 Carl C. Icahn, Statement of Acquisition of Beneficial Ownership by Individuals (Form 13-G) (Dec. 21, 2009). This was filed pursuant to Rule 13d-1(c), which requires that the filing individual “[i]s not directly or indirectly the beneficial owner of 20 percent or more of the class.” See 17 C.F.R. § 240.13d-1(c).

99 Carl C. Icahn, Statement of Acquisition of Beneficial Ownership by Individuals (Form 13-G) (Dec. 21, 2009).

100 CIT Group Inc., Quarterly Report (Form 10-Q) (Nov. 16, 2009).


102 See text accompanying notes 64 & 66, supra, for discussion of agreement regarding accelerated replacement of directors.

103 CIT Group Inc., Definitive Notice and Proxy Statement (Form 14/A), at 10 (Mar. 31, 2010) [hereinafter Management Proxy].

104 Id.

105 Id. See also CIT Group Inc., Quarterly Report (Form 10-Q), at 50 (Nov. 16, 2009).

106 Id.

Winston & Strawn, Ninivaggi spent six years at Lear Corporation.\textsuperscript{108} During that time, Icahn held a 16% stake and launched a failed tender offer for the company.\textsuperscript{109} After Ninivaggi was appointed to the CIT board, Icahn made him President of Icahn Enterprises L.P. ("Icahn Enterprises").\textsuperscript{110} One month later, Federal-Mogul Corporation, of which Icahn owns a 76% stake and serves as Chairman of the Board, increased the size of its board and appointed Ninivaggi.\textsuperscript{111} Although Federal-Mogul considers Ninivaggi to be a non-independent director,\textsuperscript{112} CIT has determined that he is an independent director,\textsuperscript{113} perhaps because Icahn’s stake in CIT is so much smaller.

Ninivaggi’s employment agreement with Icahn Enterprises provided a base salary of $650,000 per year,\textsuperscript{114} a guaranteed bonus of $450,000 (up to $650,000),\textsuperscript{115} and $300,000 in relocation expenses.\textsuperscript{116} It is an extremely acceptable compensation package for somebody Icahn characterized as “extremely competent.”\textsuperscript{117} By comparison, CIT pays Ninivaggi $160,000 per year to serve as the Chair of the compensation of the Nominating & Governance Committee.\textsuperscript{118} The employment agreement also provides that “[s]o long as [Ninivaggi] remains employed by [Icahn Enterprises] or any member of the Icahn Group, [Ninivaggi] agrees that he will . . . not resign as a director of any public or private corporation on whose board he is then serving.”\textsuperscript{119}

The Nominating & Governance Committee under Ninivaggi has considered only one potential interested transaction: CIT’s purchase of equipment and services from American Railcar, the company Icahn chairs, and of which he is majority shareholder.\textsuperscript{120} The Nominating & Governance Committee determined that they were arm’s-length transactions and that there was no conflict of interest.\textsuperscript{121}

\textsuperscript{108} Management Proxy, supra note 103, at 5.
\textsuperscript{109} See, e.g., Andrew Ross Sorkin, Icahn Shears Stake in Lear, N.Y. TIMES, (Nov. 4, 2008).
\textsuperscript{110} Icahn Enterprises L.P., Current Report (Form 8-K), Ex-10.1 (Feb. 18, 2010) [Ninivaggi Employment Agreement].
\textsuperscript{111} Federal-Mogul Corporation, Current Report (Form 8-K) (Mar. 24, 2010).
\textsuperscript{112} Federal-Mogul Corporation, Current Report (Form 8-K) (Mar. 24, 2010).
\textsuperscript{113} Management Proxy, supra note 103, at 10.
\textsuperscript{114} Ninivaggi Employment Agreement, supra note 110, at para. 4.
\textsuperscript{115} Id. at para. 5.
\textsuperscript{116} Id. at para. 6.
\textsuperscript{117} See Lear Corp., General Statement of Acquisition of Beneficial Ownership [Amend] (Schedule 13D/A), at Ex. 2 (Nov. 3, 2008). On the same day he sold off his stake in Lear Corp, a disappointed Icahn sent a letter to the board that essentially said “I am known for publicly ridiculing incompetent executives; Ninivaggi was extremely competent.” See id.
\textsuperscript{118} Management Proxy, supra note 103, at 42 (listing compensation for committee chair as $160,000).
\textsuperscript{119} Ninivaggi Employment Agreement, supra note 170, at para 3.
\textsuperscript{120} See Management Proxy, supra note 103, at 46.
\textsuperscript{121} See Management Proxy, supra note 103, at 10, 46 (“[T]he Board considered these transactions with Icahn Enterprises and concluded that they are not material for this purpose because they have been (and continue to be) conducted on an arms-length basis on customary market terms . . . .”).
(d) The Meaning of CIT

Icahn's involvement with CIT has at least three lessons for anyone concerned about creditor opportunist. First, we do not really know how much debt Icahn actually owned when CIT first announced its restructuring in October 2009. He purported to be CIT's largest creditor. This is possible. But it was virtually impossible to verify. Icahn's debt would likely have been acquired in the secondary market for debt trading. This market is over-the-counter, meaning it is largely off exchanges and outside the scope of either the federal securities laws or the Bankruptcy Code. If Icahn had sought to acquire control by purchasing shares, section 13(d) of the 1934 Act, would have required him to report this with the issuer and the SEC.122 The problem is that this rule does not apply to "straight" debt securities.123 Dodd-Frank does not appear to change this. In short, Icahn may have been able to engage in a simple head-fake. At that point, he might have held no CIT debt at all.

Although Icahn did comply with the 1934 Act when it became clear that CIT's plan would convert his debt to a major portion of CIT's equity, no rule required him to disclose the fact that he was acquiring debt that would, in the end, likely give him as much--if not more--control than shares. Thus, it was simply not possible to know whether he really was CIT's largest creditor or, if he was, that he would end up having some control of the company.

This gap in information in the market for corporate control makes the CIT board's capitulation understandable. It is unlikely that the board could have known with certainty how serious a threat Icahn was under the company's existing agreements, because it could not verify whether, or to what extent, he was a party to those agreements. The "shadow bankruptcy" system means, in part, that it is not possible to know who has what capacity to exert control through legal mechanisms.

Second, (and) whether or not Icahn's claims about his stake were legitimate, he was able to use this credible threat to circumvent CIT's anti-takeover devices. Icahn shows that investing in distress debt may be a way around these devices.

Third, it is reasonably clear that Icahn exercised his control not merely to maximize the value of his debt—a goal that would generally have been considered reasonable under the old model—but instead to place someone on the board to protect Icahn's other positions, notably his investment in American Railcar. While it would appear that CIT followed applicable procedure in vetting and approving the American Railcar contract, it is

122 See 17 C.F.R. § 240.13d-1 (2008). The rule provides, in part, as follows:

(a) Any person who, after acquiring directly or indirectly the beneficial ownership of any equity security of a class which is specified in paragraph (j) of this section, is directly or indirectly the beneficial owner of more than five percent of the class shall, within 10 days after the acquisition, file with the Commission, a statement containing the information required by Schedule 13D (§ 240.13d-101).

123 See Anne Marrs Huber & Thomas H. Young, The Trading of Bank Debt In and Out of Chapter 11, 15 J. BANKR. L. & PRACT. 15, 33 n.21 (2006) (“It is noteworthy that there is no need to file a 13D with the Securities and Exchange Commission when acquiring large amounts of claims against a debtor in bankruptcy, making acquiring control of a corporation in bankruptcy somewhat easier than acquiring a large block of shares in the open market, prepetition.”). It might apply to convertible debt.
difficult to avoid the suspicion that Icahn's appointed director approved it not because it was
good for CIT, but because it was good for Icahn.

Was Icahn an opportunist or an activist? It is difficult to say. Icahn exercised
indirect, de facto control over the workout process; he obtained more than his contractual
rights would have given him in the sense that he obtained one seat on the board and indirect
control of the process governing CIT's relationship with American Railcar. It is certainly
possible that American Railcar benefited at the expense of CIT, although it is difficult to
know at this point. At minimum, Icahn's involvement must have been a distraction for CIT
and its bondholders. Distraction is not costless.

3. De Facto Control—Heterogeneity and Conflict Transactions

Another kind of de facto control—which creates opportunities for opportunism—
arises from the heterogeneity of private investors' positions against distressed firms. While
the amount of any single position—debt or equity—may not give the investor actual control,
the combination will.

Consider, for example, the MarketXT case. Here, Softbank, held common and
preferred stock as well as debt of the debtor, an electronic securities trading firm. Softbank
also held two seats on the debtor's board of directors, and had significant rights as a
preferred stockholder, including 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. According
to the plaintiffs in the lawsuit that arose from the relationship (the other creditors
and bankruptcy trustee), the bank "used these powers to its advantage and to the
disadvantage of other creditors." 124

While Softbank had significant interests in the debtor, it also indirectly held about
27% of the common stock of E*Trade, effectively a competitor of the debtor. It appears
that the debtor's only viable asset was a subsidiary, Momentum, which it sought to sell to
raise cash. Although it received at least eleven bids, Softbank's preferred stock gave it a
veto over any sale of Momentum. For reasons not explained in the opinion, the debtors
ignored the other offers received for Momentum, and instead agreed to sell Momentum to
E*Trade for $280 million in E*Trade stock. Although the opinion does not say why this
sale occurred, it is difficult to escape the conclusion that it did because that is what Softbank
wanted.

