Equity Unbound: A Meaningful Test for Equitable Subordination

Jay L. Koh†

I. INTRODUCTION

In the 1939 case of Pepper v. Litton,1 the U.S. Supreme Court announced that equitable subordination, the power of the bankruptcy court to change the order in which creditors will be paid by a bankrupt debtor, must be used “to the end that fraud will not prevail, that substance will not give way to form, [and] that technical considerations will not prevent substantial justice from being done.”2 Exercised by early courts as an application of their equity powers in bankruptcy, equitable subordination was aimed at piercing formal and legal subterfuges to ensure that a bankruptcy estate was properly distributed among similarly situated creditors. Courts flexibly examined the conduct of creditors, originally focusing on insiders, to prevent superficially legal behavior from creating unfair or inequitable advantages in priority. In 1978, Congress formally recognized the importance of equitable subordination by codifying a provision for it at section 510(c) of the Bankruptcy Code.3 Congress specifically refrained, however, from defining or limiting the courts’ application or development of the doctrine, leaving the shaping of this remedy to the courts themselves.

Historically, bankruptcy courts have restricted the exercise of equitable subordination to situations in which creditors had engaged in “inequitable conduct.”4 Unfortunately, however, the courts have been unable to define inequitable conduct in any meaningful way.5


1. 308 U.S. 295 (1939).
2. Id. at 305.
5. See id. at 839 (“[T]hese definitions [of inequitable conduct] provide little guidance; they describe a standard that is rarely if ever met.”); 2 DAVID G. EPSTEIN ET AL., BANKRUPTCY, § 6-93, at 256 (1992) (characterizing inequitable conduct as “very slippery concept with little predictive value”).

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In response to concerns about the inconsistent or excessive application of this power to the detriment of creditors ex post as well as debtors ex ante, a number of courts in recent years have turned to a bright-line rule that I will call the "formalist contract-rights presumption": Creditor conduct in accordance with specific rights explicitly stated in a written contract is presumptively not inequitable. This rule resurrects the language and doctrine of formalist contract to define a zone of conduct that courts will presume not inequitable. This Note argues that this bright-line rule should be reformulated or rejected as inconsistent with contract and bankruptcy law, unjustified, and fundamentally misguided.

First, the presumption relies on an excessively limited concept of contract rights and is thus inconsistent with important strands of modern contract law. This inconsistency itself makes the presumption legally unjustified, undermines the goals of equitable subordination, and generates perverse and confusing incentives for creditors. Furthermore, the presumption's exclusive focus on formal contract provisions is also inconsistent with bankruptcy preference law. This inconsistency, too, creates conflicting incentives and undermines the goals of preference law. Most importantly, the presumption subverts the fundamental purpose of equitable subordination, which is to provide flexible and equitable remedies for technically valid but equitably unacceptable behavior. The presumption undermines the need for clear justification, accuracy, and flexibility in guiding the application of equitable subordination. Moreover, the presumption undermines the objectives of efficiency and fairness espoused by its advocates.

This Note, therefore, suggests that the formalist contract-rights presumption be amended to incorporate an inquiry into the course of dealings between creditor and debtor and an explicit standard for identifying the acceptable boundaries of creditor conduct.

Part II of this Note will briefly outline the development of the formalist contract-rights presumption in equitable subordination. Part III will demonstrate that the presumption is fundamentally inconsistent with modern contract and bankruptcy preference law. Accordingly, this Part will argue that the presumption is thus both legally unjustified and undesirable. Part IV will argue that the presumption subverts the fundamental purpose of the power of equitable subordination by placing inconsistent and excessively formalistic limits on what must remain a flexible equity power. Part IV will also evaluate specific arguments in favor of the presumption on the basis of its purported efficiency, fairness, and precision, ultimately concluding that enforcing the presumption will in the end undermine rather than promote these objectives. Part IV will then propose a new and more accurate approach for identifying inequitable conduct.
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Part V will conclude.

II. THE RISE OF THE FORMALIST CONTRACT-RIGHTS PRESUMPTION

In their struggle to define the limits of equitable subordination, courts have created the bright-line rule that a creditor's conduct within the written terms of a contract will be presumed not inequitable. This Part describes the power of equitable subordination and its requirement of inequitable conduct. It then traces the courts' development of the formalist contract-rights presumption, which considers only the limits of a contract's express terms to determine whether a creditor has behaved inequitably.

A. The Requirement of Inequitable Conduct

Equitable subordination is a dynamic concept. In a trilogy of early cases, bankruptcy courts developed the power to change the priority of payment of claims and interests in bankruptcy. Known as equitable subordination, this power was exercised by courts originally to prevent insiders from using legal mechanisms to gain priority in the order of payment of their claims against a bankrupt. Courts retained this power as an equitable mechanism for preventing legal formalism from subverting the equitable objective of equality of distribution in bankruptcy. As the Supreme Court's broadly worded proposition in Pepper v. Litton demonstrates, equitable subordination was designed to provide courts with the ultimate flexibility to ensure fairness in the administration of a bankruptcy estate.

Few formal guidelines exist for the exercise of equitable subordination. Codified in section 510(c) of the Bankruptcy Code, this power is subject only to the bankruptcy courts' understanding of the "principles of equitable subordination." The Code never defines these principles,
however; in fact, legislative history indicates that Congress intended the interpretation of section 510(c) to "follow existing case law and le[ft] to the courts development of th[e] principle [of equitable subordination]."

Over time, courts have generally recognized a requirement of inequitable conduct as a prerequisite to exercising equitable subordination. The seminal case of In re Mobile Steel Co. provides the best expression of this formulation. In Mobile Steel, the Fifth Circuit held that a creditor’s claims would be equitably subordinated only if three conditions were met: (1) The claimant had engaged in some kind of inequitable conduct; (2) the misconduct had resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant; and (3) equitable subordination of the claim was not inconsistent with the provisions of the Bankruptcy Code.

A consistent definition of inequitable conduct, central to the meaning of Mobile Steel, has continued to elude the courts. Courts have identified three general categories of inequitable conduct: "(1) fraud, illegality, or breach of fiduciary duties; (2) undercapitalization; and (3) a claimant’s use of the debtor as a mere instrumentality or alter ego." These categories encompass a large number of equitable subordination cases and identify general areas of conduct for a court to examine; courts, however, do not consider these categories exhaustive, and thus they do not provide a court with concrete rules for determining when marginal behavior is inequitable. In particular, courts have little guidance in determining whether creditors are exerting too much control or merely enforcing their contract rights zealously.

poses 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... [or] order that any lien securing such a subordinated claim be transferred to the estate.


13. Courts have recently begun to carve out some specific exceptions to this rule; these exceptions, however, have been limited. See Scott M. Browning, Note, No Fault Equitable Subordination: Reassuring Investors That Only Government Penalty Claims Are at Risk, 34 WM. & MARY L. REV. 487, 504-21 (1993) (discussing rise of “no-fault” equitable subordination of tax penalty claims); Peter A. Christou, Note, Federal Tax Claims in Bankruptcy and the Doctrine of Equitable Subordination: United States v. Noland and United States v. Reorganized CF & I Fabricators of Utah, Inc., 50 TAX LAW. 237, 246 (1996) (discussing continued ambiguity over whether creditor misconduct is required under doctrine of equitable subordination).


15. See id. at 700.


17. See Andrew DeNatale & Prudence B. Abram, The Doctrine of Equitable Subordination as Applied to Nonmanagement Creditors, 40 BUS. LAW. 417, 430-47 (1985) (discussing fraud or misrepresentation, domination and control, and other inequitable conduct as categories of creditor misconduct that have caused courts to apply equitable subordination).


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As a result of this ambiguity, nonmanagement creditors in particular have become quite concerned about the scope of the power of equitable subordination. Commentators DeNatale and Abram note that "[t]he most commonly feared equitable subordination cases arise in connection with allegations of domination and control on the part of a nonmanagement creditor, generally a financial institution." Practitioners have argued strongly in favor of better understood rules in related contexts. Courts wrestling with the concept of equitable subordination have similarly noted concerns generated by the uncertainties involved.

A number of courts have reacted to these concerns about ambiguity by creating what I shall call the formalist contract-rights presumption. Beginning with the surprising self-reversal of the Fifth Circuit in the case of the bankruptcy of the Clark Pipe & Supply Company in 1989-90, courts have begun to hold that creditor conduct within the express written terms of a contract is presumptively not inequitable.

