Just the (Ipso) Fact(o)s, Ma'am

By Jordan B. Segal

> This Agreement shall terminate, without notice, (i) upon the institution by or against either party of insolvency, receivership or bankruptcy proceedings or any other proceedings for the settlement of either party's debts, (ii) upon either party making an assignment for the benefit of creditors, or (iii) upon either party's dissolution or ceasing to do business.
>
> —A sample ipso facto clause

Just about every businessperson has signed a contract containing an ipso facto clause. Such clauses commonly appear in commercial and residential leases, short- and long-term services agreements, and many other commercial transactions. Nevertheless, they are almost always unenforceable and have been since the adoption of the modern Bankruptcy Code in 1979.[1] It is tempting to assume that these form clauses persist only as a vestige of the pre-1979 bankruptcy system—under which ipso facto clauses were routinely enforceable—as if curmudgeonly law firm partners across the country simply refuse to update template agreements. However, despite their unenforceability, ipso facto clauses can still serve important commercial functions.

An ipso facto clause is any clause which provides that the contract is breached simply by virtue of a bankruptcy filing. In other words, the bankruptcy filing is "ipso facto"[2] a breach of the contract. As with most common contract clauses, there are myriad variations, including (1) a safe harbor if the bankruptcy is dismissed quickly (and particularly if the bankruptcy is involuntary); (2) triggering upon bankruptcy-like state court proceedings (such as assignments for the benefit of creditors) or a party's insolvency; or (3) that, upon the filing of a bankruptcy, the nonbreaching creditor has the discretion to declare the contract breached or that further notice is required before the contract is in breach.

The ipso facto breach may then entitle the nonbreaching party to a broad variety of remedies, including termination of the contract, acceleration of debt,[3] sale of membership units,[4] or even the use of specific liquidation or sale procedures.[5] However, some courts have declined to hold that clauses which are not specifically triggered upon bankruptcy but are more generally triggered upon "any transfer"—even if this, by necessity, includes transfer of an ownership interest to a trustee in bankruptcy—are ipso facto clauses.[6]

At least with regard to executory contracts and unexpired leases,[7] the Bankruptcy Code is abundantly clear: ipso facto clauses frustrate the purpose of bankruptcy by hampering rehabilitation efforts. Consequently, the code provides:

> Notwithstanding a provision in an executory contract…an executory contract…of the debtor may not be terminated or modified, and any right or obligation under such contract…may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract…that is conditioned on (A) the insolvency or financial condition of the debtor at any time before the closing of the case; (B) the commencement of a case under this title; or (C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement.[8]

The purpose behind this provision is simple: under the Bankruptcy Code, a debtor can assume or reject executory contracts during the debtor's reorganization. This ability would be rendered meaningless if the executory contract were in breach simply because of the bankruptcy filing.

Additionally, under 11 USC 541(c)(1)(A)–(B), an ipso facto clause cannot prevent a

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debtor's asset from becoming property of the bankruptcy estate upon filing:

> [A]n interest of the debtor in property becomes property of the estate…notwithstanding any provision in an agreement, transfer instrument, or applicable nonbankruptcy law…that is conditioned on the insolvency or financial condition of the debtor, on the commencement of a case under this title…

In other words, the interest a debtor would have (but for the bankruptcy filing) inures to the estate notwithstanding the filing of the bankruptcy. The policy underlying this provision is the same as 11 USC 365(e); that is, the purpose of a bankruptcy is to provide a debtor with a fresh start. That purpose is frustrated if the debtor breaches the very contracts he is seeking to reorganize merely because he attempted to reorganize them.

Taken together, these two provisions will invalidate most ipso facto clauses. However, as with most laws, there are several exceptions—situations in which ipso facto clauses are enforceable even under bankruptcy law. Most notably, 11 USC 365(e)(2)(A)–(B) carves out two specific types of contracts that may be terminated upon filing a bankruptcy: (1) certain personal services contracts (typically contracts that are to be performed by a person with special knowledge, judgment, taste, skill or ability) and (2) contracts to extend credit or issue securities. Additionally, 11 USC 555, 11 USC 556, 11 USC 559, and 11 USC 561 allow for enforcement of ipso facto provisions in specific securities and financial market transactions. A creditor may also petition the bankruptcy court to terminate the contract during the bankruptcy itself.