But there was a problem. Since the E*Trade stock was not registered, it could not be
traded by the debtors, so it would not solve the debtors' liquidity problems. Worse, it
turned out the E*Trade stock was overvalued. 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

125 Id. at 376.
126 Id. at 387-88 (citing Complaint ¶¶ 20, 127-129, 134-135, 137, 153-155, 159-162, 168-194, 310)).
127 Id. at 378.
128 Id. at 379.
129 Id. at 379.
Cotsakos, $90 million in compensation, a disclosure which immediately pushed the stock's value down. 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.\textsuperscript{130}

Although the E*Trade stock was dropping in value, and was not registered for resale, the debtors nevertheless wanted to borrow against it on a short-term basis until it was registered for resale, in order to improve liquidity. Softbank had and used its control of the debtor's board to prohibit the debtors from doing so unless $17 million in unsecured claims and $18 million in liquidation preferences were paid to it\textsuperscript{131} and the debtors pledged most of the E*Trade stock to Softbank.\textsuperscript{132} After "locking up" the E*Trade stock in favor of Softbank, it appears that matters did not improve for the debtors.\textsuperscript{133} The debtors' lack of liquidity led the NASD to shut down the debtors' only operating subsidiary, MarketXT, at the end of July 2002, less than two months after the Momentum sale.

At this point, the relationship between Softbank and the debtors became overtly ugly. During the fall of 2002, the debtors asked Softbank for permission to sell E*Trade stock in order to pay creditors. Softbank refused unless the debtors agreed to take new loans from Softbank secured by the unencumbered E*Trade stock, and use the proceeds to pay off existing debts to Softbank.\textsuperscript{134} A Softbank vice-president allegedly "made threats of physical harm against [the debtors' CEO] and his wife" unless the debtors so agreed.\textsuperscript{135} The debtors did, and entered into an agreement that apparently included a release of all of the debtor's claims against Softbank.\textsuperscript{136}

After MarketXT was forced into bankruptcy, its bankruptcy trustee and creditors sued Softbank. As discussed in greater detail in Part II, the bankruptcy court was largely unwilling to recognize the control that Softbank had over MarketXT.\textsuperscript{137} While it is true that

\textsuperscript{130} \textit{Id.} at 380.

\textsuperscript{131} \textit{Id.} at 380-81

\textsuperscript{132} \textit{Id.} at 380-81 ("Softbank refused to take any action, including attending a board of directors meeting to deal with the ongoing cash flow problems, until the Debtor executed such a "lock-up" agreement"). The opinion is oddly indifferent to the effect of this transaction. While the details are not specified, it appears to have had the effect of giving Softbank "control" of the E*Trade shares. Under the Uniform Commercial Code, a creditor has "control" of stock if, among other things, it has the right to direct the disposition of the stock on default by the borrower. \textit{See} Unif. Comm. Code §§ 9-106 & 8-106 (2010). This control would appear to have had the effect of creating a security interest in the stock, which would have rendered the E*Trade stock essentially worthless to the debtor, since it is difficult to imagine a lender who would lend against stock already in the control of another lender. Since the E*Trade stock appears to have been an important--perhaps the most important--source of liquidity for the debtor, the Momentum sale and lock-up transaction appear to have had the effect of causing the debtors to sell a valuable asset in exchange for consideration of essentially no value to it. Obviously, this created fraudulent conveyance concerns as well.

\textsuperscript{133} \textit{Id.} at 381 ("After the E*Trade Merger closed, MarketXT, Inc. was the Debtor's sole operating subsidiary. It operating problems and lack of cash crippled its business . . . .").

\textsuperscript{134} \textit{Id.} at 381-82.

\textsuperscript{135} \textit{Id.} at 382.

\textsuperscript{136} \textit{Id.} at 382.

\textsuperscript{137} \textit{See} \textit{id.} at 391 (declining to treat Softbank as controlling stakeholder). The court did deny the motion to dismiss a claim to equitably subordinate Softbank's claims based, at least indirectly, on Softbank's abuse of the
no single type of claim necessarily gave Softbank control of the company, the combination
of rights Softbank held—in particular the ability to determine a board quorum and to sell the
E*Trade shares—gave it the power to determine the company’s fate. Softbank used this
control to engage in a self-dealing transaction by obtaining (through E*Trade) an interest in
Momentum.

Control comes in many forms. The foregoing examples show that it is easily
possible—and tempting—for private investors to use this control to obtain extra-contractual
gain that may harm distressed firms. While some cases—CIT, for example—may well be
marginal, they simply make all the more urgent the need to better define and police creditor
opportunism. Before explaining how courts can do this (in Part III), the next part explains
why current doctrine does not.

II. CURRENT APPROACHES TO REGULATING CREDITOR OPPORTUNISM

If opportunism is a problem, why do courts permit it? In simple terms, courts have
failed to appreciate the work that good faith can do in this context. Although they recognize
that good faith is a baseline normative standard against which to measure creditor conduct,
they are caught in a binary vision of the doctrine: Good faith is either license to impose
community norms on the lender, no matter how hostile the community might be to lenders,
or they refuse to look outside the contract, treating good faith as little more than a “gap
filler.” Yet, neither approach responds to modern conditions of creditor opportunism.

A. Communitarianism—Lender Liability

Until the early 1990s, courts often took a “communitarian” approach to problems of
creditor opportunism. They subjected claims against lenders to equitable scrutiny or the
norms of civil juries. Not surprisingly, the results were unpredictable, difficult to
rationalize and, as such, scary to lenders.

1. Lender Liability

Historically, the chief doctrinal response to creditor opportunism was “lender
liability.” Lender liability is shorthand for a cluster of causes of action that a borrower may
bring against a lender, including breach of contract, fraud, breach of the implied
covenant of good faith and fair dealing and even breach of fiduciary duty. Famous cases

138 See Fischel, supra note 35, at 132, n. 6 (collecting cases involving civil jury awards in lender liability and similar cases).
such as *K.M.C v. Irving*\(^{143}\) and *Farah Manufacturing*\(^{144}\) shocked the lending community in the 1980s, when courts held lenders liable because they did not deal fairly with the borrower in some way—most commonly by concluding that a lender gave inadequate notice of a default, accelerated a loan without “good cause,” or exercised control over the borrower’s business.\(^{145}\)

Although “lender liability” was a host category for a variety of more-traditional doctrines, the most important was the duty of “good faith and fair dealing.” The Uniform Commercial Code and the Restatement (Second) of Contracts both impose obligations of good faith in contract, and purport to provide some content to the term.\(^{146}\) The 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,”\(^{147}\) an obligation that cannot


In *A. Gay Jenson Farms Co. v. Cargill, Inc.*, 309 N.W.2d 285 (Minn. 1981), a jury found that a debtor-creditor relationship had evolved into one of principal and agent, and held the lender, Cargill, responsible for the debts of its borrower, Warren. The agency was based on explicit findings that the lender was an ‘active participant’ in the debtor's grain business, not ‘simply a financier.’ Id.

Section 14 O of the Restatement (Second) of Agency provides that "[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.” The Restatement (Second) of Agency § 14O (1958).

\(^{143}\) See *K.M.C.*, supra.


\(^{146}\) Current articulations of good faith derive from the 1933 opinion of the New York Court of Appeals in *Kirke La Shelle Co. v. Paul Armstrong Co.*: “In 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.” 263 N.Y. 79, 188 N.E. 163 (1933).

Here, the plaintiff had obtained in settlement of a prior lawsuit a contract right to one-half the gross receipts from future stage productions of a play, and a right to approve all contracts, sales, licenses, and other arrangements affecting the stage production of the play, except “motion picture” rights. Without obtaining such approval, the defendant sold the “talkie” movie rights. *Kirke La Shelle* sued for one-half of the net amount received from the sale. The New York Court of Appeals upheld the plaintiff’s claim because a “talkie” movie — not invented at the time of contracting — was not within the contemplation of the parties when they excepted “motion pictures” and would impair the market for the stage play and therefore the plaintiff’s income from the contract. The express promise giving the plaintiff a right of approval thus was broken.

*Kirke La Shelle* is troubling for at least two reasons. First, as Professor Burton has observed, it may have been decided incorrectly on the facts. Burton, 379, n. 42 (“There is some question whether the case was correctly decided on its facts.”) (citing See L.C. Page & Co. v. Fox Film Corp., 83 F.2d 196, 199 (2d Cir. 1936) for the proposition that the words “motion picture” in a pre-“talkie” contract were held to include “talkies”. Second, it used good faith but also rested in part on a conclusion that a fiduciary relationship existed between the parties. “By entering into the contract and accepting and retaining the consideration therefor,” the court reasoned, “the respondents assumed a fiduciary relationship which had its origin in the contract, and which imposed upon them the duty of utmost good faith” Id., 263 N.Y. at 85.