B. The Development of the Formalist Contract-rights Presumption

1. Highlighting the Presumption: Clark Pipe I & II

In In re Clark Pipe & Supply Co. (Clark Pipe I), a Fifth Circuit panel engaged in a fact-based, relational inquiry into the conduct of a nonmanagement creditor, Associates Commercial Corp. ("Associates"). The court ultimately determined that Associates's exertion of near complete control over the debtor's operations in a manner detrimental to the debtor's unsecured creditors constituted inequitable conduct. The court first examined Associates's conduct towards and relationship to the debtor, Clark Pipe. It found that Associates effectively controlled Clark Pipe's operations by manipulating its cash flow and that Associates deliberately used this power to induce Clark Pipe to convert its inventory to pay Associates's claims at the expense of other creditors. After detailing this level of control, the Clark Pipe I court concluded that the facts were similar enough to other patterns of inequitable conduct to warrant equi-

19. See DeNatale & Abram, supra note 17, at 432.
20. See id. at 447 (discussing concern of practitioners and lenders at growing numbers of equitable subordination cases).
21. See Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting (Kham II), 908 F.2d 1351, 1356 (7th Cir. 1990) (expressing concern that equitable subordination and good faith and fair dealings leaves interpretation of duties of parties to contracts "in the discretion of a bankruptcy judge assessing the situation years later").
22. 870 F.2d 1022 (5th Cir. 1989).
23. See id. at 1030-31.
24. See id. at 1024, 1029.
table subordination. Based on this factual inquiry, the court affirmed the bankruptcy court’s conclusion that Associates had acted inequitably, upholding the bankruptcy and district courts’ equitable subordination of Associates’s claims.

In January 1990, the Fifth Circuit withdrew its previous decision in Clark Pipe I and substituted a new opinion, In re Clark Pipe & Supply Co. (Clark Pipe II), that substantially reversed its earlier holding. In contrast to Clark Pipe I, the court based its reversal on the proposition that a creditor’s conduct pursuant to rights explicitly stated in a written agreement is presumptively not inequitable. Because Associates exerted its control under the rights outlined in its loan agreement with Clark, the court on reexamination chose not to characterize this level of control as “total” or involving “inequitable conduct”:

In our prior opinion, we agreed with the district court and the bankruptcy court that, as a practical matter, Associates asserted total control over Clark’s liquidation, and that it used its control in a manner detrimental to the unsecured creditors. Upon reconsideration, we have concluded that we cannot say that the sort of control Associates asserted over Clark’s financial affairs rises to the level of unconscionable conduct necessary to justify the application of the doctrine of equitable subordination. We have reached our revised conclusion primarily because we cannot escape the salient fact that, pursuant to its loan agreement with Clark, Associates had the right to reduce funding, just as it did, as Clark’s sales slowed.

The court relied primarily on its finding that all of Associates’s activities were within the rights established by the loan agreements:

In our original opinion, we failed to focus sufficiently on the loan agreement, which gave Associates the right to conduct its affairs with Clark in the manner in which it did.... Our careful examination of the record does not reveal any conduct... that was inconsistent with the loan agreement, irrespective of what [the loan agent’s] personal motive may have been.

The test that emerges from the court’s reasoning is based not on the substantive level of creditor control, but on whether such conduct is within the rights detailed by a written agreement between creditor and

25. See id. at 1029.
26. See id.
27. See id. at 1031. In considering the requirements for equitable subordination, the court found that this inequitable conduct had injured other creditors, see id. at 1030-31, and that equitable subordination in this case would be consistent with the Bankruptcy Code’s policy of promoting equality of distribution, see id. at 1031.
28. In re Clark Pipe & Supply Co. (Clark Pipe II), 893 F.2d 693 (5th Cir. 1990).
29. Id. at 699-700 (footnote omitted) (emphasis added).
30. Id. at 700-01. In support of its position, the court made much of the fact that “[t]he agreement provided that Associates could reduce the percentage advance rates at any time in its discretion,” id. at 700, and that the agreement had been executed in 1980, before any financial trouble, at arm’s length, see id.
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debtor executed at arm's length. In Clark Pipe II, the Fifth Circuit articulated the following principle: If a creditor has acted within the rights articulated in a contract with a debtor, the creditor will be presumed not to have engaged in inequitable conduct for the purposes of equitable subordination even if it exercised "powerful and ultimately severe" control to the detriment of other creditors. I call this rule the "formalist contract-rights presumption." The rule is formalist in that it looks at the letter of the contract and not at past conduct between the parties under it. It is presumptive in that it assumes that conduct within defined contract rights is not inequitable.

2. Asserting Formalism: Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting

The Seventh Circuit reiterated and elaborated upon this presumption in Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting (Kham II), in which it reversed a district court's finding of inequitable conduct. The bankruptcy court's opinion in the case (Kham I) demonstrated a fact-based inquiry into the conduct of a creditor bank. The bank had induced the debtor to declare Chapter 11 bankruptcy in return for providing additional credit and converting its letters of credit to super-priority status. It had then terminated that line of financing and forced the debtor's other creditors to draw down on the letters of credit. The bankruptcy judge held in an evidentiary hearing that the bank had acted inequitably in terminating its line of credit and inducing the debtor's suppliers to draw on the letters of credit. The judge concluded that these draws had converted the bank from an unsecured lender to a super-secured lender, to the detriment of other creditors. Ultimately, the bankruptcy court in Kham engaged in a fact-based, pattern-matching inquiry into the nature of the bank's conduct, determining that the bank had acted ineq-

31. The court did return in part to the fact-based, pattern-matching technique it used in Clark Pipe I. See Clark Pipe II, 893 F.2d at 701-02 (contrasting facts of this case with In re American Lumber Co., 5 B.R. 470 (D. Minn. 1980)). However, at the end of its analysis, the Fifth Circuit returned to its core argument regarding contract rights: "Associates' control over Clark's finances, admittedly powerful and ultimately severe, was based solely on the exercise of powers found in the loan agreement." Id. at 702.
32. Id.
33. 908 F.2d 1351 (7th Cir. 1990).
34. See id. at 1356-59.
36. See id. at 422.
37. See id.
38. See Kham II, 908 F.2d at 1354.
39. See id.
uitably by analogy to the case of *K.M.C. Co. v. Irving Trust Co.* In *K.M.C.*, a creditor was held to have violated the requirement of good faith by suddenly and inexplicably refusing, within the explicit terms of the contract, to make further advances under a line-of-credit agreement. The court in *Kham I* held that the bank’s inexplicable refusal to advance further funds was a similar breach of good faith and fair dealings and thus was grounds for equitable subordination.

Following reasoning similar to that of the *Clark Pipe II* court, the Seventh Circuit in *Kham II* reversed the district court’s affirmation of the bankruptcy court’s decision, holding that conduct under the express terms of a written contract would not, as a rule, be considered inequitable:

Debtor submits that conduct may be “unfair” and “inequitable” for [the] purpose [of determining whether to apply equitable subordination] even though the creditor complies with all contractual requirements, but we 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.

The Seventh Circuit’s interpretation precluded all inquiries save those directed to the letter of the contract itself: “Firms that have negotiated contracts are entitled to enforce them to the letter, even to the great discomfort of their trading partners, without being mulcted for lack of ‘good faith.’” The Seventh Circuit very strongly limited its inquiry to the formal provisions of the contract; even the bankruptcy judge’s finding that the bank had propelled the debtor into bankruptcy by conditioning its loan on filing for bankruptcy was irrelevant. Thus, the Seventh Circuit in *Kham II* clarified the emerging bright-line rule: Conduct is presumptively not inequitable if it falls within the parties’ rights under the contract, where the contract is interpreted as strictly adhering to its written letter.

3. Restating the Presumption: The Legacy of *Clark Pipe II* and *Kham II*

A series of cases has begun to apply the formalist contract-rights pre-

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40. 757 F.2d 752 (6th Cir. 1985).
41. See id. at 760-63.
42. See *Kham I*, 97 B.R. at 428.
43. *Kham II* 908 F.2d at 1356.
44. Id. at 1357. The Seventh Circuit went on to argue that the letter of the contract itself is determinative and that the notion of good faith in contract deals only with “gap filling.” See id.
45. See id. at 1358 (“Although Debtor contends, and the bankruptcy judge found, that Bank’s termination of advances frustrated Debtor’s efforts to secure credit from other sources, and so propelled it down hill, this is legally irrelevant so long as Bank kept its promises.”).
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sumption established by Clark Pipe II and Kham II. First, a number of courts have denied actions for equitable subordination based on the reasoning in Clark Pipe II and Kham II, holding that creditors’ conduct has not been inequitable if it has fallen within written contract rights. For example, in In re M. Paollella & Sons, Inc., the court held that a creditor’s close monitoring of a debtor, including daily calls, control over all receivables proceeds, and a sudden request for repayment of long-outstanding and well-monitored debts that severely impaired the debtor’s ability to pay other creditors, did not constitute inequitable conduct.

Citing Kham II, the court argued that the creditor’s exercise of its contractual right to demand repayment at any time—even in the face of findings by the bankruptcy court that the creditor had altered (1) its method of dealing with the debtor, (2) its method of obtaining information, and (3) the type of information it obtained from the debtor—was not inequitable, since it was part of the written terms of the contract.

