I. Enforceability of "Termination on Bankruptcy" or *Ipso Facto* Contract Clauses.

A. What Are *Ipso Facto* Clauses?

1. Definition and Underlying Purpose

Termination on bankruptcy, or *ipso facto* clauses, are contract terms "according to which the insolvency of a party automatically terminates the contract or constitutes a material breach."[1] These clauses therefore purport to automatically terminate or give the non-debtor party the right to terminate the contract if some specified triggering event occurs.[2] *Ipso facto* provisions may therefore provide for the termination of the contract with or without notice to the debtor party. These clauses may be triggered by bankruptcy proceedings, the insolvency of a party, assignments for the benefit of creditors, or other events. [3]

Ipso facto clauses thus serve two functions. First, they purport to allow a party to avoid a contractual relationship with a financially unstable counterpart.[4] Second, they seek to restrain a bankrupt debtor party from strategically electing to assume only those contracts that will grant it a windfall at the expense of the non-debtor party.[5]

2. Typical Language Used in *Ipso Facto* Clauses

A template *ipso facto* clause reads:

> Each of the following events or conditions shall constitute an "Event of Default":
>
> (a)the Company shall commence any case, proceeding, or other action (i) under any existing or future Requirement of Law relating to bankruptcy, insolvency, reorganization, or other relief of debtors, seeking to have an order for relief entered with respect to it, or seeking to adjudicate it as bankrupt or insolvent, or seeking reorganization, arrangement, adjustment, winding-up, liquidation, dissolution, composition, or other relief with respect to it or its debts, or (ii) seeking appointment of a receiver, trustee, custodian, conservator, or other similar official for it or for all or any substantial part of its assets, or the Company shall make a general assignment for the benefit of its creditors;
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> (b)there shall be commenced against the Company any case, proceeding, or other action of a nature referred to in clause (a) above which (i) results in the entry of an order for relief or any such adjudication or appointment or (ii) remains undismissed, undischarged, or unbonded for a period of [NUMBER] days; or

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[1] *See In re S. Pac. Funding Corp.*, 268 F.3d 712, 715 (9th Cir. 2001); *In re Cole*, 226 B.R. 647, 652 (B.A.P. 9th Cir. 1998).
[2] *See In re Peaches Records & Tapes, Inc.*, 51 B.R. 583, 585 (B.A.P. 9th Cir. 1985)
[3] *See Summit Inv. & Dev. Corp. v. Leroux*, 69 F.3d 608, 609 (1st Cir. 1995); *In re Lee W. Enterprises, Inc.*, 179 B.R. 204, 209 (Bankr. C.D. Cal. 1995); *151 W. Assocs. v. Printsiples Fabric Corp.*, 61 N.Y.2d 732, 733 (1984).
[4] *See* Andrea Coles-Bjerre, *Ipso Facto: The Pattern of Assumable Contracts in Bankruptcy*, 40 N.M. L. Rev. 77 (2010).
[5] *See Id.* at 82.

(c)the Company shall generally not, or shall be unable to, or shall admit in writing its inability to, pay its debts as they become due and payable.[6]

Another typical *ipso facto* clause reads:

> 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.

B. Types of Contracts that Ordinarily Feature *Ipso Facto* Clauses.

Though *ipso facto* provisions are pervasive and found in almost every type of contract, no authorities describe the presence of such terms in asset purchase agreements and the reasons for including them in such contracts.

C. Enforceability of *Ipso Facto* Clauses.

Generally, courts do not enforce *ipso facto* provisions. Defaults contemplated by *ipso facto* provisions are usually impossible to cure; a debtor cannot easily cure insolvency, the filing of a bankruptcy case, or an assignment for the benefit of creditors. Enforcement of *ipso facto* clauses would mean that the debtor or trustee could almost never assume ongoing contracts or leases.[7] This would prevent debtors from performing under "beneficial contracts that otherwise would have terminated automatically or would have been terminated by the other contracting party." Enforcement of *ipso facto* clauses therefore undermines public policy promoting debtor rehabilitation.[8] Thus, the general rule against the enforceability of *ipso facto* clauses protects debtors, and by extension, their creditors.[9]

1. Statutory Authority

Section 365(e) of Title 11 of the United States Code provides:

> (1) Notwithstanding a provision in an executory contract or unexpired lease, or in applicable law, an executory contract or unexpired lease of the debtor may not be terminated or modified, and any right or obligation under such contract or lease may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract or lease 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

[6] Ipso Facto Clause, PRACTICAL LAW STANDARD CLAUSES 1-381-3321

[7] *See In re Claremont Acquisition Corp., Inc.*, 113 F.3d 1029, 1033 (9th Cir. 1997).