\(^{147}\) U.C.C. § 1-201(a)(20)(2009). This is the “revised” definition of good faith, which has been adopted in roughly half of the states. The prior definition—“honesty in fact in the conduct or transaction concerned”—
be wholly eliminated by contract.\textsuperscript{148} Restatement (Second) of Contracts section 205 provides that “[e]very contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement.”\textsuperscript{149} The comments to the Restatement (Second) acknowledge that good faith is used in a variety of contexts, and “emphasizes faithfulness to an agreed common purpose and consistency with the justified expectations of the other party.”\textsuperscript{150}

We generally recognize that good faith has both a subjective and an objective component. Subjective good faith is reflected in the U.C.C.’s “honesty in fact” formulation, which is sometimes characterized as the “clean heart empty head test.” Subjectively, a contracting party cannot act with “malice” toward the other. Courts sometimes say that subjective bad faith is the only bad faith that matters.\textsuperscript{151}

Objective good faith looks to community standards to determine whether behavior was, in effect, reasonable.\textsuperscript{152} In K.M.C., for example, the Sixth Circuit Court of Appeals sustained the jury’s finding of lender liability because it concluded that there was evidence that Irving Trust, the lender, had lacked both subjective and objective good faith. The court found lack of subjective good faith because a senior executive at the bank acknowledged that if the loan officer who refused the advance knew that the loan was fully secured, the refusal without notice would, in his view, not have been in good faith.\textsuperscript{153}

Because the loan agreement gave Irving discretion to refuse to make advances, the more difficult question was whether the refusal to do so in that case was objectively in bad faith. The Court of Appeals sustained the jury’s verdict for the company, based largely on

\begin{addmargin}[2em]{0em}
\begin{itemize}
  \item\textsuperscript{149} Restatement (Second) of Contracts §205 (1981).
  \item\textsuperscript{150} Restatement (Second) Contracts, § 205, cmt 1.
  \item\textsuperscript{151} See, e.g., Brant Constr. Co. v. Metro. Water Reclamation Dist. of Greater Chi., 967 F.2d 244, 247 (7th Cir. 1992) (“The only limit on contracts which provide for subjective satisfaction is bad faith.”); Daniels v. Army Nat’l Bank, 822 P.2d 39, 43 (Kan. 1991) (finding a good faith test is subjective with respect to arguments by borrowers against lenders).
  \item\textsuperscript{152} For transactions within current Article 2 involving a merchant, and all transactions under Article 9, good faith includes an “objective” component—“reasonable commercial standards of fair dealing.” U.C.C. §§ 2-103(1)(b) & 9-102(a)(43). Article 2 limited this objective component to an understanding of standards “in the trade.” U.C.C. § 2-103(1)(b).
  \item\textsuperscript{153} K.M.C. Co. v. Irving Trust Co., 757 F.2d 752, 761 (6th Cir. 1985) (executive vice president of lender testified that “Irving owed its clients a duty of good faith, that it was not a policy of Irving to terminate financing without notice, and that if [the loan officer] believed that Irving was adequately secured he would not have been acting in accordance with that duty of good faith to have refused without notice to advance funds to K.M.C.”).
\end{itemize}

remains the standard throughout many versions of the U.C.C. As of March 1, 2010, Revised Article 1 was in effect in thirty-seven states: Alabama, Alaska, Arizona, Arkansas, California, Colorado, Connecticut, Delaware, Florida, Hawaii, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Minnesota, Montana, Nebraska, Nevada, New Hampshire, New Mexico, North Carolina, North Dakota, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Dakota, Tennessee, Texas, Utah, Vermont, Virginia, and West Virginia. Of the 37 enacting states, 26 have adopted the uniform definition, while 11 have retained the pre-revised definition that, in conjunction with § 2-103(1)(b), imposes a different good faith standard on merchants and non-merchants.
testimony from one of Irving’s co-lenders that the loan appeared to be fully secured, so there was no objective basis for concern about repayment in full.\textsuperscript{154} a point Irving conceded.\textsuperscript{155} Being fully secured, the Court of Appeals reasoned that providing notice that it would accelerate the loan would not have harmed the lender, but might have given the borrower time to find replacement financing.\textsuperscript{156}

These cases, and others like them, "inspired fear and mystery in bankers, borrowers, and lawyers"\textsuperscript{157} because they were so difficult to predict, and so harsh in their results. Both \textit{K.M.C.} and \textit{FMC} were, according to Professor 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.”\textsuperscript{158} They were troubling because the case law lacked "a coherent theoretical framework establishing the rights of lenders and their duties to their borrowers."\textsuperscript{159} It was simply not possible, ex ante, for a lender to know whether attempting to enforce its rights, or participate in a workout of the borrower's distress, would help or hurt its own position.

Perhaps the strongest evidence of the lack of a “theoretical framework” supporting these decisions were the damages awarded. In Professor Fischel's view, they were “outrageous,”\textsuperscript{160} and “fundamentally flawed”\textsuperscript{161} 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.\textsuperscript{162} If, Professor 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.\textsuperscript{163}

\textsuperscript{154} \textit{Id.} at 761-62 (lender testified that “he believed that the loan to K.M.C. was fully secured as to both interest and principal, and that any reasonable banker looking at the loan would agree that it was fully secured.”) (emphasis in original).

\textsuperscript{155} \textit{Id.} at 762 (“counsel for Irving conceded in his summation to the jury that the bank was adequately secured on March 1, 1982”).

\textsuperscript{156} \textit{Id.} at 762 (“The jury was entitled to find that a reasonable notice period would not change the ability of K.M.C. to pay the loan. The nature of the security was such that the loan would rapidly be (correct spelling?) down on demand.”).

\textsuperscript{157} \textit{Ebke & Griffin}, supra note 142, at 776.

\textsuperscript{158} \textit{Fischel}, supra note, 35, at 146.

\textsuperscript{159} \textit{Fischel}, supra, note 35, at 133.

\textsuperscript{160} \textit{Id.} at 152.

\textsuperscript{161} \textit{Id.} at 154.

\textsuperscript{162} \textit{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%”).

\textsuperscript{163} \textit{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.” \textit{Id.} 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 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.
2. **Good Faith as Community Norms**

It may be true that no conventional economic theory rationalized the results of these cases. But a procedural one did: communitarianism. In 1990, Dennis Patterson argued that the use of good faith (and related doctrines) in lender liability cases reflected the application of communitarian norms.\

\[164\] 
“[C]ommunity standards of decency, fairness, and reasonableness [] have an important role to play in any evaluation of secured creditor misconduct,” he argued:

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.\

The lender liability cases were communitarian because they were literally decided by representatives of the community at large: lay juries. 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.\

Although he could not have known it at the time, Professor Patterson was, in 1990, writing at the twilight of communitarian responses to creditor opportunism. Whatever its merits at the time, communitarian views about debtor-creditor relations *in extremis*, as reflected in Patterson’s work, are now problematic and outmoded.

First, the rise of the secondary market in debt trading challenges the idea that there is some “community” whose norms could decide whether a distress investor did (or did not) overstep the bounds of acceptable commercial behavior. If a borrower’s debt has been traded to private investors located in various cities throughout the world, whose “community” are we talking about? The community in which the borrower and primary lender found themselves? Or does the community change as the debt changes hands? What if—as is often the case in larger loans—the debt is held in various portions, which are traded? How could we possibly know what “community” norms govern a relationship between a debtor located in, for example, Philadelphia and hedge funds located in New York, London, Dusseldorf and Dubai?

Second, institutionally, it is not clear that representatives of the “community”—civil juries or courts of general jurisdiction—are in a good position to make an appropriate normative assessment of a failed debtor-creditor relationship. As Professor Patterson acknowledged (and as discussed further below) a key gap in our understanding of commercial norms involves the role of expert decision-makers.\

\[167\]

---


\[165\] Id., at 110-111

\[166\] K.M.C. Co. v. Irving Trust Co., 757 F.2d 752, 757 (6th Cir. 1985)

\[167\] PATTERSON, *supra* note 164, at 39-44.
expert decision-makers who can address problems of creditor opportunism, they are not the ones we have used in the past, and were certainly not the ones that produced the leading communitarian lender liability opinions.

B. Contractualism

Not surprisingly, commentators have argued that we should reject communitarianism, and courts have largely come to agree.

1. The Birth of Contractualism—The Gap Filling of Fischel and Easterbrook

The beginning of the end of communitarianism came in Fischel's 1989 *Yale Law Journal* article, which (perhaps ironically) has also given us the basis for a serviceable definition of creditor opportunism. Fischel argued that the parties' contract should be the only thing that matters in questions of creditor opportunism. Anything else would risk destabilizing credit markets, leading to inefficiency, reduced economic growth, and so on.

The only important question, he believed, 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.”

In his view, courts should not. What did it mean to look outside the contract? First, courts should treat good faith as no more than a “gap filler.” Courts should not introduce extra-contractual 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 (subjectively) would have chosen.

In part, this was because good faith was a response to opportunism, and it would be “very complicated if not impossible” to distinguish opportunistic from non-opportunistic (e.g., “activist”) behavior. This was because “[a] lender will never concede that its actions were designed to obtain a benefit not bargained for in the initial agreement. On the contrary, the lender will claim that its refusal to continue funding was based on its assessment of the debtor and the probability of default.”

---

168 See Fischel, *supra* note 3. I say “ironically,” because it is unlikely Fischel would sympathize with the use to which I put his definition of “opportunism.”

169 Id. at 140 (“Courts faced with a lender liability case must decide whether the challenged conduct of the lender was consistent with the agreement between the parties. This inquiry is primarily a matter of contract interpretation.”).

170 Id.


172 Id.

173 Id. at 141-142. This is true, but proves too much. Defendants rarely “concede” anything that will hurt them in litigation. The important question is not what they will concede, but the standard by which their conduct—admitted or proved at trial—will be judged.
Second, deviating from an interpretation of the contract that favored the lender would increase the cost of capital, he believed. “The 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.”

Third, Fischel argued that creditors were unlikely to behave opportunistically in the first place:

Three factors limit the ability of the lender to behave opportunistically to extract additional concessions from the borrower. 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.

