

**KHAM & NATE'S SHOES NO. 2, INC., Debtor-Appellee, v. FIRST BANK
OF WHITING, Defendant-Appellant.**
United States Court of Appeals, Seventh Circuit
908 F.2d 1351 (7th Cir. 1990)

Before WOOD, Jr., and EASTERBROOK, Circuit Judges, and ESCHBACH, Senior Circuit Judge.

EASTERBROOK, Circuit Judge.

Kham & Nate's Shoes No. 2, Inc., ran four retail shoe stores in Chicago. It has been in bankruptcy since 1984, operating as a debtor in possession. First Bank of Whiting, one of Kham & Nate's creditors, appeals from the order confirming its plan of reorganization. This order . . . reduces the Bank's secured claim to unsecured status . . . after finding . . . that [the Bank] behaved "inequitably"

I

The Bank first extended credit to the Debtor in July 1981. This \$50,000 loan was renewed in December 1981 and repaid in part in July 1982. The balance was rolled over until late 1983, when with interest it came to \$42,000. In September 1983 Bank issued several letters of credit in favor of Debtor's customers. Debtor furnished a [promissory] note to support these letters of credit; the Bank's security interest was limited to the goods the suppliers furnished. In late 1983 Debtor, experiencing serious cash-flow problems, asked for additional capital, which Bank agreed to provide if the loan could be made secure. That was hard to do, for Debtor had lost money the previous two years and owed more than \$440,000 to tax collectors; any new loan from Bank would stand behind the back tax liabilities. The parties discussed two ways to make Bank secure: a guarantee by the Small Business Administration, and a bankruptcy petition followed by an order giving a post-petition loan super-priority.

While waiting for the SBA to act on its application, Debtor filed its petition under Chapter 11 of the Bankruptcy Code in January 1984. Judge Toles granted its application for an order under 11 U.S.C. § 364(c)(1) giving a loan from Bank priority even over the administrative expenses of the bankruptcy. Debtor and Bank then signed their loan agreement, which opens a \$300,000 line of credit. The contract provides for cancellation on five days' notice and adds for good measure that "nothing provided herein shall constitute a waiver of the right of the Bank to terminate financing at any time".

The parties signed the contract on January 23, 1984, and Debtor quickly took about \$75,000. Suppliers began to draw on the letters of credit. On February 29 Bank mailed Debtor a letter stating that it would make no additional advances after March 7. Although the note underlying the line of credit required payment on demand, Bank did not make the demand. It continued honoring draws on the letters of credit. Debtor's ultimate indebtedness to Bank was approximately \$164,000: \$42,000 outstanding on the loan made in 1981, \$47,000 on the letters of credit, and \$75,000 on the line of credit. Debtor paid \$10,000 against the line of credit in April 1985 but has made no further payments. Debtor did not ask the court to order Bank to make

further advances or to grant super-priority to another creditor to facilitate loans from another source.

There matters stood until the spring of 1988, when Debtor proposed its fourth plan of reorganization. Although the previous three plans had called for Bank to be paid in full, the fourth plan proposed to treat Bank's claims as general unsecured debts. This fourth plan also proposed to allow the shareholders to keep their stock, in exchange for guaranteeing new loans to Debtor.

Bankruptcy Judge Coar held an evidentiary hearing and concluded that Bank had behaved inequitably in terminating the line of credit and inducing Debtor's suppliers to draw on the letters of credit. These draws, the judge concluded, converted Bank from an unsecured lender (the position it held before the bankruptcy) to a super-secured lender under Judge Toles' financing order. Judge Coar first vacated the financing order and then subordinated Bank's debt, on the authority of 11 U.S.C. § 510(c). Finally, Judge Coar confirmed the plan of reorganization The district judge affirmed

II

. . . After Bank stopped making loans, Debtor closed its head office in a snazzy building on Michigan Avenue; a deterioration in the prestige of its address made suppliers less willing to deliver shoes on credit, Debtor insists, with the result that it shrunk from four stores (two in ritzy locations) to one on Chicago's south side.

[The Court ruled that it had jurisdiction to decide the appeal, notwithstanding the fact that the debtor was still pursuing a claim for damages against the Bank.]

III

. . .

[Section] 364(e) [of the Bankruptcy Code] provides that the reversal or modification of a financing order on appeal "does not affect the validity of any debt so incurred, or any priority or lien so granted, to an entity that extended such credit in good faith". In other words, a lender that extends credit in reliance on a financing order is entitled to the benefit of that order, even if it turns out to be legally or factually erroneous. Although § 364(e) speaks only of modification on appeal, it instantiates the principle that bankruptcy judges may make binding commitments to give priority to new credit. If creditors fear that the rug will be pulled out from under them, they will hesitate to lend. So § 364(e) and companion provisions . . . disable courts from backtracking on promises in the absence of bad faith, which is a very narrow exception. . . .