Despite these exceptions, most ipso facto clauses will be held invalid, at least in the context of a bankruptcy court. Why, then, are such clauses so common? First, in most formulations of ipso facto clauses, the default is triggered by bankruptcy or insolvency. Thus, in most state court proceedings, the provision will still be enforced (unless barred by separate state law).[9] Alternatively, the clause may still be enforced if the debtor fails to complete the bankruptcy or the bankruptcy is otherwise dismissed. Second, an ipso facto clause will be invalid *as to the debtor*, but that does not bar an action against a third-party *guarantor*. In either case, the only risk in including an ipso facto clause is that it might not be enforced, so most creditors or commercial lessors will still insist that it is included; moreover, most lessees will not object, as few people anticipate becoming insolvent or filing bankruptcy down the road.

When Congress revised the Bankruptcy Code in 1979, it clearly intended to eliminate most ipso facto clauses. Indeed, if a debtor is to successfully reorganize, he or she must start with a clean slate and not be saddled with a slew of defaulted contracts. Nevertheless, these clauses continue to be included in many commercial transactions. Clearly, creditors and lessors still find protection in these clauses—perhaps reasonably so. Nevertheless, creditor's and debtor's counsel should be cognizant that they are agreeing to a provision that may well be discarded by a court. As long as ipso facto clauses remain a common feature of commercial transactions, both potential debtors and creditors should consult their respective counsel to determine whether such a clause will be desirable or enforceable in any potential contract. ■

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ENDNOTES

1. 11 USC 101 *et seq.* and Moller & Folz Jr., *Chapter 11 of the 1978 Bankruptcy Code*, 58 NC L Rev 881, 905 (1980), available at <http://scholarship.law.unc.edu/cgi/viewcontent.cgi?article=2783&context=nclr> [https://perma.cc/C4DH-TMPZ] (accessed December 10, 2019).
2. Literally "by that fact," *Definition of ipso facto*, The Merriam-Webster.com Dictionary <https://www.merriam-webster.com/dictionary/ipso%20facto> (accessed December 10, 2019).
3. *In Re Ultra Petroleum Corp*, 913 F3d 533, 548 (CA 5, 2019)
4. *In re Denman*, 513 BR 720 (Bankr WD Tenn, 2014).
5. *In re Lehman Brothers Holding Inc*, 502 BR 383, 392 (Bankr SD NY, 2013). In this case, the court ruled that the clause at issue was an ipso facto clause and enforceable as an exception to the general rule of unenforceability.
6. E.g., *In re IT Group, Inc Co*, 302 BR 483, 488 (D Del, 2003). The court enforced a right of first refusal in economic interest in membership of an LLC, and held that "the Members' right of first refusal is not an ipso facto clause. Rather, the right of first refusal is triggered by any transfer (other than a transfer to an affiliate) and not by a member filing for bankruptcy. Where, as here, the right of first refusal clause is not an ipso facto provision, courts have concluded that a right of first refusal is enforceable notwithstanding the fact that the debtor is in bankruptcy."
7. Even though executory contracts receive detailed treatment under the Bankruptcy Code, the code does not define the term "executory contracts," *In Re Terrell*, 892 F2d 469, 472 (CA 6, 1989). In this case, the court mirrored other courts in adopting the definition of executory contracts from Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 Minn L Rev 439, 460 (1973): "a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other."
8. 11 USC 365(e)(1)(A)–(C). See also *Days Inn of America, Inc v 161 Hotel Group, Inc*, 55 Conn App 118, 124–125; 739 A2d 280 (1999) and 1978 USCCAN 5963, 6304–6305 ("Subsection (e) invalidates *ipso facto* or bankruptcy clauses. These clauses, protected under present law, automatically terminate the contract or lease, or permit the other contracting party to terminate the contract or lease, in the event of bankruptcy. This frequently hampers rehabilitation efforts. If the trustee may assume or assign the contract under the limitations imposed by the remainder of the section, the contract or lease may be utilized to assist in the debtor's rehabilitation or liquidation.").
9. Michigan courts appear to not have considered this question. However, other states have split on the question, e.g., *In re Ernie Haire Ford Inc*, 403 BR 750, 757–760 (MD Fla, 2009) (holding that termination by automobile finance companies of contract purchase agreements with Chapter 11 debtor-automobile dealer under the terminable-at-will provisions of the agreements, solely because debtor had filed Chapter 11 petition, violated implied covenant of good faith and fair dealing under Florida law and constituted impermissible exercise of companies' discretion) and *First Nationwide Bank v Brookhaven Realty Assocs*, 223 AD2d 618, 621; 637 NYS2d 418 (NY App Div, 1996) (finding a "bankruptcy default" provision in mortgage nonrecourse agreement enforceable under New York law).