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. 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 extended 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. 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 Court, it appears that neither the debtor nor the bank took any action with respect to the facility. The debtor did not seek to force the bank to lend, 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. At the hearing on the last plan, however, the bankruptcy judge held an evidentiary hearing and concluded that, by refusing to lend, the bank had acted inequitably. 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 equitably subordinating the bank's claim,

174 Id. at 142.
175 Id. at 138 (footnotes omitted).
176 Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting, 908 F.2d 1351, 1357 (7th Cir. 1990).
177 908 F.2d at 1353-1354.
178 Id. at 1354.
179 Id. at 1354.
effectively leaving the bank unpaid.\textsuperscript{180}

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."\textsuperscript{181} "[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."\textsuperscript{182} Here, the bank was not an insider. According to Judge Easterbrook, "[i]t contributed new value under a contract, and it wants no more than the priority Judge Toles promised as the lure."\textsuperscript{183}

The debtor had argued that the bank's conduct was "unfair" and "inequitable" even though permitted by the language of the contract.\textsuperscript{184} 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."\textsuperscript{185} Permitting this sort of ex post review would increase the cost of capital, he believed.\textsuperscript{186} "Unless pacts are enforced according to their terms, the institution of contract, with all the advantages private negotiation and agreement brings, is jeopardized."\textsuperscript{187}

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

\textsuperscript{180} \textit{Id.} at 1354. 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." The doctrine grew out of a series of Supreme Court cases, \textit{Taylor v. Standard Gas \\& Electric Co.}, 306 U.S. 307 (1939); \textit{Pepper v. Litton}, 308 U.S. 295 (1939); \textit{Comstock v. Group of Institutional Investors}, 335 U.S. 211 (1948). Generally, a claim will be equitably subordinated if: (i) the creditor engaged in some type of inequitable conduct; and (ii) the misconduct resulted in injury to other creditors or conferred an unfair advantage on the creditor to be subordinated; and (iii) equitable subordination is not be inconsistent with the other provisions of the bankruptcy laws. \textit{See} \textit{Benjamin v. Diamond (In re Mobile Steel Co.)}, 563 F.2d 692 (5th Cir.1988). Although equitable subordination may be an appropriate remedy for creditor opportunism, it suffers from some of the flaws of communitarianism, in that its application is often unpredictable. It also provides no basis for an affirmative recovery, simply the reduction or elimination of the offender's claim. Most important, it appears that only bankruptcy courts have the power to impose this remedy, but there is no reason to believe that opportunistic controlling creditors would permit a firm to enter bankruptcy.

\textsuperscript{181} \textit{Id.} at 1356.

\textsuperscript{182} \textit{Id.} (citations omitted).

\textsuperscript{183} \textit{Id.} at 1356.

\textsuperscript{184} \textit{Id.}

\textsuperscript{185} \textit{Id.} This is obviously an exaggeration. In \textit{Khan v. Nate's}, the bankruptcy judge had approved the financing, and had jurisdiction to resolve disputes over it more or less contemporaneously.

\textsuperscript{186} \textit{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.").

\textsuperscript{187} \textit{Id.} at 1357 (citations omitted).
contract has been renegotiated."\textsuperscript{188} Apparently collapsing equity and good faith, Judge Easterbrook also reasoned that the bank's conduct was not in bad faith. "'Good faith'\textsuperscript{189}, he explained "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."\textsuperscript{189} Treating good faith as a "gap filler," he reasoned that "principles of good faith—such as the UCC's standard of honesty in fact" and "the reasonable expectations of the trade\textsuperscript{190}—would apply "[w]hen the contract is silent."\textsuperscript{190} Creditors are not, however, their borrower's fiduciaries: "they are not bound to treat [borrowers] with the same consideration reserved for their families."\textsuperscript{192} Thus, the bank won.

These early expressions of contractualism are problematic today. It may have been difficult to imagine creditors acting opportunistically in 1989 because, as Fischel believed, they would be liable for breach of contract or ruin their reputations. Perhaps there really was competition among lenders. Today, while there may be some competition among financial institutions, we have seen that changes in the marketplace offer abundant opportunities for opportunistic behavior by controlling creditors, from outright self-dealing to the misuse of private information in the derivatives market.

2. \textit{Blinkered Contractualism}

The key failure of contractualism is, in a sense, that it is the opposite of communitarianism. Where communitarianism opens the lens too wide, and may take in too much irrelevant information in order to decide whether creditors have overstepped the bounds, contractualism literally contracts the lens: Constrained by the language of the express agreement, courts force themselves to ignore context. While such steroidal expressions of the parole evidence rule might be appropriate in truly bilateral disputes over good faith, contractualism fails in the distress context because it ignores the reality that opportunism harms not only the other party to the contract, but the borrower's other stakeholders, as well.

Consider again the \textit{MarketXT} case, described in Part I.\textsuperscript{193} Recall that creditor Softbank held common and preferred stock of the debtor as well as (apparently secured) debt. It held two seats on the debtor's board of directors and controlled the board's ability to obtain a quorum.\textsuperscript{194} Recall, too, that Softbank apparently forced the debtor to sell a subsidiary to a Softbank affiliate for questionable consideration and effectively blocked the debtor's attempts to restructure. After the debtor went into bankruptcy, the debtor's trustee sued Softbank, arguing that Softbank was a controlling stakeholder that had and breached fiduciary duties to the debtor and that it had behaved inequitably. Softbank moved to

\textsuperscript{188} \textit{Id.} (citations omitted; emphasis in original).

\textsuperscript{189} \textit{Id.} at 1357

\textsuperscript{190} \textit{Id.}

\textsuperscript{191} \textit{Id.}

\textsuperscript{192} \textit{Id.}

\textsuperscript{193} In re MarketXT Holdings Corp., 361 B.R. 369, 387 (Bankr. S.D.N.Y. 2007).

\textsuperscript{194} \textit{Id.} at 387-88 (citing Complaint ¶¶ 20, 127-129, 134-135, 137, 153-155, 159-162, 168-194, 310)).
dismiss these claims for failure to state a claim.\footnote{195}{Id. Softbank apparently did not move to dismiss claims to avoid preferential or fraudulent transfers. \textit{Id.} at 384.}

Although the court denied the motion to dismiss the equitable subordination claims,\footnote{196}{\textit{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 . . . "). As discussed at note 180, equitable subordination might be a useful weapon against creditor opportunism, but for one problem: It appears to be a creature of bankruptcy courts. The problem this article confronts is behavior that may never be subject to bankruptcy court review because it occurs before bankruptcy, and controlling creditors keep the distressed firm out of bankruptcy. In any event, equitable subordination creates no basis for affirmative recovery, so is unlikely to provide a remedy for those harmed by opportunistic behavior.}\footnote{197}{\textit{Id.} at 390 (quoting Kahn v. Lynch Comm. Sys., Inc., 638 A.2d 1110, 1113-1114 (De. 1994)).} it granted the motions to dismiss the fiduciary duty claims because it refused to recognize the control that Softbank’s multiple positions gave it. Citing \textit{Kahn v. Lynch}, the bankruptcy court reasoned that “‘a shareholder owes a fiduciary duty only if it owns a majority interest or exercises control over the business affairs of the corporation.’”\footnote{198}{\textit{Id.} at 390-391.} Here, the court looked only at Softbank’s shareholdings—not its claims as a creditor—to assess its control. The court recognized that a shareholder might be in actual (de facto) control if it appointed a director who had the power to control a borrower, or otherwise had “close ties with” officers of the debtor.\footnote{199}{\textit{Id.}}

The court recognized that Softbank’s status as a creditor could alter the level of scrutiny that would be applied. The court acknowledged that “[t]here 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.”\footnote{200}{\textit{Id.}}

But, such a finding requires a “confluence of factors” that was not present here. Here, the bankruptcy court concluded, “the ‘confluence of factors’ relating to control and wrongdoing involved, for the most part, Softbank’s exercise of its rights as a lender, its refusal to give up those 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.”

[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. On the contrary, on the allegations of the Complaint, the Debtor came back to Softbank time and again to borrow

\footnote{195}{Id. Softbank apparently did not move to dismiss claims to avoid preferential or fraudulent transfers. \textit{Id.} at 384.}

\footnote{196}{\textit{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 . . . "). As discussed at note 180, equitable subordination might be a useful weapon against creditor opportunism, but for one problem: It appears to be a creature of bankruptcy courts. The problem this article confronts is behavior that may never be subject to bankruptcy court review because it occurs before bankruptcy, and controlling creditors keep the distressed firm out of bankruptcy. In any event, equitable subordination creates no basis for affirmative recovery, so is unlikely to provide a remedy for those harmed by opportunistic behavior.}

\footnote{197}{\textit{Id.} at 390 (quoting Kahn v. Lynch Comm. Sys., Inc., 638 A.2d 1110, 1113-1114 (De. 1994)).}

\footnote{198}{\textit{Id.} at 390-391.}


\footnote{200}{\textit{Id.}}
funds, with Softbank as a reluctant provider.  

This analysis does not wash. Softbank caused the debtor to behave irrationally by apparently forcing it accept illiquid, overvalued consideration (the E*Trade stock) at a moment when the company was desperate for cash. Because Softbank effectively controlled its board and its assets, MarketXT had no choice but to return to Softbank to borrow. While the loans may not have been “usurious” or “illegal”—but what of the threats of physical violence?—that has nothing to do with the standard in question: was Softbank in actual control?