[8] *See In re S. Pac. Funding Corp.*, 268 F.3d at 716.

[9] Andrea Coles-Bjerre, *Ipso Facto: The Pattern of Assumable Contracts in Bankruptcy*, 40 N.M. L. Rev. 77, 81 (2010).

(C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement.[10]

Section 541(c)(1)(B) is a related provision establishing that "an interest of the debtor in property becomes property of the estate" regardless of any "agreement, transfer instrument, or applicable nonbankruptcy law" to the contrary conditioned on the same three grounds articulated in § 365(e), where that provision "effects or gives an option to effect a forfeiture, modification, or termination of the debtor's interest in the property."[11] Thus, this section prevents a non-debtor party from denying a debtor property or rights under a contract because of its financial condition.

Section 363(l) permits a trustee to use, sell, or lease the debtor's property during the pendency of the bankruptcy case, notwithstanding an *ipso facto* clause.[12] Finally, § 545(1) allows a trustee to avoid a statutory lien when the debtor petitions for bankruptcy, becomes insolvent, appoints a custodian or authorizes one to take possession, or becomes the subject of any other sort of insolvency proceeding.[13]

2. Case Authority

a. California/Ninth Circuit

§ 365(e)

In re Peaches Records & Tapes, Inc.[14]

In this case, Nehi Record Distributing Corporation ("Nehi") leased commercial properties from non-debtors. Nehi entered into a sublease with Peaches Records and Tapes, Inc. ("Peaches"). Nehi was the guarantor of Peaches's sublease. The master lease and sublease agreements provided non-debtors a right of reentry "should the lessee or its guarantor become a bankrupt or insolvent or enter into any debtor proceedings." Nehi and Peaches filed petitions under Chapter 11 on the same day, and their actions were consolidated. Peaches attempted to assign its sublease to a third party. Non-debtors challenged § 365(e). Alternatively, they argued that the bankruptcy filing by Nehi, the guarantor of the sublease, was an enforceable ground for termination.

The court applied § 365(e) and refused to enforce the *ipso facto* provision. Moreover, it held that, because Nehi and Peaches's Chapter 11 petition was consolidated, they were a single debtor for purposes of § 365(e). Thus, Peaches could assume the lease and assign it to a third party.

In re Lee West Enterprises, Inc.[15]

This case is illustrative of the fact that provisions resembling *ipso facto* clauses in their effect are not invalidated by § 365(e). A debtor operated a series of car dealerships as a franchisee of a series of non-debtor companies. The franchise agreement empowered the non-debtors to terminate the

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[10] *See* 11 U.S.C. § 365(e).

[11] *See* 11 U.S.C. § 541(c)(1)(B).
[12] *See* 11 U.S.C. § 363(l).
[13] *See* 11 U.S.C. § 545(1).
[14] *See In re Peaches Records & Tapes, Inc.*, 51 B.R. 583, 587 (B.A.P. 9th Cir. 1985)
[15] *See In re Lee West Enterprises, Inc.*, 179 B.R. 204 (Bankr. C.D. Cal. 1995).

relationship if debtor failed to conduct regular operations during customary business hours or ceased to function as a going concern. The debtor became insolvent, commenced a voluntary action for bankruptcy, and temporarily shuttered its operations.

The trustee moved to assume and assign the debtor's rights under the contracts, and the non-debtor companies opposed the motion. The trustee argued that "to the extent the closure provisions…relate[d] to the insolvency or financial condition of the [d]ebtor, they [were] invalid *ipso facto* clauses." The court found that the default was not based on the debtor's financial condition, "but rather on the closure of the dealership's operations. The [non-debtors] did not invoke the closure provisions at the onset of the case or during the pendency of the Chapter 11 proceedings." Thus, the non-debtors were entitled to terminate the contract and divest the debtor of any rights it enjoyed thereunder.[16]

§ 541(c)

In re Thorpe Insulation Co.[17]

In this case, Thorpe, a distributor of asbestos products entered into a settlement agreement with Continental, an insurer, after the parties disputed Thorpe's coverage limits. As part of the agreement, Thorpe agreed not to "assign, transfer, convey or sell…to any entity or person any cause of action…arising out of or connected with the matters released." Thorpe neared its coverage limits with its remaining insurers, and negotiated with them. The remaining insurers agreed to (1) fund a statutorily authorized trust to pay damages to individuals with claims against Thorpe, and (2) assign their contribution, indemnity, and subrogation rights against Continental to Thorpe and the trust. In exchange, Thorpe agreed to file for bankruptcy.

