AMERICAN BANKRUPTCY INSTITUTE
JOURNAL
The Essential Resource for Today's Busy Insolvency Professional

Feature

BY PAUL RUBIN

Not Every *Ipso Facto* Clause Is Unenforceable in Bankruptcy

Paul Rubin
Herrick, Feinstein LLP
New York

Paul Rubin is a partner in the Bankruptcy and Restructuring Department of Herrick, Feinstein LLP in New York.

An "*ipso facto*" clause is a contract or lease provision that terminates or modifies a debtor's interest in property based on the insolvency or financial condition of the debtor or on the commencement of a bankruptcy case concerning the debtor.[1] Generally speaking, the Bankruptcy Code invalidates clauses in contracts that deprive a debtor of the right to use, sell or lease property based on the debtor's insolvency or financial condition, or on the commencement of a case under the Bankruptcy Code concerning the debtor.[2] The Code also invalidates provisions in agreements, transfer instruments and applicable nonbankruptcy law that would otherwise operate to prevent a debtor's property from becoming property of its bankruptcy estate based on the debtor's insolvency or financial condition or on a bankruptcy filing.[3]

The Code further limits the enforceability of *ipso facto* clauses contained in executory contracts.[4] An executory contract of a debtor may not be terminated or modified after the filing of the debtor's bankruptcy case solely because of an *ipso facto* clause, unless applicable law excuses a party to such contract other than the debtor from accepting performance from or rendering performance to the debtor or an assignee of the contract, and such party does not consent.[5] Moreover, should a debtor seek to assume an executory contract, the nondebtor counterparty may not demand payment based on a default triggered solely by an *ipso facto* clause.[6]

Bankruptcy interdicts *ipso facto* clauses because they lead to the forfeiture of valuable assets and hamper the debtor's rehabilitation or liquidation.[7] However, Congress included specific exceptions in the Bankruptcy Code that allow for the enforcement of *ipso facto* clauses in securities contracts, commodities and forward contracts, as well as other contracts utilized by sophisticated financial participants.[8]

Where Courts Disagree: The Bankruptcy Default Clause

One specific type of *ipso facto* clause that has engendered controversy is the bankruptcy default clause, which is a clause providing that a party's bankruptcy filing constitutes an event of default under the parties' agreement. The Bankruptcy Code does not expressly invalidate all bankruptcy default clauses contained in nonexecutory contracts, but some courts have held that they are unenforceable as a matter of law. In *Riggs Nat'l Bank v. Perry*,[9] a secured creditor sought relief from the automatic stay so that it could compel the chapter 7 debtor to surrender the automobile pledged to it. The lender maintained that the debtor's bankruptcy filing, which constituted a breach of their installment sales contract, qualified as cause for stay relief under § 362(d)(1) of the Bankruptcy Code.[10] The Fourth Circuit Court

1 *See In re Qimonda AG Bankruptcy Litigation*, 433 B.R. 547, 562 n.20 (E.D. Va. 2010); *see also* H.R. Rep. No. 595, 95th Cong., 1st Sess. 348-49 (1977); S. Rep. No. 989, 95th Cong., 2d Sess. 59 (1978) (*ipso facto* clauses automatically terminate contract or lease, or permit other contracting party to terminate contract or lease, in event of bankruptcy).
2 *See* 11 U.S.C. § 363(l).
3 *See* 11 U.S.C. § 541(c)(1).
4 The Bankruptcy Code does not define the term "executory contract." As noted in *In re Penn Traffic Co.*, 524 F.3d 373, 379 (2d Cir. 2008), most courts and scholars look to the *Countryman* test, which defines an "executory contract" as 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 the performance would constitute a material breach excusing the performance of the other." Vernon Countryman, "Executory Contracts in Bankruptcy: Part I," 57 *Minn. L. Rev.* 439, 460 (1973). If the performance of one side of the contract has been completed, it is no longer executory. H.R. Rep. 595, 95th Cong., 1st Sess. 347 (1977); S. Rep. No. 989, 95th Cong. 2d Sess. 58 (1978).
5 *See* 11 U.S.C. § 365(e)(1).
6 *See* 11 U.S.C. § 365(b)(2).
7 H.R. Rep. No. 595, 95th Cong., 1st Sess. 348 (1977); S. Rep. No. 989, 95th Cong., 2d Sess. 59 (1978).
8 *See, e.g.*, 11 U.S.C. § 555 (securities contracts), 11 U.S.C. § 556 (commodities and forward contracts), 11 U.S.C. § 559 (repurchase agreements), 11 U.S.C. § 560 (swap agreements) and 11 U.S.C. § 561 (master netting agreements and safe-harbor contracts in chapter 15 proceedings).
9 729 F.2d 982, 984 (4th Cir. 1984).
10 *Riggs*, 729 F.2d at 984.