The real problem with the MarketXT opinion lies in the disaggregation, and isolation, of the analysis of Softbank’s rights vis a vis the borrower. True, Softbank should not be liable as a control person solely for exercising its rights as a creditor—as some communitarian courts would have had it. But, “those actions alone,” in the words of Judge Gropper, were not taken in isolation. Softbank had positions at virtually every important point in the capital structure—debt and equity—and contractual control of the board, through its power to filibuster a quorum. The real confluence of factors—which the court ignored—was the fact that Softbank completely controlled the borrower’s ability to revive itself. For reasons that are best left to speculation, it chose to cause the borrower to sell its only valuable assets to an affiliate (E*Trade) for essentially valueless consideration. That is not what creditors do: that is what disloyal controlling shareholders do.

Viewing good faith in binary terms—communitarianism versus contractualism—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. The structure of debates about good faith are self-consciously conceptual, and thus antiseptic, devoid, in Patterson’s terms, of the “purposiveness” that should inform our understanding of institutionally vital terms. Moreover, neither approach is dominant. Some modern courts and juries have punished lenders who have defrauded their borrowers, committed torts, or were grossly negligent, just as others have declined to do so for conduct that

---

201 Id.

202 Id.


204 PATTERSON, supra note 164 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 can never be exhausted in any one of its instances, nor is any particular instance uniquely illustrative or paradigmatic.”).


206 Busy Bee, Inc. v. Wachovia Bank, N.A., 2006 WL 723487, Pa.Com.Pl., February 28, 2006 (No. 97 CV 5078.) (Holding that the borrower’s tort claims, including breach of fiduciary duty, were not precluded by the contractual relationship because the lender exercised substantial control over the borrower.)

207 In re Yellowstone Mountain Club, LLC, 2009 Bankr. LEXIS 2047, 25 (Bankr. D. Mt. 2009) (The court found the actions “so far overreaching and self-serving that they shocked the conscience of the Court.”)

C:\inetpub\wwwroot\results\215486-text.native.1282164148.doc
appears equally egregious.\(^{208}\)

Yet, the basic point—the one that has escaped courts and commentators alike—is that while the context in which creditors act has changed dramatically in the last 20 years, our doctrinal response has not. This new context—the modern distress investing market—means that the communitarian v. contractualist dichotomy does little work because it rests on a series of faulty structural assumptions about the nature of disputes about good faith.

III. THREE DIMENSIONS OF GOOD FAITH

Conventional approaches to controlling creditor opportunism fail because they have note kept pace with market changes. The key conceptual failure has been to view good faith in bilateral terms. In fact, if we think more carefully about the context in which distress investing occurs, the multilateral and institutional dimensions of good faith take on greater significance and offer more meaningful guidance about controlling creditor opportunism.

A. Bilateral Good Faith—Good Faith in Traditional Contract Doctrine—The Ontological Question

Good faith is the Zelig of private law.\(^{209}\) It appears, chameleon-like, in many different contexts. Academics disagree about everything having to do with good faith, including whether it even exists,\(^{210}\) or is an obligation distinct from fiduciary duty.\(^{211}\) Doctrinally, courts have long treated good faith as the antidote for bilateral opportunism.

\(^{208}\) Famm Steel, Inc. v. Sovereign Bank, 571 F.3d 93, 102 (1st Cir. 2009) (Court held that "the relationship between a lender and a borrower, without more, does not establish a fiduciary duty.").


\(^{210}\) Auer, supra note 203, 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; Robert S. Summers, “Good Faith” in General Contract Law and the Sales Provisions of the Uniform Commercial Code, 54 Va. L. Rev. 195 (1968); Robert S. Summers, The General Duty of Good Faith—Its Recognition and Conceptualization, 67 Cornell L. Rev. 810 (1982).

\(^{211}\) 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.

Frank H. Easterbrook & Daniel R. Fischel, Contract and Fiduciary Duty, 36 J.L. & Econ. 425, 438 (1993); Andrew S. Gold, On the Elimination of Fiduciary Duties: A Theory of Good Faith for Unincorporated Firms, 41 Wake Forest L. Rev. 123, 134 (2006). Others, however, have a different view. See, e.g., Claire Moore Dickerson, From Behind the Looking Glass: Good Faith, Fiduciary Duty & Permitted Harm, 22 Fla. St. U. L. Rev. 955, 993 (1995) ("[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 was born in confusion. Its modern progenitor, Kirk LaShelle, appeared to collapse good faith and fiduciary duty, and we have struggled with the distinction ever since. See discussion at note 146.
This means that one party cannot use the contract to “harm” the other party or use discretion in the contract to frustrate its purpose. Even Judge Easterbrook, in *Kham & Nates*, paid lip service to the idea that good faith checks opportunism. “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.”

The central scholarly debate about good faith is, in a sense, ontological: Does “good faith” exist? Do the words “good faith” import 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?

Robert Summers famously argued the latter. Restatement (Second) Section 205, he claimed, reflected an “excluder” analysis because, quoting reporter Robert Braucher, “‘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.”

Steven Burton took the former position—good faith has positive content—because it forbade opportunism. Burton argued that bad faith captured two essential ideas: (i) discretion to act within the contract, and (ii) the misuse of that discretion to recapture an

---

212 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 rights 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).

213 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)));

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

215 Id.


See id at 819 (quoting J Austin, SENSE AND SENSIBILIA 70-71 (G. Warnock ed. 1962)).

217 Id. at 820 (quoting and citing Restatement (Second) of Contracts § 205, Comments a, d, e). “Subterfuge and evasions violate the obligation of good faith in performance,” the Restatement comments indicate. 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.

RESTATEMENT (SECOND) OF CONTRACTS § 205, Comment [a].
opportunity foregone in the contract.\textsuperscript{218} 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.”\textsuperscript{219}

At first blush, these depictions of good faith—although conceptual antagonists—would all seem to proscribe the sorts of creditor opportunism we have seen. Surely, short sales “evade the spirit” of any direct rights a distress investor might hold against a firm. The kind of holding-out we increasingly see sounds like “slacking off” at minimum, like Judge Easterbrook’s imaginary “sulking star.”\textsuperscript{220} The way lenders like Softbank in the \textit{MarketXT} case use their “confluence” of rights certainly seems like an “abuse of discretion to define terms.”

![“Bilateral Good Faith” (Contract)](image)

\textit{Figure 4—good faith in simple contract (“K” = contract party)}

Why has this general notion of good faith not impeded creditor opportunism? The answer may be that it is too strong. These examples of bad faith do 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 (correctly) forego the “opportunity” to buy equity because they believe that the debt they purchase instead will convert to new and improved 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 it is essentially concerned with bilateral relationships: The tenant who rearranges his shop to avoid paying percentage rent to the landlord;\textsuperscript{221} the commodity buyer who locks in a low


\textsuperscript{219} Burton, \textit{Good Faith}, supra note 218, at 373.

\textsuperscript{220} Kham & Nate’s Shoes No. 2, Inc. v. First Bank of Whiting, 908 F.2d 1351, 1357 (7th Cir. 1990).

price and uses it to compete with his supplier when prices rise.\textsuperscript{222}Restructurings, by contrast, will almost always be multilateral, involving multiple contracts, parties, positions and types of rights. Perhaps the strength of good faith analysis has simply reflected the purity of the simplified, dual relationships contemplated by traditional contract doctrine.

B. \textit{Multilateral Good Faith—Good Faith in Corporate Governance—Rereading Credit Lyonnais}

Good faith is not, however, solely about bilateral relationships. It is also a bulwark against opportunism in the corporate governance context, where the central question about good faith is not ontological, but 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.

As a statutory matter, good faith clearly has a 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 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."\textsuperscript{223} Delaware’s General Corporation Law provides that protections such as exculpation and indemnification are available only to those who have acted in “good faith.”\textsuperscript{224}

Good faith was thus 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 \textit{Cede & Co. v. Technicolor, Inc.}\textsuperscript{225} that good faith enjoyed equal dignity with the duties of care and loyalty, that there were, in other words, three duties, not two. This announcement was followed by the \textit{Disney}\textsuperscript{226} and \textit{Stone}\textsuperscript{227} cases, which whipsawed back and forth, \textit{Disney} suggesting that corporate directors are bound by an independent duty of good faith, \textit{Stone} holding that good faith is nothing more than a species of loyalty, having no independent doctrinal stature in the world of corporate governance.

\begin{itemize}
\item \textsuperscript{222}New York Cent. Iron Works Co. v. United States Radiator Co., 174 N.Y. 331, 334, 66 N.E. 967, 968 (1903).
\item \textsuperscript{223}MODEL BUS. CORP. ACT § 8.30(a)-(b) (2008).
\item \textsuperscript{224}See, e.g., DEL. CODE ANN. tit. 8, §§ 102(b)(7), 141(e), 144, 145(a)-(b). See also Ryan v. Lyondell Chem. Co., 970 A.2d 235 (Del. 2009) (discussing good faith in connection with exculpation clause).
\item \textsuperscript{225}634 A.2d 345 (De. 1993). Earlier cases such as Perrine v. Pennroad Corp., seemed to assume that corporate actors owed the firm a duty of good faith. 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 \textit{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.”).
\item \textsuperscript{226}\textit{In re} The Walt Disney Co. Deriv. Lit, 907 A.2d 693 (Del. Ch. 2005); 906 A.2d 27 (Del. 2006).
\item \textsuperscript{227}Stone v. Ritter, 911 A.2d 362 (2006).
\end{itemize}
As with good faith in contract law, good faith in corporate law has been the subject of an enormous literature. But this literature rarely considers whether good faith might have a special meaning in the distress context.