Continental argued that Thorpe violated the settlement agreement by acquiring the insurers' contribution, indemnity, and subrogation rights against Continental, and by assigning those rights to the trust. The court found that it "is against public policy for a debtor to waive the prepetition protection of the Bankruptcy Code…. Otherwise, astute creditors would routinely require their debtors to waive." The settlement agreement contravened public policy though it did not mention bankruptcy, because it effectively forced Thorpe to waive its protections under the Bankruptcy Code by limiting its ability to assign its property.

Additionally, the court found that the agreement violated § 541(c), which provides that interests of the debtor becomes property of the estate upon the filing of a Chapter 11 case. Thus, Thorpe had "the right to acquire [the] assets and assign them to the [] trust."

b.Delaware

Milford Power Co., LLC v. PDC Milford Power, LLC,[18]

In this case, a group of lenders ("Milford") assumed 95% control of an LLC established to operate an electric generation facility. PDC was a single-purpose entity that owned 5% of the LLC originally, and continued to own 5% of the LLC after Milford assumed control. The LLC agreement vested

[16] *See also In re Cole*, 226 B.R. at 647 (holding that *ipso facto* clauses are "generally unenforceable in bankruptcy.").
[17] *See In re Thorpe Insulation Co.*, 671 F.3d 1011, 1025 (9th Cir. 2012).
[18] *See* 866 A.2d 738 (Del. Ch. 2004)

management power in the members. After assuming control of the LLC, the Lenders attempted to foreclose PDC's membership interest. PDC responded by filing a voluntary petition for bankruptcy. Milford argued that, pursuant to a term in the LLC agreement, PDC had "withdrawn from the company" "immediately" after it "voluntarily file[d] with the Bankruptcy Court a petition seeking an order for relief under the Federal bankruptcy laws." Milford asserted that it owed PDC no consideration for its withdrawal. PDC asserted that this term was an unenforceable *ipso facto* provision, and that even if the provision was enforceable, it did not require PDC to transfer its membership.

The court found that § 365(e) and § 541(c) do apply to invalidate *ipso facto* provisions. However, the court noted that § 365(e)(2) contains an exception to § 365(e) specifying that *ipso facto* provisions may be enforceable where "applicable law excuses" the non-debtor "from accepting performance from or rendering performance to the trustee or to an assignee" of the contract. Furthermore, § 365(c)(1) bars a trustee from assuming a contract where applicable law excuses the non-debtor from accepting substituted performance. (See below for detailed discussion).

The court determined the Delaware LLC Act establishes that "unique relationships…exist among members of LLCs" that protect "solvent members from being forced into relationships they did not choose that result from the bankruptcy of one of their chosen co-investors." LLCs are typically closely held, and members share managerial and voting rights. Thus, strong policy reasons, applicable state law, and § 365(e)(2) supported a finding that *ipso facto* provisions are enforceable.

The court limited its ruling to membership rights. The policy considerations enumerated did not support the conclusion that members would be excused from rendering economic performance to an assignee. Thus, debtor-members can transfer their "bare economic rights," but not their voting and managerial rights.

The *ipso facto* clause providing that PDC surrendered its managerial and voting rights was enforceable because the Delaware LLC Act provides that members of an LLC need not accept substituted performance from assignees. On the other hand, the LLC Act did not exempt members from accepting or rendering economic performance to an assignee. Thus, DPC was free to transfer its financial rights in the LLC, and the *ipso facto* clause would not be enforced against those rights.

c. New York

<u>In re Lehman Bros. Holdings Inc.</u>[19]

This case provides a thorough discussion of § 365(e) and § 541(c) under New York law.

In this case, LBSF, an indirect subsidiary of LBHI, was party to a series of credit Swap agreements. Under those agreements, LBSF purchased credit protection from entities ("Issuers"). The Issuers also executed notes in favor of a series of noteholders. All of the notes and Swaps were secured by collateral, which was held by a trustee for the benefit of the Issuers' creditors. LBSF and the noteholders thus held competing interest in the collateral.