Second, even in cases where courts have engaged in more detailed discussion of the facts, they have used the formalistic contract reasoning of Kham II and Clark Pipe II to find a creditor’s refusal to lend additional funds not inequitable or to characterize creditor conduct as not impermissibly controlling. For example, in In re Clemens, the court found that

46. See, e.g., United States Abatement Corp. v. Mobil Exploration & Producing U.S., Inc. (In re United States Abatement Corp.), 39 F.3d 556, 562 (5th Cir. 1994) (“We reached this conclusion based primarily upon the fact that the contract between the lender and borrower expressly permitted [lender’s conduct].”) (citing In re Clark Pipe & Supply Co. (Clark II), 893 F.2d 693, 702 (5th Cir. 1990)); Sloan v. Zions First National Bank (In re Castletons, Inc.), 990 F.2d 551, 559 (10th Cir. 1993) (upholding bankruptcy court’s decision that conduct was not inequitable because creditor “was simply exercising the contract rights it had, and there’s nothing wrong with that”) (citing Clark II, 893 F.2d at 701); Waslow v. MNC Commercial Corp. (In re M. Paolella & Sons, Inc.), 161 B.R. 107, 121 (E.D. Pa. 1993) (citing Kham II, 908 F.2d at 1357); Davlin v. Fidelcor Business Credit Corp. (In re Southern Standard Fittings Co.), 1991 WL 197018, at *3 (E.D. La. 1991) (holding creditor’s actions not inequitable because they were “permitted under the loan documents”) (citing Clark Pipe II, 893 F.2d at 702); NBD Park Ridge Bank v. SRJ Enterprises, Inc. (In re SRJ Enterprises, Inc.), 151 B.R. 189, 197 (Bankr. N.D. Ill. 1993) (“[B]ecause there is no duty of ‘kindness’ among nonfiduciaries, mere enforcement of contract rights will not give rise to a claim for equitable subordination.”) (citing Kham II, 908 F.2d at 1357).


48. See id. at 119.

49. Id. at 120 (“Firms that have negotiated contracts are entitled to enforce them to the letter.”) (quoting Kham II, 908 F.2d at 1357 (Easterbrook, J.)).


51. See Clemens v. West Milton Bank (In re Clemens), 197 B.R. 779, 795 (Bankr. M.D. Pa. 1996) (holding that because creditor conduct was pursuant to contract, creditor was not an insider and did not behave inequitably) (citing Paolella, 161 B.R. at 120); see also Lynn v. Continental Bank (In re Murchison), 154 B.R. 909, 913 (Bankr. N.D. Tex. 1993) (holding that creditor did not become subject to higher standard for insiders in preference action because its controlling conduct was contractual) (citing Clark II, 893 F.2d at 700-01); Boyd v. Sachs (In re
“there was significant evidence that the [creditor] controlled much of the affairs of the [debtor] during some significant time periods”\(^5\) while the debtor was not in technical default.\(^3\) It held, however, that the creditor’s conduct was not impermissibly controlling against the “background”\(^5\) of Paolella, which “carefully pointed out . . . that ‘a creditor does not act inequitably in exercising its contractual rights . . .’”\(^5\)

Finally, even in the rare cases where inequitable conduct is found, courts have been forced to attack misconduct that occurs outside the terms of the contract.\(^5\) In In re Century Glove, Inc., for example, the court denied a motion to dismiss a claim for equitable subordination.\(^7\) The complaint alleged that the creditor had engaged in inequitable conduct when it entered into a plan with one of the debtor’s officers to liquidate the debtor for the exclusive benefit of the officer and creditor.\(^8\) An essential part of the “plan” theory was the allegation that the creditor refused to waive the provision in the loan agreement that would have enabled the debtor to remove the misbehaving and allegedly conspiring officer without triggering a default.\(^9\) The creditor argued that this conduct was not inequitable under the reasoning of Clark Pipe II.\(^6\) The court both agreed and disagreed. It followed the formalist contract-rights presumption, holding that the creditor’s refusal in and of itself did not constitute inequitable conduct under Clark Pipe II.\(^6\) It reasoned, however, that because the refusal was part of a larger conspiracy plan, the complaint successfully “allege[d] such other inequitable conduct as Clark Pipe requires.”\(^6\) The Century Glove court was thus forced under the presumption to look beyond the opportunistic refusal ac-

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52. 197 B.R. at 796.
53. Id.
54. Id.
55. Id. at 795 (quoting Paolella, 161 B.R. at 120).
56. See, e.g., Capitol Bank & Trust Co. v. 604 Columbus Ave. Realty Trust (In re 604 Columbus Ave. Realty Trust), 968 F.2d 1332, 1362 (1st Cir. 1992) (finding bank’s misappropriation of loan proceeds inequitable conduct in contrast to permissible contractual behavior under Kham); Century Glove, Inc. v. Iselin (In re Century Glove, Inc.), 151 B.R. 327, 335 (Bankr. D. Del. 1993) (finding that plan to liquidate debtor was distinguishable from permissible “mere exercise of contractual rights” under Clark II); Great Am. Ins. Co. v. Bailey (In re Cutty’s-Gurnee, Inc.), 133 B.R. 934, 959 (Bankr. N.D. Ill. 1991) (holding that, under Kham, bank was entitled to advance own interests to extent of contract terms, but that additional attempts to take priority lien position despite notice of adverse claims was inequitable conduct); Aluminum Mills Corp. v. Citicorp N. Am., Inc. (In re Aluminum Mills Corp.), 132 B.R. 869, 896 (Bankr. N.D. Ill. 1991) (holding that alleged creditor fraud was sufficiently more egregious than “[merely enforcing the terms of a contract] to survive motion to dismiss under Kham.”
57. See 151 B.R. at 335.
58. See id.
59. See id.
60. See id. (citing Clark Pipe II, 893 F.2d at 700-01).
61. See id.
62. Id.
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tion itself to sustain the inequitable conduct complaint.

Thus, in cases of dramatic changes in creditor behavior, "significant control" of the debtor, and even alleged conspiracy, the courts have re-stated the formalist rule: Conduct under the rights specified by the written terms of a contract is presumptively not inequitable.

III. CONFLICT WITH MODERN CONTRACT AND BANKRUPTCY PREFERENCE LAW

The formalist contract-rights presumption should be rejected or re-formulated because it is fundamentally inconsistent with important parts of modern contract law and bankruptcy preference law. This Part demonstrates that modern contract law recognizes concepts of relational contract and good faith and fair dealings that require courts to look beyond the express terms of a contract in evaluating the contract rights of the parties. It then argues that the presumption's inconsistency with these concepts renders it legally unjustified, undermines the goal of equality of distribution, and creates perverse and confusing incentives. In addition, this Part explains that bankruptcy preference law also recognizes and applies a relational approach to evaluating a creditor's conduct that goes beyond the express terms of the contract. This Part then argues that the presumption's inconsistency with bankruptcy preference law makes its application unprincipled, creates conflicting and confusing incentives for creditors within bankruptcy law, and undermines the important goals of reducing the pressure towards bankruptcy and promoting equality of distribution.

A. Conflict with Modern Contract Law

1. The Modern Concept of Relational Contract and the Covenant of Good Faith and Fair Dealings

Unlike the formalist contract-rights presumption, modern contract law recognizes and requires an inquiry into the relations between the contracting parties to determine whether a party's conduct is within its contractual rights.

First, modern contract law recognizes that contracts can be created, modified, and properly interpreted through behavior. For example, the Restatement (Second) of Contracts (Restatement) recognizes that the terms of a final written contract can be interpreted using parol and extrinsic evidence, including evidence of the two parties' course of dealing.
or performance. Specifically, the Restatement recognizes that in a contract that involves repeated occasions for performance, one party's actual course of performance and the other party's acceptance or acquiescence in that performance are relevant to the interpretation of the contract. In fact, the Restatement consistently includes an inquiry into the relationship and course of dealings and performance with an exploration of the express contract terms themselves in its guidelines for determining the meaning of a contract. Other sources of modern contract law such as the Uniform Commercial Code (U.C.C.) even recognize that a contractual relationship between parties can be created and defined by their conduct alone and not merely by the terms of written contracts.

Second, the implied covenant of good faith and fair dealings in modern contract law recognizes that evaluating the performance of a contract requires an inquiry into more than simply the express contractual rights; evaluating the implied covenant of good faith and fair dealings requires an inquiry into the performance and enforcement of those rights under contract.

Modern contract law requires that courts examine both contractual rights and the parties' exercise of those rights to determine whether a contract has been breached. Under modern contract law in most jurisdictions, "[e]very contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement." Scholars have read the scope of this obligation to include more than a mere adherence to the letter of a contract. For example, in interpreting the duties of merchants

63. See RESTATEMENT (SECOND) OF CONTRACTS § 202 (1981) (stating that the rules in aid of interpretation of contracts include interpreting the course of dealings and performance of parties to a contract in addition to contract's express terms); see also U.C.C. § 2-202 (1978) (same).

64. See RESTATEMENT (SECOND) OF CONTRACTS § 202(4) (1981); see also U.C.C. § 2-208(1) (1978) ("Where the contract for sale involves repeated occasions for performance by either party with knowledge of the nature of the performance and opportunity for objection to it by the other, any course of performance accepted or acquiesced in without objection shall be relevant to determine the meaning of the agreement.").

65. See RESTATEMENT (SECOND) OF CONTRACTS § 203 (1981) (reporting priority of interpretive sources, including parties' course of performance and course of dealing); see also U.C.C. § 2-208(2) (1978) (explaining that express terms of agreement, course of performance, and course of dealing and usage of trade should be construed as consistent with each other whenever possible in interpreting contracts).