Courts have considered the role that good faith plays in the governance of distressed firms, but the focus is largely on the behavior of directors. In the Gheewalla case, for example, the Delaware Supreme Court’s most recent pronouncement on the controversial question of directors’ duties to creditors, the Court reasoned that directors owed creditors of firms in the zone of distress no such 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.”

Gheewalla laid to rest concerns raised by the controversial Credit Lyonnais decision, which was often read to mean that directors of firms in the zone of distress owe fiduciaries duties to or for the benefit of corporate creditors. Yet, a stronger inference to draw from

---


229 See North American Catholic Programming Foundation, Inc. v. Gheewalla, 930 A.2d 92, 103 (Del. 2007). (“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.

230 Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc’ns Corp., No. 12150, 1991 Del. Ch. LEXIS 215, at *7-*8 (Del. Ch. Dec. 30, 1991). Those who argued that Credit Lyonnais created risk for corporate directors included 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,
Credit Lyonnais may be that controlling creditors—like all corporate stakeholders—have a duty to act in good faith when dealing with a firm in the zone of distress.

Credit Lyonnais arose out of the failed leveraged buyout (LBO) and bankruptcy of MGM, financed by Credit Lyonnais Bank Nederland (CLBN). As part of the strategy to have the 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. Despite the restructuring agreement, it appears that Parretti persisted in attempting to control MGM. 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, led by Alan Ladd. CLBN then asked the Delaware Chancery Court to confirm its appointments and enforce the restructuring agreement.

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 directors and refusing to sell certain assets. 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.” There was, according to Chancellor Allen, no basis for claiming the breach of any duty to Parretti as there was “persuasive evidence that the Ladd management group acted prudently with respect to these transactions from the point of view of MGM.”

---


232 See id. at *33 (discussing bank’s control under restructuring agreement). Although Parretti retained the right to appoint three of the five members of MGM’s board of directors, the board’s power was significantly diminished because the restructuring agreement also created an executive committee, which was controlled by the bank’s appointee. The executive committee was to have all of the powers and the duties permissible under the Delaware General Corporation Law and in most respects to act as the board of directors for MGM. Id. at *36 n.22.

233 See id. at *35-*70.

234 See id. at *70.

235 See id. at *3.

236 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.


238 Id. at *108.
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, ceded control to creditor CLBN under the restructuring agreement. However, Chancellor Allen went on to announce what appears to have been a new, and ill-defined, set of duties owed by 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.”

What did this mean? In an elaborate footnote, Chancellor Allen explained that Ladd and the creditor-appointed managers had no duty to act for Parretti, or any particular constituency, because they instead were to “conceive[e] of the corporation as a legal and economic entity.”

Most analysis of this opinion 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. Others have observed that the meaning of the opinion is, for a variety of reasons, indeterminate or “much ado about nothing.”

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 effectively control the borrower. What duty would that be? 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 promise. 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.

---

239 *Id.* at *108 (footnotes omitted). In using the term “residue risk bearer,” Chancellor Allen invoked the language and construct of priority, a subject treated in Part II.A. below. Strictly speaking, Chancellor Allen could not have treated CLBN (or any of MGM’s creditors) as such because the company was not yet insolvent. Being only in the “vicinity” of insolvency, the residual risk bearer on a standard theory of priority would be either junior unsecured creditors or Parretti (through his holding company, PCC). The indeterminacy implicit in the construction of this “zone” of insolvency is one of several frustrating features of *Credit Lyonnais*.

240 *Id.* “Such directors,” he explained, “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.”


243 *Credit Lyonnais*, 1991 Del. Ch. LEXIS 215 at *22 (emphasis supplied) (citations omitted). 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
Here, the absence of good faith was not an affirmative claim the bank asserted to recover money. Instead, it appears to have been the basis for a defense to Parretti’s complaint. Procedurally, this matters, because (as discussed below) it is not clear whether courts can or will treat good faith as a distinct cause of action for which the plaintiff can recover damages.

Nevertheless, this re-reading of Credit Lyonnais makes sense. Parretti was acting opportunistically—seeking extra-contractual benefits that harmed the other party (CLBN)—and the antidote for opportunism is good faith review. It is equally clear, if we take the facts of the case seriously, that it could just as easily have been about creditor control, since the creditors in that case did have actual control, through the workout agreement.

Credit Lyonnais offers three lessons about the role that good faith can play in policing creditor opportunism. First, cases involving claims of creditor opportunism are, in many cases, problems of corporate governance. The governance of firms in distress will, however, usually be multilateral problems: Creditors, shareholders, directors, officers and others all jockey for control of the corporation. The multilateral nature of these problems, among other things, justifies (and perhaps demands) that courts such as the Delaware Chancery Court treat them as problems of equity, not traditional contract doctrine. But, Credit Lyonnais teaches that opportunism can be as problematic in the multilateral context as in the traditional contract dimension. The standard by which we should determine whether corporate actors in the distress context are acting opportunistically will involve principles of good faith, not fiduciary review.

By parity of reasoning, this means that Credit Lyonnais is, in part, a statement about the role of the corporation as an entity. To the extent that the bank-appointed directors owed duties to anyone, it was to the corporation, and not to Parretti, per se. Corporate good faith expands the universe of persons (or entities) protected by this baseline obligation. It would, as Chancellor Allen explained elsewhere in Credit Lyonnais, require:

directors who are 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.

Second, unlike fiduciary review, good faith does not require parties to a workout to act selflessly, although extreme self-seeking may be evidence of bad faith. Rather, good faith constrains opportunism. “Generally speaking,” Chancellor Allen explained—

---

244 See Lipson, Directors’ Duties, supra note 241 at 1218. (discussing “entity maximization” view of Credit Lyonnais).

245 Id.
contracting parties are, to a large extent, entitled to act selfishly to promote their own interests under the contract. While in a relational contract it may be short-sighted and bad business to do so, they generally are entitled to push their claims of entitlement under a contract in an attempt to maximize their self-interest. But while contracting parties are not fiduciaries for each other, there are outer limits to the self-seeking actions they may take under a contract.\textsuperscript{246}

This stands in contrast to what appears to be a growing consensus about the substance of good faith in corporate law, which is that it is a species of the duty of loyalty. Thus, the \textit{Stone} court explained, “The failure to act in good faith may result in liability because the requirement to act in good faith “is a subsidiary element[,]” i.e., a condition, “of the fundamental duty of loyalty.” It follows that because a showing of bad faith conduct, in the sense described in \textit{Disney} and \textit{Caremark}, is essential to establish director oversight liability, the fiduciary duty violated by that conduct is the duty of loyalty.”\textsuperscript{247}

Third, \textit{Credit Lyonnais} and \textit{Gheewalla} suggest that good faith may be an independent basis for reviewing distress investor conduct in workouts. While good faith was asserted as a defense in \textit{Credit Lyonnais}, the procedural posture is not the important point. What is important is that Chancellor Allen’s real contribution was to define the standard of care in the workout context as “good faith”—and not as the more traditional fiduciary duties. While there are arguments (described below) that good faith should have no independent status as a cause of action, the multilateral view of good faith in the distress context suggests otherwise.

\textbf{C. Institutional Good Faith—Good Faith Bankruptcy Filings}

A third dimension of good faith involves public institutions, such as 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.

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.”\textsuperscript{248} A bankruptcy court can confirm a reorganization plan only if, among other things, proposed in “good faith.”\textsuperscript{249} Although not stated in the statute, bankruptcy courts usually require that a Chapter 11 case be commenced in “good faith.”\textsuperscript{250}

\textsuperscript{246} \textit{Credit Lyonnais}, 1991 Del. Ch. LEXIS 215 at 23. Note the Chancellor Allen used the rhetoric of bilateral good faith. This is not surprising, but does not mean that principles of bilateral good faith necessarily transfer entirely to 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.

\textsuperscript{247} \textit{Stone}, 911 A.2d at 369-37 (quoting Guttman v. Huang, 823 A.2d 492, 506 n. 34 (Del.Ch.2003)). \textit{See also Lyondell Chem.}, 970 A.2d 235.

\textsuperscript{248} 11 U.S.C. § 363(m) (“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 . . . .”).

\textsuperscript{249} 11 U.S.C. § 1129(a)(3)(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.”).

\textsuperscript{250} 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). 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
The Bankruptcy Code does not define good faith, and it is not clear that the term has (or should have) the same meaning across bankruptcy contexts. Yet, the good faith filing requirement appears chiefly to be an attempt to patrol the “borderline between fulfillment and perversion[ and] . . . [to] accomplishing the objectives of rehabilitation and reorganization,” while discouraging “the use of [the Bankruptcy Code] to destroy and undermine the legitimate rights and interests of those [whom the code] intended to benefit[.]”

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. Courts have been concerned with debtors who file bankruptcy in an attempt to gain an advantage in litigation strategies, or to buy themselves time to get out of foreclosure proceedings. Important factors in assessing whether a petition has been filed in “bad faith,” include whether there is a “valid reorganizational purpose,” or evidence of “subjective bad faith” practices. Among other things, bad faith may be shown if the debtor is subject to “new debtor syndrome”; there is no realistic possibility of reorganization; or the reorganization is really a two-party dispute.

good faith in the commencement of the case as a basis for dismissal. See e.g. SGL Carbon Corp., 200 F.3d 154 (3d Cir. 1999); In re Little Creek Dev. Co., 779 F.2d 1068 (5th Cir. 1986).