. . . A judge lacks the power to undo the priority granted by a financing order without first finding that the creditor acted in bad faith. Yet it may be that Judge Coar omitted this finding because Bank did not insist on it. Even in this court, Bank ignores the principle behind § 364(e) and is content to argue that Debtor did not meet the criteria for [equitable] subordination We take commercial cases as the parties frame them, so we shall press on . . . without implying

that this is the proper way to proceed in future cases.

Judge Coar gave two principal reasons for subordinating Bank's claim. One is that the "Bank was fully aware of the Debtor's plight, and its reliance upon the line of credit, and disregarded the consequences for the Debtor and its creditors." The other is that Bank obtained an "unfair advantage" by inducing suppliers to draw on the letters of credit after the financing order, thus promoting its position on these advances from unsecured to supersecured. Bank has made our analysis of the second reason simple by disclaiming priority for either the \$47,000 advanced to satisfy the letters of credit or the \$42,000 outstanding on the loan made in 1981. These are, and always have been, unsecured loans. . . . So although the financing order appears to give Bank priority on all of its loans, pre- and post-filing, Bank wisely concedes that the order could not properly have done so. The 1981 loan and the advances in 1984 to honor the letters of credit always were unsecured. The plan of reorganization properly treats them as unsecured.

Subordination matters only for the \$65,000 outstanding on advances under the line of credit authorized by the financing order. Section 510(c) [of the Bankruptcy Code] lets bankruptcy judges subordinate claims but does not provide criteria for the exercise of this power. Absence of statutory criteria commits the subject to the courts, to be worked out in the common law fashion. . . . Equitable subordination usually is a response to efforts by corporate insiders to convert their equity interests into secured debt in anticipation of bankruptcy. . . . Courts require the insiders to return to their position at the end of the line. . . . But Bank [has not attempted to jump to the head of the line in this manner.] It contributed new value under a contract, and it wants no more than the priority Judge Toles promised as the lure.

Cases subordinating the claims of creditors that dealt at arm's length with the debtor are few and far between. *Benjamin v. Diamond*, 563 F.2d 692 (5th Cir.1977) (*Mobile Steel Co.*), suggests that subordination depends on a combination of inequitable conduct, unfair advantage to the creditor, and injury to other creditors. Debtor submits that conduct may be "unfair" and "inequitable" for this purpose 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. Contracts specify the duties of the parties to each other, and each may exercise the privileges it obtained. Banks sometimes bind themselves to make loans (commitment letters and letters of credit have this effect) and sometimes reserve the right to terminate further advances. Courts may not convert one form of contract into the other after the fact, without raising the cost of credit or jeopardizing its availability. Unless pacts are enforced according to their terms, the institution of contract, with all the advantages private negotiation and agreement brings, is jeopardized. See *Travelers Insurance Co. v. Budget Rent-A-Car Systems, Inc.*, 901 F.2d 765 (9th Cir.1990); Alan Schwartz, *Justice and the Law of Contracts: A Case for the Traditional Approach*, 9 *Harv.J.L. & Pub. Pol'y* 107 (1986).

"Inequitable conduct" in commercial life means breach plus some advantage-taking, such as the star who agrees to act in a motion picture and then, after \$20 million has been spent, sulks in his dressing room until the contract has been renegotiated. See, e.g., *United States v. Stump*

Home Specialties Mfg., Inc., 905 F.2d 1117, 1120-21 (7th Cir.1990). . . . 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". Although courts often refer to the obligation of good faith that exists in every contractual relation, e.g., UCC § 1-201; Jordan v. Duff & Phelps, Inc., 815 F.2d 429, 438 (7th Cir.1987), this is not an invitation to the court to decide whether one party ought to have exercised privileges expressly reserved in the document. "Good faith" is a compact reference to an implied undertaking not to take opportunistic advantage in a way that could not have been contemplated at the time of drafting, and which therefore was not resolved explicitly by the parties. When the contract is silent, principles of good faith--such as the UCC's standard of honesty in fact, UCC § 1-201(19), and the reasonable expectations of the trade, UCC § 2-103(b) (a principle applicable, however, only to "merchants", which Bank is not)--fill the gap. They do not block use of terms that actually appear in the contract.