66. See U.C.C. § 2-204(1-3) (1978) (explaining that contracts can be formed by any manner sufficient to show agreement, including mutual conduct recognizing an agreement, and that indefiniteness of time of formation and of certain terms does not necessarily bar contract's formation); U.C.C. § 2-207(3) (1978) ("Conduct by both parties which recognizes the existence of a contract is sufficient to establish a contract for sale although the writings of the parties do not otherwise establish a contract.").

67. RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981); see also U.C.C. § 1-102 (1989) ("Every contract or duty within [the U.C.C.] imposes an obligation of good faith in its performance or enforcement."). But see English v. Fischer, 660 S.W.2d 521, 522 (Tex. 1983) (holding that there is not an implied covenant of good faith and fair dealing in every contract in Texas).
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under the U.C.C., Professor E. Allan Farnsworth stated three standards that behavior under a contract must meet to fulfill the obligation of good faith and fair dealings:

Under the general obligation of good faith, [a merchant] must meet the test of "honesty in fact." That is one standard. Because he is a merchant, he must observe "reasonable commercial standards of fair dealing in the trade." This is a second standard. And because the applicable section specifically requires it, he must act "in good faith and within limits set by commercial reasonableness." And this is a third standard.68

Other conceptions of the implied covenant of good faith and fair dealings point to similar inquiries regarding not merely the rights specified by the express terms of a contract but the exercise of those rights. In fact, Professor Robert Summers has classified bad faith performance of contract into six general areas (which are not exhaustive) that look beyond the mere letter of the contract: (1) evasion of the spirit of the deal; (2) lack of diligence and slacking off; (3) willful rendering of only substantial performance; (4) abuse of a power to specify terms; (5) abuse of a power to determine compliance; and (6) interference with, or failure to cooperate in, the other party's performance.69

Courts have used this analysis to require that the exercise of discretionary powers be reasonable and in the spirit of the transaction. For example, in B.P.G. Autoland Jeep-Eagle, Inc. v. Chrysler Credit Corp.,70 the court held that a creditor's lenient course of dealing throughout its relationship with the debtor made its abrupt termination of financing for the debtor a breach of the covenant of good faith and fair dealings.71 The court noted that "[d]espite the mechanical provisions of an agreement, the actual historical relationship between a borrower and lender may alter a lender's obligations when it attempts to enforce those provisions at a later time."72 Specifically, if a lender initially displays leniency towards a borrower in the administration of a loan agreement, "it may later violate the good faith obligation if it suddenly changes its previously lenient course of dealing."73 Similarly, courts have held that, if discretion is vested completely in one party to a contract, the covenant of good faith and fair dealings requires that "a party vested with contractual discretion


71. See id. at 229.

72. Id. at 228.

must exercise that discretion reasonably and with proper motive, and may not do so arbitrarily, capriciously, or in a manner inconsistent with the reasonable expectations of the parties. Consequently, for example, if a contract’s completion is dependent on one party’s certification of a computer system that is arbitrarily withheld (even though it is within that party’s discretion to do so), the covenant of good faith and fair dealings could be violated. Similarly, if the contractual obligation of one party was contingent on a condition “peculiarly within the power of that party, such as obtaining mortgage financing or obtaining necessary licenses or permits,” the controlling party’s discretion to create that condition is limited by the covenant of good faith and fair dealings; the covenant requires the controlling party to use reasonable efforts to bring about that condition. Thus, courts applying the covenant of good faith and fair dealings have examined conduct outside of the express terms of the contract to determine restrictions on the exercise of discretion in performing or enforcing written contract terms.

In the context of bankruptcy, the Sixth Circuit in *K.M.C. Co. v. Irving Trust Co.*, held that the failure of a creditor, on whose financing a debtor was wholly dependent, to give reasonable notice of a decision to refuse further funds was a violation of the implied covenant of good faith and fair dealings.

The record clearly established that a medium-sized company in the wholesale grocery business, such as [the debtor], could not operate without outside financing. Thus, the literal interpretation of the financing agreement urged upon us by [the creditor] . . . would leave [the debtor’s] continued existence entirely at the whim or mercy of [the creditor], absent an obligation of good faith performance.

In evaluating the implied covenant of good faith and fair dealings, the Sixth Circuit looked beyond the terms of the contract. In determining the equities of the situation, the court considered the actual effect of the action on the parties involved and their past performance.

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75. *See Williams v. Jader Fuel Co.*, 944 F.2d 1388 (7th Cir. 1991) (holding that refusal to provide certification for computer system presented question of violation of covenant of good faith and fair dealings for jury to decide).
76. *Dayan*, 466 N.E.2d at 972.
77. *See id.* (collecting Illinois cases regarding mortgage and licensing approvals); see also *BA Mortgage & Int’l Realty Corp. v. American Nat’l Bank & Trust Co. of Chicago*, 706 F. Supp. 1364 (N.D. Ill. 1989) (holding that plaintiffs adequately stated claim for breach of good faith and fair dealings by alleging that lending contract had vested approval power in mortgage lender to be exercised in sole discretion and that discretion was exercised arbitrarily and capriciously and for benefit of lender’s other interests).
78. 757 F.2d 752 (6th Cir. 1985).
79. *See id.* at 759.
80. *Id.*
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Of course, modern contract law recognizes the importance and dominance of express terms in interpreting contracts. Express terms are generally given significant weight in interpreting agreements.\(^8\) Some courts have also recognized limitations on the ability of a course of dealings or the covenant of good faith and fair dealings to override express contract terms or impose additional obligations.\(^8\) Significantly, courts have held the implied covenant of good faith and fair dealings not to create benefits not bargained for in the original agreement.\(^8\) They have suggested that "[t]he covenant is breached only when one party to a contract seeks to prevent its performance by, or to withhold its benefits from, the other. The mere exercise of one's contractual rights, without more, cannot constitute such a breach."\(^8\) However, modern contract law's recognition of the importance of express contract terms does not extend to the limits of the formalist contract-rights presumption. Although the covenant of good faith and fair dealings and the recognition of relational contract principles cannot override or add to express contract terms, they do govern the interpretation and performance of those contract terms, and they do generate a legally recognized context in which the parties' adherence to the contract or enforcement of its express terms must be evaluated. The covenant of good faith and fair dealings governs the enforcement of express contract terms, and relational contract principles and the course of dealing help explain the interpretation of those terms. As a result, to evaluate the nature of the contract and whether the rights it secures are being exercised in good faith, courts continue to engage in inquiries regarding the nature of the benefits bargained for in transactions and the performance and intent of the parties engaged in them. These inquiries range beyond merely determining whether a course of conduct is within the rights expressed in a written contract.\(^8\)

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81. See Restatement (Second) of Contracts § 203(b) (1981) (giving express terms greatest weight in interpreting agreements).

82. See, e.g., Badgett v. Security State Bank, 807 P.2d 356, 361 (Wash. 1991) ("[A] course of dealing does not override express terms in a contract or add additional obligations.").

83. See, e.g., Harris Trust and Savings Bank v. E-II Holdings, Inc., 926 F.2d 636 (7th Cir. 1991) (holding that implied covenant did not require disclosure of information supporting management evaluation of bonds in addition to opinions required in bond covenants); Geren v. Quantum Chemical Corp., 832 F. Supp. 728 (S.D.N.Y. 1993) (holding that implied covenant of good faith and fair dealings did not prevent firm from incurring substantial additional debt to pay special dividend to shareholders); Metropolitan Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504 (S.D.N.Y. 1989) (holding that implied covenant of good faith and fair dealings did not include negative covenant preventing bond issuer from incurring massive LBO debt that decreased value of bonds).


85. See, e.g., B.P.G. Autoland Jeep-Eagle, Inc. v. Chrysler Credit Corp., 785 F. Supp. 222, 228 (D. Mass. 1991) ("[W]hen the lender initially displays leniency toward the borrower in its administration of the loan agreement, it may later violate the good faith obligation if it suddenly
2. Inconsistent Conceptions of Contract Rights

The formalist contract-rights presumption is thus fundamentally inconsistent with an important part of modern contract law. Instead of evaluating the non-written relationship between contracting parties to determine the extent and content of contract rights, courts using the presumption limit their inquiry to the written terms of the contract alone. Instead of examining the performance and exercise of contract rights under the standard of good faith and fair dealings, those courts simply inquire whether conduct is in literal compliance with contract terms.

This inconsistency with modern contract law is important for several reasons. First, if the formalist contract-rights presumption is inconsistent with modern contract law, it loses its primary source of express legal justification. Courts justify shielding creditor conduct under the formalist contract-rights presumption because such conduct is in accordance with contract rights and thus is protected under contract law. Contract law, they argue, presents a standard for acceptable conduct and a source of justification for creditors’ taking certain actions. If the courts’ conception of contract law is incorrect, and a creditor’s conduct is not in accordance with contract rights as recognized by modern contract law, then the explicit, legal justification for shielding the creditor’s inequitable behavior is a fiction. Contract law neither lends protection to nor justifies the protection of such conduct. If the creditor’s conduct were being evaluated outside of the bankruptcy context, it would not be justifiable under modern contract law. As a matter of modern contract law, what the parties agreed to and what they can reasonably expect is determined by a fact-based relational evaluation, not by mere reference to the written terms of an agreement.