252 See, In re Greenwood Supply Co., 295 B.R. 787, 793 (Bankr. S.D.C. 2002); see also, In re Miller, 886 F.2d at 701 (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”).

253 See e.g. SGL Carbon Corp., 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).

254 See e.g. In re Phoenix Piccadilly, Ltd., 849 F.2d at 1395.

255 That is, that the corporation filing for Chapter 11 relief is objectively able to be able to reorganize and continue its operation. This is also referred to as “objective futility,” and usually involves a question as to whether reorganization is truly a necessity for the company at the time of filing, or a realistic possibility. See In re Marsch, 36 F.3d at 828; Miller, 709 F.2d at 754 (there must be an obvious relation between the petition in question and the objective of the bankruptcy code to provide equitable relief to a troubled debtor (quoting In re Coastal Cable T.V., Inc., 709 F.2d 762, 765 (1st Cir. 1983))); See also In re Greenwood Supply Co., 295 B.R. at 787; In re Liberate Technologies, 314 B.R. 206 (Bankr. N.D. Cal. 2004).

256 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 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.C. 2008) (citing In re Greenwood Supply Co., 295 B.R. at 787); see also Miller, 709 F.2d at 700-01; cf: In re Little Creek, 779 F.2d at 1072 (“good faith depends largely upon the bankruptcy court’s on-the-spot evaluation of the debtor’s financial condition, motives, and the local financial realities”).

257 Where “a one-asset entity has been created or revitalized on the eve of foreclosure to isolate the insolvent property and its creditors[.]” See Little Creek, 779 F.2d at 1073.

258 See Harmony Holdings, 393 B.R. at 418 (citing In re Greenwood Supply Co., 295 B.R. at 787). These factors have been enumerated over time, and have been compiled together from various courts. Compare Little Creek, 779 F.2d at 1073 (listing several of the Harmony factors), and 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. 825 F.2d 296), with Little Creek, 779 F.2d at 1073. See generally COLLIER ON
Bankruptcy courts thus use “good faith” as a way to preserve their integrity, and the integrity of the bankruptcy process. 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.” A case that offends this policy goal lacks institutional good faith, and should be dismissed.

Figure 6: Good faith and institutional integrity

The point here is not to suggest that prebankruptcy behavior should be governed by the rules and standards of the bankruptcy process. The whole point of distress investing is often to keep debtors out of bankruptcy, for good or for ill. While bankruptcy courts may not have jurisdiction over distress investors—because a case is never commenced—the 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.

IV. NEW WORK OF GOOD FAITH: CONTROLLING CREDITOR OPPORTUNISM

Thus far, we have seen that creditors can behave opportunistically in the zone of distress, and that good faith has three different dimensions which explain the limited work good faith has thus far done in policing creditor opportunism. The key mistake courts make...

BANKRUPTCY (MATTHEW BENDER & CO., Inc., 2010) (discussing several specific circumstances where “good faith” has found to be lacking).

259 Little Creek, 779 F.2d 1068, 1072 (5th Cir.1986). 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.

when asked to solve problems of creditor opportu

nism is to view them as problems of bilateral good faith, when in fact they are (also) problems of multilateral and institutional good faith. This part explains substantive and procedural adjustments to good faith courts should make when presented with problems of creditor opportu

nism.

A. Substantive Good Faith

Although it is a mistake to view creditor opportu

nism as a problem of bilateral good faith, traditional contract doctrine offers several concrete lessons about how good faith has constrained opportunism that appear relevant to current distress investing.

1. Good Faith and Disclosure

Good faith requires some disclosure. In *Market Street Associates v. Frey*, for example, Judge Posner famously concluded that good faith required disclosure of important information to avoid opportunism.\(^{261}\)

\[\text{It 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.}\(^{262}\)

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, we have 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 5% of a firm’s debt—when you in fact hold less or none—might be bad faith.

2. Good Faith and Choice

An important body of scholarship considers the role that good faith plays in contract modification.\(^{263}\) 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 on grounds of want of

\(^{261}\) 941 F.2d 588, 595 (7th Cir. 1991).

\(^{262}\) Id. at 594 (citing Burton, supra note 218, at 393) & 596.

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. The pre-existing duty rule was, in the words of Professor Hillman, “both too broad and too narrow,” often producing the “wrong result.”

Professor 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.” According to Professor 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.

Good faith in contract modifications, the court in the Roth Steel case explained, prohibits changes produced by “extortion or overreaching.”

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.

3. **Good Faith and the “Community of Interests”**

Good faith requires those involved in a workout to consider the interests of all those affected by the workout. In part, this reflects the multilateral character of good faith in corporate distress context. Thus, Chancellor Allen observed in Credit Lyonnais, the directors of MGM—the distressed firm—“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.”

If, as we have seen, creditors have the actual power to choose directors, or to materially influence their decisions, it is not clear why they should be exempt from this reasoning. Like the directors and managers they can appoint, they too should consider the larger community of interests affected by their decisions.

---

264 See Hillman, Restatement Modifications, supra note 263, 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.”)(citations omitted).

265 Id. at 685.

266 Id at 682.

267 Id. at 683.


269 Credit Lyonnais 1991 Del. Ch. LEXIS 215 at *134.
We can take this one step further, and recognize that good faith also has an institutional aspect. Although workouts are largely private affairs, they are different from other contract negotiations in at least one fundamental respect: they occur in the shadow of bankruptcy. Thus, as the good faith filing cases suggest, the doctrine requires distress investors to act with some understanding of the effect their behavior will have on the public institutions—in particular bankruptcy courts—likely to have to clean up after them. Workouts designed to use the bankruptcy process merely to bless a deal that benefits certain investors at the expense of the debtor and its other stakeholders may not be filed in good faith.

B. **Procedural Good Faith**

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 the communitarian era suggest that courts have had good reason to limit the use of good faith review in debtor-creditor context. To assure that good faith review is, and remains, responsive to changing market conditions, it is equally important to understand that good faith in this context is a determination that can only be 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, that context was the merchant jury.

Llewellyn intended merchant juries to clarify fuzzy common law standards such as “commercial reasonableness” — as distinguished from noncommercial disputes that could be resolved by a traditional jury according to a general standard of reasonableness. See also, Imad D. Abyad, “Commercial Reasonableness in Karl Llewellyn’s Uniform Commercial Code Jurisprudence,” 83 Va. L. Rev. 429, 436 (1997).

Llewellyn understood the commercial community’s “special need for informed judgment and the lack of mercantile knowledge on the part of the judges and lay juries” and considered merchant juries to be an effective mechanism for the resolution of disputes based on mercantile facts. For Llewellyn, therefore, process was not so much about rules that would resolve disputes as who, institutionally speaking, would make those decisions.

---


271 PATTERSON, supra note 164, 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 (emphasis in Patterson’s excerpt)).


273 See PATTERSON, supra note 164, at 41 (“it is not the process (procedure) that is important but the decision-maker The persons making decisions about commercial reasonable conduct ought to be the people who participate in the practice that is the object of the judgment.”).
Although Llewellyn’s rhetoric survived—in particular in the use of open-ended terms such as “good faith”—the procedural element did not. The idea of an expert merchant jury seemingly died before the U.C.C. was promulgated. Yet, at least in the distress context, it may be possible—and appropriate—to recapture Llewellyn’s procedural aspiration, through the use of courts with special jurisdiction and expertise. We may not have merchant juries, but we can have “merchantable” courts.

Prior to (or in lieu of) bankruptcy, 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,” there is little doubt that its bench contains the most sophisticated business jurists in the nation. Given the centrality of corporate governance law to Delaware’s economic and social stature, its courts should be eager to expand upon the real meaning of 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.

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 find good faith than lay juries. It is true that judges in courts of original jurisdiction—United States District Courts—are not likely familiar with the norms and practices of specialized commercial enterprises (e.g., private investment funds). 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. 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 (criticized above) in the MarketXT case was authored by Judge Gropper, of the Southern District of New York.

274 Id at 42. (Patterson explains that the merchant jury “did not survive past the Second Revised Uniform Sales Act (1941)).
275 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).
276 There is also evidence that the court may be looking for work. See John Armour, Bernard Black & Brian Cheffins, Is Delaware Losing Its Cases?, (March 2010 draft), available at http://ssrn.com/abstract=1578404.
The key question 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 non-equity matters by the Seventh Amendment.\(^{281}\) Recall that the problematic lender liability cases of the 1980s were decided by lay juries, not expert judges.\(^{282}\) 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.\(^{283}\)

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.\(^{284}\) 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, etc.\(^{285}\) There are a variety of reasons courts have made this determination in the distress context, but one must 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 realistic expertise of a lay jury. The equity receiverships of the 19\(^{th}\) and early 20\(^{th}\) 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 shareholders of large, troubled firms such as railroads.\(^{286}\)

\(^{281}\) 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 (“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.”).

\(^{282}\) See discussion in Part II.


\(^{284}\) 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 Chauffers, 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).


\(^{286}\) See Lipson, supra note 6 (discussing railroad receiverships).
Thus, claims of creditor opportunism in the distress context should be treated as problems of equity. This removes them from the province of juries which, during the communitarian era, 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. Some may object that creditor opportunism claims should be subjected to the community norms of lay juries. But this creates serious logistical problems—whose community are we talking about?—and ignores the sophisticated, multilateral character of these problems. If Llewellyn thought experts were the ones to handle questions of good faith generally, surely that should be true in the volatile and complex world of distress investing.