We do not doubt the force of the proverb that the letter killeth, while the spirit giveth life. Literal implementation of unadorned language may destroy the essence of the venture. Few people pass out of childhood without learning fables about genies, whose wickedly literal interpretation of their "masters' " wishes always leads to calamity. Yet knowledge that literal enforcement means some mismatch between the parties' expectation and the outcome does not imply a general duty of "kindness" in performance, or of judicial oversight into whether a party had "good cause" to act as it did. Parties to a contract are not each others' fiduciaries; they are not bound to treat customers with the same consideration reserved for their families. Any attempt to add an overlay of "just cause"--as the bankruptcy judge effectively did--to the exercise of contractual privileges would reduce commercial certainty and breed costly litigation. The UCC's requirement of "honesty in fact" stops well short of the requirements the bankruptcy judge thought incident to contractual performance. "[I]n commercial transactions it does not in the end promote justice to seek strained interpretations in aid of those who do not protect themselves." James Baird Co. v. Gimbel Bros., Inc., 64 F.2d 344, 346 (2d Cir.1933) (L. Hand, J.).

Bank did not break a promise at a time Debtor was especially vulnerable, then use the costs and delay of obtaining legal enforcement of the contract as levers to a better deal. Debtor and Bank signed a contract expressly allowing the Bank to cease making further advances. The \$300,000 was the maximum loan, not a guarantee. The Bank exercised its contractual privilege after loaning Debtor \$75,000; it made a clean break and did not demand improved terms. It had the right to do this for any reason satisfactory to itself. In re Prima Co., 98 F.2d 952, 965 (7th Cir.1938). . . .

Although Bank's decision left Debtor scratching for other sources of credit, Bank did not create Debtor's need for funds, and it was not contractually obliged to satisfy its customer's desires. The Bank was entitled to advance its own interests, and it did not need to put the interests of Debtor and Debtor's other creditors first. To the extent K.M.C., Inc. v. Irving Trust Co., 757 F.2d 752, 759-63 (6th Cir.1986), holds that a bank must loan more money or give more advance notice of termination than its contract requires, we respectfully disagree. First Bank of Whiting is not an eleemosynary institution. It need not throw good money after bad, even if other persons would catch the lucre. See Secon Service System, Inc. v. St. Joseph Bank & Trust

Co., 855 F.2d 406, 419 (7th Cir.1988); Mid-State Fertilizer Co. v. Exchange National Bank, 877 F.2d 1333 (7th Cir.1989). See also Comment, What's So Good About Good Faith? The Good Faith Performance Obligation in Commercial Lending, 55 U.Chi.L.Rev. 1335 (1988).

Debtor stresses, and the bankruptcy judge found, that Bank would have been secure in making additional advances. Perhaps so, but the contract did not oblige Bank to make all advances for which it could be assured of payment. Ex post assessments of a lender's security are no basis on which to deny it the negotiated place in the queue. Risk must be assessed ex ante by lenders, rather than ex post by judges. If a loan seems secure at the time, lenders will put up the money; their own interests are served by making loans bound to be repaid. What is more, the bankruptcy judge's finding that Bank would have been secure in making additional advances is highly questionable. The judgment of the market vindicates Bank. If more credit would have enabled Debtor to flourish, then other lenders should have been willing to supply it. Yet no one else, not even the SBA, would advance additional money to Debtor.

Both the bankruptcy and district judges characterized as inequitable Bank's decision in December 1983 not to extend additional credit unless Kham & Nate's filed a petition in bankruptcy (or obtained a guarantee from the SBA). According to the courts, this forced the firm into bankruptcy; having propelled it there, Bank was obliged to help. This is insufficient on two levels--first because filing for bankruptcy often helps rather than injures the firm (the automatic stay keeps the wolves and tax collectors from the door), and second because linking an offer of extra credit to a bankruptcy petition does not "force" a firm to file one. A bank may insist on security before lending. . . . If Kham & Nate's Shoes did not like that option, it was entitled to shop around.

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VACATED AND REMANDED.

Comment and Questions

1. As a secured creditor, in bankruptcy the Bank would be entitled to repayment from the security—collateral—provided by Kham & Nate's. In this case, the “collateral” consisted of a court order assuring the Bank that it would have the first claim on the debtor's assets in bankruptcy, even ahead of other creditors who had bargained for those assets as collateral. As an unsecured creditor, Bank would be last in priority in collecting on its loan; other, properly secured creditors would collect first. In effect, the bankruptcy judge's order condemned the Bank to recovering little or nothing on its loans.
2. What interests are involved in this dispute? Why does Judge Easterbrook side with the Bank? What reasons does he give for doing so? Do you agree with his reasoning?