Courts might find some independent reason to justify privileging or

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86. See supra notes 63-66 and accompanying text.
87. See supra Part II.
88. See supra notes 67-85 and accompanying text.
89. See supra Part II.
90. See Kham & Nate’s Shoes No. 2, Inc. v. First Bank of Whiting (Kham II), 908 F.2d 1351, 1356-58 (7th Cir. 1990); In re Clark Pipe & Supply Co. (Clark Pipe II), 893 F.2d 693, 699-701 (5th Cir. 1990).
91. See supra notes 63-85 and accompanying text.
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shielding such behavior, but they cannot and should not protect it on the basis of or with reference to contract law or contract rights, as they currently do under the formalist contract-rights presumption. If courts wish to justify using the formalist contract-rights presumption with reference to modern contract law, they must first transform modern contract law to return it to a formalist conception. Because courts do justify and calibrate the formalist presumption with reference to contract law, they should do so correctly and consistently.

There are functional reasons for aligning the presumption more closely with actual contract law doctrine. First, if the formalist contract-rights presumption is inconsistent with modern contract law, then its application undermines a fundamental principle of equitable subordination: equality of distribution. Courts equitably subordinate creditor claims in order to place creditors in the correct equitable position of priority for distribution, treating like creditors alike. Thus, unlike ordinary contract law, which focuses solely on the behavior of the parties to the contract vis-à-vis each other, equitable subordination is concerned with the relationship of a creditor to both the debtor and to the debtor's other creditors. Applying the formalist contract-rights presumption, however, a court could treat legally unequal creditors equally and legally equal creditors unequally. The presumption shields equally both the creditor who behaves according to relational principles of modern contract law and the creditor who violates modern contract law but stays within the written contract terms. Some parties who abide by their contracts and other parties who breach their contracts are treated equally. At the same time, modern-contract-law-breakers who stay within the written terms of their contracts are treated differently than are those creditors whose acts are equally wrongful under the modern contracts regime but are, additionally, in violation of the written terms of their contracts. Although a court applying the presumption treats equally those creditors who have violated the contract's express terms and also treats equally those creditors who have not done so, this policy is not in any equitable sense the equal

92. See infra Sections IV.B-C.
93. One interpretation of the Seventh Circuit's move in Kham II is that Judge Easterbrook was attempting to do just that—to reestablish a formalist notion of contract and curtail the interpretation of good faith and fair dealings. See Dennis M. Patterson, Essay, A Fable from the Seventh Circuit: Frank Easterbrook on Good Faith, 76 IOWA L. REV. 503, 526-32 (1991). Although this move towards a more formalist view of contract law can be debated at length beyond the limits of this paper, it should be recognized that this formalist characterization is a strongly contested one that is at odds with the more robust interpretation of good faith and fair dealings in specific—and contract law in general—that is recognized by a significant number of courts and jurisdictions. See supra Subsection II.A.1.
94. See In re Clark Pipe & Supply Co. (Clark Pipe I), 870 F.2d 1022, 1031 (5th Cir. 1989).
95. See id.
96. See id.; In re Kansas City Journal-Post Co., 144 F.2d 791, 804 (8th Cir. 1944).
treatment of similarly situated creditors if the formalist presumption is not consistent with modern contract law.

This inconsistency generates perverse incentives for creditor conduct. Different standards of conduct in contract and equitable subordination law could create confusion or strategic creditor behavior when a debtor is close to bankruptcy.9 For example, a group of creditors might be bound under relational contract law to provide a debtor with notice before attempting to seize its assets without being obligated to do so under the terms of their written agreements with the debtor. The closer the debtor were to bankruptcy, the stronger would be each creditor's incentive to seize those assets without notice pursuant to the formal written terms of the contract. Each creditor would try to predict the others' behavior and to foreclose prematurely in order to maximize its own interests at the other creditors' expense.98

Finally, the inconsistency between the presumption and modern contract law might allow conduct that would constitute a breach of modern contract law, such as insufficient performance, arbitrary action, and generally bad faith activities, to escape the sanction of equitable subordination merely because it is within express contract terms. Although ordinary contract law could be used to police these problems pre-bankruptcy—for example, by providing damages for breach or rescinding the contract99—by the time a court is examining creditor conduct to determine whether to exercise the power of equitable subordination, such remedies may be too little too late: Awarding damages for contract breach to the debtor from the creditor may not reestablish the correct equitable relationship of priority between the creditor and other creditors that is one goal of equitable subordination.100 Furthermore, rescind-

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97. Cf. Lawrence Ponoroff, Evil Intentions and an Irresolute Endorsement for Scientific Rationalism: Bankruptcy Preferences One More Time, 1993 Wis. L. Rev. 1439, 1450 (discussing bankruptcy preference law's objective of preventing creditors from unnecessarily pushing troubled debtor into bankruptcy).

98. Inter-creditor conflict and strategic behavior appears to be widespread in bankruptcy and makes such a scenario not unlikely. See Robert M. Lawless & Stephen P. Ferris, Professional Fees and Other Direct Costs in Chapter 7 Business Liquidations, 75 WASH. U. L.Q. 1207, 1230-31 (1997) (reporting that inter-creditor conflict constituted a significant factor in generating bankruptcy costs). Specifically, creditors have historically behaved strategically with regard to debtors under the formalist presumption model. See Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting (Kham I), 908 F.2d 1351, 1353-54 (7th Cir. 1990) (reporting bank's opportunistic moves close in time to bankruptcy); K.M.C. Co. v. Irving Trust Co., 757 F.2d 752, 762 (6th Cir. 1985) (reporting creditor's lack of notice to debtor as part of creditor's "game plan" close in time to bankruptcy).

99. See Blue v. Shoen, 556 So. 2d 1364, 1369 (La. App. 1990) (holding that remedy for bad-faith sale is rescission); Restatement (Second) of Contracts §§ 175-176 (1981) (discussing rescinding contracts for duress or threat).

100. See Kansas City, 144 F.2d at 804 (discussing equality of distribution). Again, equitable subordination is oriented not merely at reestablishing the correct debtor-creditor relationship but also at establishing the correct inter-creditor relationships in priority of distribution as well.
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ing a contract or awarding damages under contract law is limited to the contract that is breached. In contrast, courts finding inequitable and harmful conduct in any aspect of the creditor-debtor relationship can rearrange the priority of payments to reset overall equities in a much more fundamental way. Leaving the policing of these abuses to contract law alone would subvert the comprehensive regulatory objectives underlying the power of equitable subordination.

B. Conflict with Bankruptcy Preference Law

Like modern contract law, bankruptcy preference law involves a fact-based inquiry into the course of dealings between the parties. Specifically, in interpreting the ordinary business exception of section 547(c)(2) to the bankruptcy trustee’s “preference avoidance” power under section 547(b), courts must go beyond examining the express terms of a contract by evaluating the relationships and course of dealings between the creditor and the debtor.

1. The Relational Inquiry of the Ordinary Business Exception

Because of the suspicion that transfers made close in time to the filing of bankruptcy could have contributed to a debtor’s decline and might be the result of radically skewed bargaining power situations, section 547(b) of the Code gives a trustee in bankruptcy the power to “avoid” such transfers. Essentially, a trustee can cancel and reverse any suspicious-looking transfers (called “avoidable preferences”) that occur close in time to the filing of bankruptcy. Using this power, the trustee, with the court’s approval, can require the creditor to return transfers to the bankruptcy estate where they will be redistributed according to priority as determined in bankruptcy.

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See id.


102. See Kansas City, 144 F.2d at 804 (explaining that inequitable activity need not be directly related to claims being subordinated).


104. Under § 547(b), a trustee may avoid any transfer of an interest of the debtor in property (1) to or for the benefit of a creditor; (2) for or on account of an antecedent debt owed by the debtor before such transfer was made; (3) made while the debtor was insolvent; (4) made—(A) on or within 90 days before the date of the filing of the petition; or (B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and (5) that enables such creditor to receive more than such creditor would receive if—(A) the case were a case under chapter 7 of this title; (B) the transfer had not been made; and (C) such creditor received payment of such debt to the extent provided by provisions of this title.