Under the Swap agreement, LBSF would enjoy priority over the noteholders if the collateral was to be liquidated and distributed, unless LBSF filed for bankruptcy. If LBSF defaulted, the priorities

[19] *See In re Lehman Bros. Holdings Inc.*, 533 B.R. 476 (Bankr. S.D.N.Y. 2016)

inverted and the noteholders would be paid first. Shortly thereafter, LBHI, the indirect parent of LBSF, filed for bankruptcy under Chapter 11. LBHI was the guarantor of LBSF under the Swap. The trustees, understanding that LBSF was insolvent, delivered termination notices to LBSF. The trustees then liquidated the collateral securing the notes and Swaps and distributed it to the noteholders before paying LBSF. LBSF filed for bankruptcy only *after* the trustees terminated the Swap and distributed much of the collateral to the noteholders.

LBSF argued that the priority provisions were unenforceable *ipso facto* provisions because they modified a debtor's rights under a contract solely because of its bankruptcy filing.

The court noted that *ipso facto* clauses are generally unenforceable under § 365(e) and § 541(c). However, the court discerned that LBSF was involved in two distinct types of transactions. The first type ("Type 1") fixed LBSF's right to priority over the noteholders *unless* LBSF defaulted. Type 1 transactions thus granted a right to priority to LBSF—it was "in the money" unless it filed for bankruptcy. The second type ("Type 2") did not fix any right to priority. Rather, no party had a right to priority until the Swap was terminated by some default. At that point, priority would be determined. It turned out that LBSF's default was the event that terminated the Swaps. Thus, in the Type 2 transactions, LBSF never enjoyed a "right" to priority; the provisions did not modify or terminate any right enjoyed under the contract. The priority provisions governing Type 2 transactions were accordingly not *ipso facto* clauses. The provisions divesting LBSF of priority in the Type 1 transactions were, however, unenforceable *ipso facto* provisions; they terminated a fixed right under the contract.

The court also determined that the "commencement of the case" occurred when LBSF—and not LBHI, its parent, filed for bankruptcy. "[T]he relevant petition date is the petition date of the debtor whose rights have been modified or whose property has been affected." "The phrase 'the case' in such sections refers only to the case of the debtor who is a party to the relevant executory contract." Thus, all terminations effected after LBHI defaulted but before LBSF filed for bankruptcy did not fall within the embrace of § 365(e) and § 541(c).

In sum, the *ipso facto* clauses were enforceable as to all Type 2 transactions and all terminations that occurred before LBSF filed for bankruptcy.

3. Limited Exception for Executory Contracts

Section 365(e)(2) recognizes exceptions to the general rule against enforcement of *ipso facto* clauses.[20] The general rule against enforcement does not apply to executory contracts in two cases.[21] First, *ipso facto* clauses may be enforced if: (1) "applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to the trustee or an assignee of such contract," and (2) the non-debtor party does not consent to the assumption or assignment. Second, *ipso facto* clauses may be enforced where the contract "is a contract to make a loan, or extend other debt financing or financial accommodations" for the benefit of the debtor, or "to issue a security of the debtor." Thus, these types of contracts may be terminated by the insolvency or bankruptcy of a party to the agreement.

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[20] *See also* § 365(c)(2) which prevents a trustee from assuming or assigning executory contracts and expired leases under the same conditions as § 365(e)(2).
[21] *See* § 365(e)(2).

An executory contract is one "on which performance is due to some extent on both sides," such that failure to complete performance would constitute a material breach by both parties.[22]

Applicable non-bankruptcy law renders an array of contracts nonassignable, and thus places them within the exception established by § 365(e)(2). Contracts for personal services fall within the exception.[23] There is a split of authority as to whether franchise agreements are assignable.[24] State law usually makes partnership agreements nonassignable because they are contracts "based upon personal trust and confidence."[25] Because, in trademark licensing cases, "the identity of the licensee is crucially important to the licensor," "federal trademark law generally bans assignment of trademark licenses absent the licensor's consent."[26] The same is true of nonexclusive patent licenses.[27]

D. Why do Parties Insert *Ipso Facto* Provisions into M&A Agreements?

Parties may insert *ipso facto* provisions into M&A agreements because they give a non-debtor the ability to terminate the contract before a bankruptcy action is filed.[28] [29] Non-debtors who terminate before bankruptcy proceedings begin may to "end business dealings with the debtor" or "reinstate and renegotiate the contract on more favorable terms."[30] If a non-debtor party does not wish to terminate the contract, it may grant short-term waivers, monitor the solvency of the debtor, and secure letters of credit and guaranties before the debtor may file for bankruptcy.[31]

Additionally, a non-debtor may insert an *ipso facto* provision into the agreement that becomes effective on the insolvency of a guarantor, as opposed to the debtor; this will avoid the unenforceability issues raised by § 365(e).[32]

Ipso facto provisions are not foolproof in the M&A context, however. In *In re Ardent, Inc.*, the sole shareholders of Business Anywhere, Inc. ("BAC") entered into a merger agreement with another

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22 *See In re Sentle Trucking Corp.*, 839 F.2d 533, 536 (Bankr. N.D. Ohio 1988); *In re Kemeta, LLC*, 470 B.R. 304, 322-25 (Bankr. D. Del. 2012).