V. 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 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 objection to the vision of good faith described above is that it suggests good faith should be an independent cause of action, distinct from other claims arising at, e.g., contract, tort, etc. This objection is important because, as the ontological debates about good faith in classical contract suggest, it is not clear that good faith should have any independent content at all. Even if, as Professors Burton might argue, it should, that does not necessarily mean it creates a free-standing cause of action on which allegedly aggrieved parties can sue.

Consistent with the view that good faith is no more than a “gap filler,” conventional wisdom teaches that good faith does not stand apart from the contract as a basis for legal action. 287 The implied covenant of good faith does not allow for a claim “separate and distinct” of a breach of contract claim. 288 Thus, conduct falling outside the scope of “good faith and fair dealing”, without more, cannot in conventional 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.”

This is an important objection because, in many cases, there may not be an explicit contract to which the debtor is a party, the breach of which creates the “host” doctrine that would house the good faith claim. For example, debtors are not usually parties to short sale contracts, such as credit default swaps. The issuer of shares is not likely party to an equity short sale. 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.

There are several responses. First, although they were not entirely clear about it, the lender liability cases of the communitarian era appeared to treat good faith as an independent and affirmative cause of action. A lender found liable for exercising rights in bad faith cannot be said to have breached the contract in a conventional sense, such that the duty of good faith merely tags along with the other “real” claims of breach. It is possible, of course, that the combination of other claims—fraud, breach of fiduciary duty—might have coalesced to tip the balance in some way. But, the key to cases like K.M.C. appears to have been a breach of the duty of good faith; the problem with those cases was, in part, with the procedural choice to give the good faith determination to a lay jury rather than an expert.

Second, there is a certain circularity to the objection. In many cases, the problem is not that there is some independent claim of breach. Rather, the lack of good faith in the enforcement of the contract is, itself, the breach. But if that is true, it simply means that a court has concluded that it cannot enforce a contract that abets opportunism. Whether it does because there was an independent breach, or the bad faith was the breach, takes on an angels-on-the-head-of-pins quality.

Third, and perhaps most important, this objection seems to be a feature of bilateral good faith, not the multilateral and institutional dimensions of good faith, which appear to have greater traction in addressing problems of creditor opportunism. The Delaware Chancery Court’s heavy reliance on good faith as the standard of review in cases involving distress suggests that it may view good faith as an independent cause of action in that context. Certainly, bankruptcy courts that dismiss cases for want of good faith do not look to see whether there are other “primary” grounds for doing so. In short, if we see distress investing as involving problems of multilateral and institutional good faith, then the relaxation of pleading requirements from those contexts should apply here, too.

2. Remedial Redundancy

A second, and related, objection is that good faith in this context will largely overlap with existing causes of action that could, if properly pled, better address creditor opportunism.

Consider, first, the view that fiduciary duty might be a more appropriate way to deal
with such behavior. It is, for example, tempting to think that fiduciary review would be for
the reasons that Stout and Anabtawi have argued activists shareholders should be subject to
fiduciary review: if someone is in actual control, and they use their control in a disloyal way,
they should be liable for breach of fiduciary duty. Whether they are creditors of a
distressed firm or shareholders is, in reality, immaterial: It is the fact of control that should
result in the imposition of a fiduciary duty.

Professor Harner has taken a somewhat similar tack, albeit one she claims does not
technically involve fiduciary review. She has argued that a board should lose business
judgment protection for having engaged in a transaction with a stakeholder. Harner argues
that creditors should not be viewed as fiduciaries because they are "outsiders" to the firm,
whereas shareholders and directors are “insiders.” Harner argues
that creditors should not be viewed as fiduciaries because they are "outsiders" to the firm,
whereas shareholders and directors are “insiders.” She claims, "are commonly 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.”

Harner is right, but for the wrong reasons. Given what we know about the ability
creditors have to obtain and exploit confidential information in workouts, creditors could
just as easily be “insiders” as widely dispersed public shareholders. Moreover, private
investors appear often to hold debt and shares: Are they both insiders and outsiders on this
analysis? 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.”

The real reason that creditors qua creditors are not fiduciaries for their borrowers is
because of the inherently oppositional nature of the debtor-creditor relationship. Fiduciary
relationships are largely about power disparities—about trust, broadly construed.
Fiduciaries may end up in actual conflict with their beneficiaries—most corporate
governance disputes take that form—but the relationship is predicated on a very different
level of adversity. Debtors and creditors may get along—and creditors may actually have all
sorts of control of the borrowers—but those facts do not change the underlying economic
and social reality that lending relationships function very differently than do fiduciary
relationships. In the first instance, debtors do not repose trust in their lenders in ways that
beneficiaries—even corporations and shareholders—trust directors and officers.

This is especially true of workouts. While creditors may exercise control rights, and
may vie with one another in a fight to control the debtor’s fate, it is unrealistic to expect that
they will act as fiduciaries for one another, or the distressed firm. If context is what matters,
then the aggressive tactics of even most the legitimate workout has little in common with a
fiduciary relationship.

291 See Stout & Anabtawi, supra note 30, at 1265.
292 Id. at 545 (rejecting fiduciary review as "not a good fit.").
293 See Harner, supra note 17, at 104.
294 Id. at 543.
295 Id.
296 Id.
297 See Lipson, Directors Duties, supra note 241.

C:\inetpub\wwwroot\results\215486-text.native.1282164148.doc
Similarly, other claims may well arise in connection with claims of creditor opportunism, suggesting that there is no need for a new, independent duty of good faith. For example, as discussed above, the doctrine of equitable subordination has often been used in cases of lender over-reaching, including in the MarketXT case, discussed above. The problem, as noted above, is that equitable subordination appears to be available only if a bankruptcy case is actually commenced. Because the opportunism that concerns us occurs before bankruptcy—and a bankruptcy may never occur—there is no reason to think this doctrine will have much effect. In any event, it creates no basis for an affirmative recovery, only the reduction or elimination of the offender's claim.

Fraudulent conveyance may be another cause of action that arises in connection with claims of creditor opportunism, and which might suggest there is no need for an independent duty of good faith. Fraudulent conveyance doctrine voids a transaction by a debtor that conveys assets, or incurs claims, while insolvent for less than fair value. For better or for worse, however, the Supreme Court has held that “procedurally regular” foreclosures can almost never be treated as fraudulent conveyances, even if they have that economic effect.

The problem here is that much of what appears to be opportunistic either involves no transfers by the debtors, or could easily be structured to avoid the reach of the fraudulent conveyance laws. As discussed above, short-sale transactions do not involve transfers by a debtor, so could not be challenged under these laws. Creditors that cause debtors to engage in conflict transactions—as in MarketXT and, apparently, CIT—might be causing a fraudulent transfer. If, however, the creditor holds a secured claim and the transfer is made in connection with the enforcement of that claim, it would appear immune from challenge, if it was “procedurally regular.”

In short, there are plenty of other doctrines that could be brought to bear on problems of creditor opportunism. But none respond quite as well as good faith, once we recognize its multi-dimensional character, and constrain its application procedurally.

B. Further Inquiry

Just because good faith may be the best doctrinal option courts have does not mean it creates no questions. This paper has largely identified a new way to conceive of an old doctrine, in order to address fundamental changes in the market place. Good faith has a long history of helping courts adapt to changing environments, and there is no reason to think current market changes are somehow different. However, 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 law suit gets to speak for the 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 (3) the relief requested redresses the plaintiff's injury. The multilateral nature of distress led Congress to enact the Bankruptcy Code, which gives specialized courts special jurisdiction and some clarity on standing. 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 (e.g., 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 refinement.

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? They do so in Delaware, notwithstanding the equitable nature of corporate governance disputes. Not all courts may be comfortable doing so. If not, what specific or other equitable remedies would be appropriate? Disgorgement on an unjust enrichment theory? Subordination?

Similarly, even if one permits the award of money damages, what should the measure be? In contract, it is traditionally “expectation.” But here, we are not dealing with traditional contract doctrine or bilateral contractual relationships. Should some other measure apply? If so, what would form the principled basis for the money award?

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.

Conclusion

Problems of opportunism are problems of good faith. The fact that opportunists may be creditors of distressed firms should not change that. What creditor opportunism does require, however, is new thinking about the doctrinal work that good faith can do.

The financial crisis of 2008 has thrown into play much of our thinking about extra-contractual obligations. Judge Posner surprised many when he argued in a strongly-worded 2008 dissent that the economic foundations of contractualism are now “ripe for

examination.” The Delaware Supreme Court recently surprised many by holding that corporate officers have the same fiduciary duties as corporate directors. Judge Easterbrook notwithstanding, it may be time to recognize that not all ex post determinations of bad faith are forms of “mulcting,” that opportunism warrants more than “gap filling”.

This paper advances that project. Courts should recognize that problems of creditor opportunism are rarely problems of bilateral good faith. Instead, questions of good faith in distress investing will involve many parties, public institutions, or both. Appreciating these other dimensions of good faith will enable courts to identify substantive indicia of bad faith—undisclosed material conflicts, “unreasonable” holding out—and construct a more disciplined and responsive procedural setting in which to make those determinations.

This article has shown that, notwithstanding the omissions of Dodd-Frank, we have the tools to control creditor opportunism. We need only recognize how to use them.


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