When a creditor challenges the trustee’s avoidance of a transfer, courts must engage in a fact-based, relational inquiry to evaluate whether the transfer was made in the ordinary course of business between the creditor and the debtor. Under section 547(c)(2), a trustee cannot avoid a transfer: “(2) to the extent that such transfer was—(A) in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee; (B) made in the ordinary course of business or financial affairs of the debtor and the transferee; and (C) made according to ordinary business terms.”105 In applying the ordinary business exception of section 547(c)(2)(B), courts have frequently considered factors beyond the mere exercise of contract rights. They have looked to subjective understandings of the course of dealings between the debtor and creditor in these relationships and, in some jurisdictions, to the objective course of dealings of similarly situated parties in the debtor’s and creditor’s respective industries.106

First, under section 547(c)(2), courts have engaged in a fact-based analysis to uphold transfers that are in breach of the express terms of a contract. In a series of cases, for example, courts have upheld debtors’ late payments that violate the express payment terms of the contract as valid within the ordinary business exception because they fit into the pattern of past dealings between the creditor and the debtor.107

In addition, courts have engaged in a fact-based analysis to determine that a creditor’s exercise of clearly delineated contract rights was not in the ordinary course of business and thus subject to the avoiding power. For example, in the case of In re Southern Industrial Banking Corporation,108 the court held that although an investor’s withdrawal of money from his account with the debtor was in strict compliance with the express terms of his deposit agreement, the transfer could still be avoided as preferential.109 The court reasoned that regardless of the investor’s express rights to make his withdrawal, the fact that the debtor was in the course of a “run” meant that it was not operating in the ordinary course

106. See Ponoroff, supra note 97, at 1452-70 (explaining tests).
107. See, e.g., In re Tennessee Chemical Co., 112 F.3d 234 (6th Cir. 1997) (holding that late payments between debtor chemical company and creditor gas company were not avoidable because they fell within in ordinary course of business exception due to long history of consistently late payments); Windsor Communications Group v. Freedom Greeting Card Co., 63 B.R. 770 (E.D. Pa. 1986) (holding that return of unsold greeting cards to supplier in return for credit was made according to “ordinary business terms” because it was consistent with prior dealings and therefore could not be avoided as preferential); In re Bee Furniture Co., 206 B.R. 989 (Bankr. M.D. Fla. 1997) (holding that late payments to advertising creditor were not avoidable because they were consistent with pattern of prior course of dealing between parties and were thus in ordinary course of business).
109. See id. at 704.
of business. The court could therefore not allow the transfer under the ordinary course of business exception. The court went beyond a simple examination of express contract rights and evaluated the situation surrounding the debtor, the creditor, and the transfer itself.

In fact, courts have even used fact-based analysis to determine that bringing a series of transfers into closer compliance with express contract terms can actually bring them outside of the ordinary course of business and thus render them avoidable by the trustee. In *In re Miniscribe Corp.*, the court engaged in a fact-based analysis of a series of payments made between a debtor and creditor shortly before bankruptcy. As in *Clark Pipe I*, the court first explored the contract between the two parties. The court found that the debtor had expressly agreed to pay a key supplier/creditor within 30 days of receiving critical supplies. The court then examined the course of dealings between the parties and determined that the debtor had run into financial trouble and stretched out payments to the supplier and other creditors beyond the express payment terms. The court’s inquiry further revealed that, in the 90-day period prior to bankruptcy, the creditor used its position as a key supplier to ensure that it received payments on outstanding invoices and began to enforce the express terms of payment. Looking over the entire course of dealing between debtor and creditor, the court determined that the much more erratic payment schedule of the earlier relationship suddenly became more regular and matched contract terms in the period preceding bankruptcy. As a result, the court concluded that the contractual payments did not fall within the ordinary business exception. The court thus looked beyond the express terms of the written contract to determine that the transfers were subject to the trustee’s avoiding power.

Bankruptcy precedents uniformly indicate that, under the ordinary business exception in bankruptcy preference law, courts must look beyond the express contract terms to determine whether transfers should be subject to the trustee’s avoiding power. Just as in modern contract law, courts in bankruptcy preference law give weight to the relationship between parties over time. Bankruptcy preference law thus appears to

110. *See id.*
112. *See id.* at 88.
113. *See id.*
114. *See id.* at 89.
115. *See id.*
116. *See id.*
117. The court cited other cases, such as *J.P. Frye, Inc. of Florida v. Bradco Supply Corp.*, 891 F.2d 66 (3d Cir. 1989), and *In re Bob Grissett Golf Shoppes, Inc.*, 78 B.R. 787 (Bankr. E.D. Va. 1987), where attempts to shift to prompt payment in accordance with negotiated terms led to the avoidance of those transfers.
recognize the same norms of relational contract and good faith and fair dealings that are central to modern contract law.  

2. Inconsistent Approaches to Evaluating Conduct

The formalist contract-rights presumption is thus inconsistent with underpinnings of bankruptcy preference law. Instead of examining the course of dealings between creditors and debtors to determine whether conduct is within the ordinary course of business, courts applying the formalist presumption limit their inquiry to the written terms of the contract.

This inconsistency is troubling for at least two reasons. First, courts have held that one of the requirements of equitable subordination is that its exercise must not be inconsistent with the provisions of the Bankruptcy Code. If the formalist presumption establishes a standard for creditor conduct that is inconsistent with other areas of the bankruptcy law, equitable subordination under this presumption may be more likely to be inconsistent with the provisions of the Code and thus invalid or unjustified.

Second, this inconsistency creates conflicting and confusing incentives for creditor behavior. On the one hand, the presumption will shield from equitable subordination some behavior that is outside of the ordinary course of business but within the written terms of the contract. On the other hand, the presumption will not shield behavior that is consistent with a long history of ordinary business dealings but that is not in accordance with strict contract terms. Thus, creditors will face conflicting incentives from equitable subordination and bankruptcy preference law. The protection of the presumption will encourage them to enforce their written contract terms to the fullest, while the ordinary business exception will discourage them from doing so outside of the course of past dealings. This combination of conflicting incentives and treatments will only produce confusion, inconsistent behavior, and strategic behavior by creditors when debtors appear on the brink of bankruptcy.

118. See supra notes 63-85 and accompanying text.
119. See Benjamin v. Diamond (In re Mobile Steel Co.), 563 F.2d 692, 700 (5th Cir. 1977).
120. For example, the creditor behavior in Miniscribe would probably be protected from equitable subordination by the formalist contract rights presumption, because, although the behavior was held to create an invalid preference, it was within the written terms of the contract. See supra notes 111-117 and accompanying text.
121. For example, the consistently late payments of debtors to creditors that the courts ruled as valid within the ordinary course of business, see supra note 107 and accompanying text, would probably not be protected by the presumption.
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IV. THE CASE FOR A VIABLE STANDARD

Concerns about inconsistency aside, the formalist contract-rights presumption should be rejected first and foremost because it subverts the very purpose of equitable subordination by establishing an inflexible, unjustified, and inaccurate standard for evaluating the equities of creditor conduct. This Part argues that the purposes of equitable subordination are undermined by the enforcement of the formalist presumption. Furthermore, it argues that instead of increasing efficiency and fairness, the presumption decreases them. This Part concludes by proposing an alternative to the formalist contract-rights presumption that meets these concerns.

A. Precision of Remedy

The formalist contract-rights presumption should be rejected because it attempts to establish an inflexible and inaccurate legal restriction on what was intended to be a flexible and narrowly focused equity power of last resort. First, as was noted above, in the early development of the power of equitable subordination, the Supreme Court established that this equitable remedy should be used flexibly in the defense of substantive and equitable justice against the legal machinations of inequitable actors. As the Court stated in Pepper v. Litton: “[E]quity will undo the wrong or intervene to prevent its consummation.”

To accomplish these equitable ends, courts exercising the power of equitable subordination have been directed to analyze closely the actual behavior of the actors involved and not merely to examine their performance under the technical or mechanical boundaries of law and contract. In fact, the Supreme Court charged the bankruptcy courts with the specific duty to “sift the circumstances surrounding any claim to see that injustice or unfairness is not done in the administration of the estate.”

The breadth of this analysis under the power of equitable subordination is expansive. Courts have been directed to examine any conduct of the claimant that affects the bankruptcy results when deciding whether to apply equitable subordination:

The inequity which will entitle a bankruptcy court to regulate the distribution to a creditor, by subordination or other equitable means, need not therefore

122. See supra note 2 and accompanying text.
125. Id. at 310.
be specifically related to the creditor's claim, either in its origin or in its acquisition, but it may equally arise out of any unfair act on the part of the creditor, which affects the bankruptcy results to other creditors and so makes it inequitable that he should assert a parity with them in the distribution of the estate . . . .

Thus, bankruptcy courts in general must undertake a fact-intensive analysis to ensure equality of distribution and equity.

Equitable subordination in particular requires a careful and close analysis because it strikes at the heart of the purpose of bankruptcy; it is the Code's safety valve on creditor conduct and fairness of distribution. The court in *In re Teltronics Services, Inc.* stated:

> The remedy of equitable subordination must remain sufficiently flexible to deal with manifest injustice resulting from the violation of the rules of fair play. . . . "[w]here ingenuity spawns unprecedented vagaries of unfairness, [the bankruptcy courts] should not decline to recognize their marks, nor hesitate to turn the twilight for [the offending claimant] into a new dawn for other creditors."

This need for flexibility in the power of equitable subordination has been generally demonstrated by the Supreme Court's approval of the use of the power to alter the priority of tax penalties in recent cases regarding the priority of creditors in bankruptcy and specifically demonstrated by the traditional use of the power (before the ascendency of the formalist presumption) to examine the terms of a contract in bankruptcy to determine if the creditor was inequitably controlling.

Accordingly, equitable subordination should reject the rigid, formalistic, bright-line rule of the formalist contract-rights presumption because it is and must remain the most flexible mechanism that the Code provides for the policing of inequitable but ill-defined behavior. Although some limits and guidelines on the exercise of the power of equitable subordination are justified and should be given to guide courts in their application of this potent and far-reaching equity power, these rules should be flexible, justified and consistent with other areas of the law. Specifically, the limits or guidelines should not provide some creditors with the incentive or opportunity, as the formalist presumption would, to avoid the court's equity powers by behaving within express contract terms.