23 *See In re Health Plan of Redwoords*, 286 B.R. 407, 409 (Bankr. N.D. Cal. 2002) ("Whether or not a contract is a personal services contract is a question of fact to be made under state law." "In order to be considered a personal services contract, there must be a special relationship between the parties or the party to perform must possess special knowledge or a unique skill, such that no performance save that of the contracting party could meet the obligations of the contract.").

24 *See In re Claremont Acquisition Corp., Inc.*, 113 F.3d 2019, 1031-32 (9th Cir. 1997) (recognizing split in authority); *In re Pioneer Ford Sales, Inc.,* 729 F.2d 27, 28-30 (1st Cir. 1984); *In re Van Ness Auto Plaza, Inc.*, 120 B.R. 545, 546 (Bankr. N.D. Cal. 1990) (finding franchise agreements nonassignable where a manufacturer reasonably withholds consent to transfer).

25 *See In re Harms*, 10 B.R. 817, 821 (Bankr. D. Colo. 1981)

26 *See In re Trump Entm't Resorts, Inc.*, 526 B.R. 116, 124 (Bankr. D. Del. 2015).

27 *See In re Catapult Entertainment, Inc.*, 165 F.ed 747, 750, 752 (9th Cir. 1999).

28 *See* Executory Contracts and Leases in Bankruptcy: Strategies for Non-Debtors, PRACTICAL LAW AND PRACTICAL LAW FINANCE.

29 *See In re Lehman Bros. Holdings Inc.*, 553 B.R. 476, 495 (Bankr. S.D.N.Y. 2016) ("under [sections 541(c)(1) and 365(e)(1)], unless a debtor's right has been modified after its petition date, enforcement of the contractual provision at issue, even if conditioned on the commencement of 'a' bankruptcy case, is not contrary to the Code.").

30 *See Id.*

31 *See Id.*

32 *See Id.*; *but see also Peaches Records & Tapes, Inc.*, 51 B.R. at 590 (declining to enforce an *ipso facto* clause where the guarantor and debtor's bankruptcy petitions have been consolidated, "rendering these parties into a single debtor, for purposes of the Bankruptcy Code.").

corporation, CAIS.[33] Under the agreement, CAIS was obligated to pay the BAC shareholders $200,000 cash and provide $3,500,000 in CAIS stock over three installments. CAIS failed to provide the final $1,000,000 in CAIS stock. CAIS apparently filed a bankruptcy petition and attempted to assume the Merger Agreement.

The court found that CAIS was barred from assuming the contract by § 365(c)(2), reasoning that the contract was "clearly" a contract "to issue security of the debtor." CAIS claimed that the merger agreement did not fall into the exceptions recognized by § 365(c)(2) because "stock was only a part of the consideration that the movants were to receive" under the merger. The court found that the $3.5m in stock was the "prime consideration" flowing to the BAC shareholders. Furthermore—and more significantly—the court ruled that § 365(c)(2) "makes no distinction between executory contracts which contemplate that securities shall be the sole consideration and executory contracts that contemplate securities shall only be one element of the consideration." The court did not disturb previous decisions that did not enforce *ipso facto* provisions where "the extension of credit or the issuance of security is incidental to a contract," however, because the stock "made up the lion's share of the consideration" that the BAC shareholders were to receive under the merger. Thus, the stock was not merely "incidental" to the sale.

Parties inserting *ipso facto* provisions into M&A agreements must be careful to structure their transactions so that they do not fall into the exceptions established by § 365(e)(2) and (c)(2). Where securities or financial accommodations make up anything more than an "incidental" portion of the consideration to be received, parties run the risk of triggering these exceptions and rendering *ipso facto* provisions unenforceable. If the parties in *Ardent* had recharacterized the deal so that the BAC shareholders would have been compensated by cash payments or the equivalent, CAIS's trustee may have been able to assume the merger agreement, and the BAC shareholders would not have been entitled to terminate the contract.

[33] *See In re Ardent, Inc.*, 275 B.R. 122 (Bankr. D.D.C. 2001).