126. *In re Kansas City Journal-Post Co.*, 144 F.2d 791, 804 (8th Cir. 1944).
130. See *supra* notes 94-102 and accompanying text.
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lines should also not establish inaccurate or inconsistent boundaries as the presumption appears to do.

Some courts have implicitly argued that the special and powerful nature of equitable subordination requires that the standard for establishing inequitable conduct be different from and perhaps more rigorous than the standard for establishing impermissible behavior under modern contract or bankruptcy preference law. This argument has been implicitly advanced by some courts when applying the formalist presumption. The Paollela court, for example, stated that "[the degree of misconduct required for equitable subordination] has been variously described as 'very substantial' misconduct involving 'moral turpitude or some breach of duty or some misrepresentation whereby other creditors were deceived to their damage' or as gross misconduct amounting to fraud, overreaching or spoliation." Other courts have similarly noted the dramatic impact of equitable subordination and suggested that its use be limited. All of these considerations suggest that a different kind of standard for inequitable conduct might be justified.

Although equitable subordination may warrant a different or higher standard for inequitable conduct, the formalist contract-rights presumption should be substantially recharacterized or rejected for several important reasons. First, the formalist contract-rights presumption misstates the modern law of contract rights and is unjustified. If the courts wish to continue to protect creditor conduct within the express terms of a written contract, they should at a minimum recharacterize that conduct and explicitly justify protecting it on grounds other than contract law. The courts' failure to do so has ignored or mischaracterized modern contract law by ignoring the rights recognized by the relational model of contract and good faith and fair dealings. Furthermore, using contract terminology presents a disingenuous justification for protecting this kind of conduct; it is not within the limits of modern contract law. If equitable subordination is such a special and powerful remedy, the mechanism for deciding when to apply it should be both correctly stated and carefully justified. In its current formulation, the formalist contract-rights presumption is neither.

Second, the formalist contract-rights presumption should be rejected because it is inaccurate. If equitable subordination is such an extraordinary power, its application should be as precise as possible. Simply inquiring

133. See supra notes 63-85 and accompanying text.
134. See id.
into the express terms of a written contract under the formalist contract-rights presumption ignores significant variations in a creditor’s conduct. A full inquiry into the nature of a creditor’s conduct vis-à-vis a debtor and an application of a consistent and high standard for inequitable conduct would take advantage of the tests and standards developed in modern contract and bankruptcy preference law to assess more accurately the nature of creditor conduct. Such an inquiry would allow courts to place inequitable conduct on a constant scale of behavior along with good faith performance and conduct within the ordinary course of business.

If courts simply want to apply a higher standard for inequitable conduct, then they could do so by engaging in a fact-based analysis of the relationship between the parties and thereafter applying to it an explicitly higher standard for inequitable conduct. By applying a consistent method of evaluation in equitable subordination, modern contract law, and bankruptcy preference law, the courts can make an accurate evaluation of creditors’ conduct without lowering the level of misconduct required to trigger equitable subordination.

The formalist contract-rights presumption should be rejected because it is too inflexible as a standard for applying equitable subordination. It privileges form over substance in direct opposition to the objectives of equitable subordination and offers to the remedy neither a more principled justification nor improved precision.

B. Efficiency

Although courts and commentators have made two efficiency-based arguments in favor of a formalist contract-rights model, the presumption in reality fails to support either and, in fact, may generate greater inefficiencies instead.

1. Freedom and Certainty of Contract

First, advocates argue that a formalist model of express contract rights would promote overall efficiency in the market by ensuring both freedom and certainty of contract. They argue that without a formalist

136. See, e.g., Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting (Kham II), 908 F.2d 1351, 1356-57 (7th Cir. 1990) (discussing efficiency enhancements of formalist contract model); DENNIS PATTERSON, GOOD FAITH AND LENDER LIABILITY: TOWARD A UNIFIED THEORY (1990) (arguing that good faith can interfere with market efficiency when it is applied to lender liability); Daniel R. Fischel, The Economics of Lender Liability, 99 YALE L.J. 131 (1989) (discussing the efficiency of formalist contract in the lender liability context); Corey R. Chivers, Note, “Contracting Around” the Good Faith Covenant To Avoid Lender Liability, 1991 COLUM BUS. L. REV. 359, 374-75 (arguing that using the good faith doctrine to “override” contract terms increases all future borrowers’ costs of inflexibility because lenders cannot negotiate different terms); Mark Snyderman, Comment, What's So Good About Good Faith?: The Good
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contract-rights model, courts will apply fact-based analysis and concepts of good faith to "override" contract terms and misallocate the fruits of efficient, pre-agreed bargains. Furthermore, courts will apply such fact-based, relational analysis inconsistently, generating uncertainty in the marketplace and increasing overall transaction costs. Thus, its advocates argue, a formalist contract-rights model will promote efficiency by ensuring that parties will be free to make and enforce an efficient contract and that they will be certain about their rights under that contract.

Unfortunately, these arguments make four invalid assumptions about the actual nature of creditor-debtor contracts and the place of a formalist contract-rights model in equitable subordination. First, the formalist contract-rights model assumes that the written contract represents the entire content of the parties' actual agreement and that such an agreement is certain. Empirical studies of debtors and creditors in lender-liability situations, however, suggest that the written terms of the contract are often ignored, used in a way that does not reflect their literal meaning, or are superseded by oral representations or subsequent behavior.

Furthermore, modern contract law and bankruptcy preference law both recognize that the course of dealings and of performance between two parties can more precisely reflect and shape the nature of their agreement.

Finally, even if parties did want the express terms of their contract to reflect the entire agreement with certainty, they could ensure that their express rights were maintained by behaving consistently with the written agreement or taking other precautions. Consequently, rejecting the formalist contract-rights presumption would not necessarily cause courts
to rewrite contracts or interpret them inconsistently.

Second, efficiency arguments in favor of a formalist contract model assume a broader shift toward formalism. Until this hypothetical shift manifested itself, however, creditors would have to behave according to a relational contract model under ordinary contract law and bankruptcy preference law, and any gains in certainty generated by a shift to the formalist contract-rights presumption in the law of equitable subordination would be limited. Indeed, shifting to a formalist model in equitable subordination alone could generate greater uncertainty and inefficiency as a result of its inconsistency with the rest of contract and bankruptcy law.

Third, the formalist contract-rights model assumes a formalist conception of freedom and certainty of contract. Formalist contract advocates assume that agreements are intended to be fixed at the time of writing: Freedom of contract to these advocates means freedom to choose fixed terms at a single moment in time, and certainty of contract means fixing the meaning at that moment. In contrast, modern contract law ensures parties the freedom to adapt and interpret their contracts over time with recognition by both sides. Modern contract law also ensures certainty by upholding the expectations of parties generated by a course of dealings over time. Furthermore, if parties to a contract want to ensure that their original writing governs the interpretation of their contract, they can do so under a relational model of contract by behaving consistently with the express terms of the contract over time. Modern conceptions of relational contract, it can thus be argued, better secure freedom and certainty of contract.

Finally, a formalist contract model ignores the expectations of other creditors, which are a central concern in bankruptcy. A relational contract model, on the other hand, might increase efficiency of transactions

142. See supra notes 63-85, 103-118 and accompanying text.
143. It is also unclear whether lenders and borrowers contracting in a world of ordinary commercial contract will be affected by the potential for equitable subordination in their making of contracts or normal execution of them. See G. Eric Brunstad, Bankruptcy and the Conflicts of Debt 11 (1996) (unpublished manuscript, on file with author) (arguing that bankruptcy law should be understood as dealing with distinctive problems of economic futility, which differ dramatically from problems arising during ordinary business operations of debtors).
144. See supra notes 86-102, 119-121 and accompanying text. Although courts could use the formalist contract rights presumption in bankruptcy to initiate such a larger change, other considerations about the role and nature of equitable subordination itself suggest that this is exactly the wrong place to establish a formal legal barrier to evaluating the equities of actual, relational conduct. A discussion of these considerations, however, is beyond the scope of this Note.
145. See, e.g., Deitrick & Levine, supra note 136, at 122.
146. See id.
147. See supra notes 63-85 and accompanying text.
148. See id.
149. See supra note 141 and accompanying text.
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by protecting reliable behavior for other creditors. Because a creditor’s behavior and financial position may be directly affected by that of other creditors, creditors want reliable information about the rights and expectations of other creditors, particularly when a debtor is close to bankruptcy. A relational model of contract would privilege the observable course of dealings between the creditor and the debtor and uphold third-party creditor expectations based on that course of dealings. In contrast to the formalist model, by generating greater observable certainty, the relational model increases efficiency both for first and for third parties.

Thus, the formalist contract-rights presumption is unlikely to increase efficiency by ensuring freedom or certainty of contract and may very well decrease it.

2. Costs of Litigation

Advocates of the formalist contract-rights presumption also argue that it reduces the costs of litigation (and thus litigation insurance) because bright-line rules are less disputable than fact-intensive standards. By reducing these costs, they contend, the formalist contract-rights presumption would reduce the overall costs of lending in the market.

Three observations significantly undermine the argument that the formalist presumption will decrease litigation costs. First, there is no empirical evidence of any significant savings from a formalist rule. Commentators on the contract doctrine of good faith and fair dealings have noted that such arguments have never been empirically proven. In fact, em-
Empirical studies of similar arguments demonstrate no such effect.\textsuperscript{155} Second, an isolated formalist rule in equitable subordination is unlikely to generate significant savings, because litigation about good faith and fair dealings and the ordinary business exception could still occur.\textsuperscript{156} Third, any possible litigation savings are likely to be limited because bankruptcy cases are already under considerable court supervision and frequently involve litigation regarding matters related to creditor conduct;\textsuperscript{157} the costs of additional litigation are thus likely to be incremental.

Three considerations suggest that the formalist contract-rights presumption may actually increase litigation costs. First, the formalist contract-rights presumption has historically protected some opportunistic creditor behavior that propelled troubled debtors into bankruptcy.\textsuperscript{158} The formalist presumption might thus create an incentive for such behavior, unnecessarily pushing some potentially viable debtors into bankruptcy with its extremely high litigation costs.\textsuperscript{159} Second, protecting such opportunistic behavior might also generate greater intercreditor conflict, further increasing litigation costs.\textsuperscript{160} Third, inconsistency with the other standards of conduct could generate confusion and thus greater litigation over the conduct required at different times.\textsuperscript{161}

In sum, the formalist contract-rights presumption is unlikely to de-
crease litigation costs significantly and instead may generate more litigation.

C. Fairness

Although proponents of the formalist presumption also argue in favor of it on the grounds of fairness, experience with and analysis of the presumption and its premises suggest that it may not promote fairness in the interpretation of contracts and may, in fact, generate greater unfairness in bankruptcy. Advocates of the formalist contract model argue that it is unfair to one party for the courts to remake contracts that are unfavorable to the other party.\(^{162}\) A formalist contract model, they claim, protects the parties from this unfairness by ensuring that a court interprets only their express written agreement.

Several arguments rebut the fundamental bases of this argument. First, the formalist contract model incorrectly assumes that the express written contract is the parties' entire agreement.\(^{163}\) Empirical evidence suggests that the parties to a commercial lending contract usually consider their actual agreement to be manifested in their oral representations and course of dealings and not in the express terms of the contract alone.\(^{164}\) Thus, a court's enforcing only the express terms of a written agreement would be unfair to one or both parties because it would not reflect their perceived agreement.\(^{165}\)

Second, the formalist contract model is not alone in its capacity to enforce the express terms of a deal. Contract parties can ensure that a court will enforce their written contract rights "fairly" under a relational model of contract by behaving consistently with the express terms of the contract over time and structuring their contracts carefully.\(^{166}\)

Third, enforcing inconsistent standards of contract rights might be even more unfair than reforming a contract. Enforcing only express con-

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163. See Fure, supra note 139, at 752.
164. See id. at 752, 756-57, 764.
165. It could be argued that a shift to a strong formalist contract model would cause both parties to focus on and understand the express contract terms as the nature of their deal. However, the fact that most parties currently do not appear to believe that this is the case, see id., suggests that causing this shift in behavior would entail substantial costs and might not be effective. Empirically, people have not believed written contract terms to memorialize their entire agreements. See id.
166. See supra note 141 and accompanying text. In this way, both the outcomes of the existing model of behavior and the stricter formalist model can be attained. Those creditors who plan to exercise their contract terms to the letter can inform their debtors that they plan to do so and behave consistently, secure in the knowledge that they will be protected from equitable subordination. The remaining population, which appears at present to believe in the binding force of relational terms, see Fure, supra note 139, at 753, can behave relationally and have their conduct protected.
tract rights in equitable subordination law and not in modern contract law or bankruptcy preference law would not enable contract parties to establish their contracts with certainty. Contract parties can rely on courts to uphold their agreements as established in their course of dealings with each other under modern contract and bankruptcy preference law. The formalist contract-rights presumption, however, limits agreements to their express written terms when the parties may have relied on other methods of establishing or modifying a contract. An inconsistent standard for evaluating contractual conduct is more likely to force a court to interpret a contract differently than intended or expected and thus unfairly to one or both parties.

Finally, the formalist contract model ignores the issue of fairness to third parties. Because the course of dealings between a creditor and a debtor is more likely to be observed and relied upon by third-party creditors than are predictions about a creditor's interpretation of express contract terms, limiting the interpretation of a contract to its express terms and ignoring the historical and observed course of dealings between the contract parties is unfair to other creditors; it "remakes" the contract they observed and upsets their expectations.

Thus, the formalist contract-rights presumption may not protect the parties from unfairness in contract interpretation. In fact, by limiting courts' inquiries to express written contract terms that appear to be generally ignored, the presumption may inadvertently cause greater unfairness, both to the parties of the contract and to third parties.

D. A New Standard

As a result of these considerations, I suggest that the formalist presumption be replaced by a multi-step inquiry consistent with the approach of modern contract and bankruptcy preference law. This Section will outline that inquiry and its advantages.

I. A New Inquiry

First, courts should examine three factors in determining whether behavior constitutes inequitable conduct: (1) the express terms of the con-

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167. See supra notes 63-85, 103-118 and accompanying text.
168. See supra Part II.
169. See supra notes 86-102, 119-121 and accompanying text.
170. See supra note 165 and accompanying text.
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tract between the parties; (2) the course of dealings between the parties over time; and (3) the standard of conduct in dealings between similarly situated parties. These three factors should be used to determine (1) to what the parties have actually agreed—the nature of the contract—and (2) whether any of them are engaged in conduct under the contract that would (a) violate the implied covenant of good faith and fair dealings as understood in that contract or in similar contracts or (b) constitute unusual, extraordinary behavior committed outside the ordinary course of business to the detriment of other creditors.

If either of these standards is violated, the court will then examine both the intention of the parties and the effect of their actions and determine whether the misconduct or breach rises to the level of clearly defined "inequitable conduct" that is tantamount to fraud, overreaching (within this context) or spoliation. If this misconduct exceeds the high standard of being tantamount to fraud, then it will be found to be inequitable conduct and the remaining steps of the analysis (determining whether such conduct has injured other creditors and whether equitable subordination will be consistent with the Bankruptcy Code) will be pursued.

2. The Benefits

This substitute for the formalist contract-rights presumption has several advantages. First, it evaluates relationships in greater detail and thus identifies more clearly whether any misconduct occurred, and it does so in a manner consistent with the approach of modern contract law and bankruptcy preference law. Second, by separately determining whether any such misconduct rises to the level of inequitable conduct, this test enables courts to evaluate misconduct consistently across modern contract, bankruptcy preference, and equitable subordination law. Finally, modifying the presumption in this manner will make such an inquiry consistent with the general duty of bankruptcy courts to sift through the form

173. See Benjamin v. Diamond (In re Mobile Steel Co.), 563 F.2d 692, 700 (5th Cir. 1977) (outlining the requirements for equitable subordination). As an alternative, this same two part inquiry could be used as a defense to a charge of inequitable behavior. If a creditor is accused of inequitable behavior, she can raise a defense combining (1) the terms of the express contract; (2) the course of dealings between the creditor and debtor; and (3) the course of dealings between similarly situated creditors and debtors to prove either (A) that no breach of good faith and fair dealings or unusual detrimental activity occurred; or, failing that, (B) that such breach of good faith and fair dealings or unusual detrimental activity did not rise to the level of inequitable conduct.
174. See supra notes 63-85 and accompanying text.
175. See supra notes 103-118 and accompanying text.
to get at the true substance and to prevent superficial adherence to the terms of a written contract to block the demands of equity.\textsuperscript{176}

V. CONCLUSION

Bankruptcy courts continue to experiment with equitable subordination and its slippery touchstone, inequitable conduct. In the constant struggle to draw from the flexible and therefore chaotic principles of justice and equity, courts have started to develop bright-line rules and presumptions to divide legitimate from illegitimate conduct. Bankruptcy courts, however, exist in the context of a rich and well developed universe of tests and approaches to understanding and characterizing behavior. Shaping bankruptcy rules so as to make them consistent with tests in related areas will both capture important developments and lessons from other areas of law and maintain the entire legal structure for evaluating conduct. It will also continue to provide bankruptcy courts and the bankruptcy system with the flexibility it needs to address questions of equity.

The formalist contract-rights presumption, that conduct pursuant to the express terms of a contract is not inequitable, represents an important if ill-conceived attempt at guiding courts’ application of equitable subordination. Modifying this presumption to account for developments in modern contract law and the standards applied in bankruptcy preference law will achieve the ends of the formalist presumption with greater accuracy and consistency. Separating the evaluation of misconduct from the finding of misconduct will enable courts to use consistent standards without sacrificing the courts’ ability to deploy their equity powers precisely.

Equity powers must not be exercised so that form defeats the substance of justice. The formalist presumption should therefore be modified to account for the substance of subjective and objective courses of dealings between parties and not merely attend to the form of express contract rights or terms.