of Appeals affirmed the lower courts' rulings denying the lender's motion. The circuit court could have simply held that a bankruptcy filing is not sufficient "cause" for modification of the automatic stay under § 362(d)(1). Instead, the Fourth Circuit went further, stating that enforcement of a bankruptcy default clause would "clearly intrude upon the Bankruptcy Code's clear purpose of creating a way by which debtors may obtain a fresh start toward reorganization of their financial obligations" and would "deprive the debtor of the Code's liquidation procedures."[11]

In a similar situation, the bankruptcy court in *General Motors Acceptance Corp. v. Rose (In re Rose)*[12] also ruled that bankruptcy default clauses are invalid in all types of contracts. The court gleaned this result from its review of the legislative history of § 365(e) of the Bankruptcy Code.[13] It declared that "there is simply no reason to assume that Congress intended to make these clauses enforceable only in nonexecutory contracts." Such an assumption would be directly contrary to the spirit and purposes of the Bankruptcy Code, which enables debtors to make a fresh start.[14]

Relying heavily on *Rose*, a Delaware federal district court also held that bankruptcy default clauses in all types of contracts are unenforceable as a matter law, and therefore disallowed the claims of unsecured bank lenders for post-petition interest at the default rate.[15] This court stated that it agreed with the "the general trend of the federal courts that the prohibition against *ipso facto* clauses is not limited to actions based on §§ 541(c) and 365(e)."[16] This statement is peculiar for two reasons.

First, the court later went to great lengths in its decision to distinguish its holding from that of the court in *In re General Growth Properties Inc.* (*GGP*),[17] wherein a bankruptcy default clause was held to be enforceable so as to allow a secured creditors' claim for default-rate interest. If the *W.R. Grace* court believed that all bankruptcy-default provisions were unenforceable, rather than distinguishing the facts in *GGP*, it should have directly challenged its holding and argued that the *GGP* court erred because a bankruptcy default clause may not be enforced under any circumstance.

Second, the modern trend seems to favor enforcement of bankruptcy default clauses in nonexecutory contracts, at least where invocation of the clause does not interfere with the debtor's obtaining a fresh start. For example, in the second *Saint Vincent's* bankruptcy case, an oversecured creditor asserted a claim for, among other things, an "acceleration and indemnification," which the creditor argued was due under its mortgage because of an acceleration of the loan's maturity date triggered by the debtor's bankruptcy filing.[18] The debtor argued that this provision was an unenforceable *ipso facto* clause under §§ 365(e)(1) and 541(c)(1)(B) of the Code. The court observed that "[g]enerally, mortgages are not executory contracts"[19] and found that § 365(e)(1) was inapplicable because the relevant loan documents were not executory contracts.[20] The *Saint Vincent's* court also concluded that § 541(c)(1)(B) did not invalidate the acceleration and indemnification clause because it did not prevent the lender's collateral from becoming property of the debtor's estate.[21]

In *GGP*,[22] Hon. **Allan L. Gropper** upheld an oversecured lender's right to collect interest at the default rate based on a clause in its note providing for the automatic imposition of interest at the default rate upon the borrower's bankruptcy filing. The debtor did not claim that the note in question was an executory contract, and the court noted that "loan agreements are generally not considered to be executory contracts."[23] However, relying on *Rose*,[24] the debtor in *GGP* nevertheless contended that *ipso facto* clauses are generally disfavored and should not be enforceable, even when they are contained in a nonexecutory contract.

Judge Gropper rejected this argument, stating that *Rose* was not strong authority because it relied on the legislative history of § 365 to support its argument that *ipso facto* clauses should be invalid for all purposes, but the *Rose* court failed to explain why legislative history explaining a prohibition on *ipso facto* clauses contained in executory contracts should apply to nonexecutory contracts.[25] The *GGP* bankruptcy court also noted that § 365's invalidation of *ipso facto* clauses in executory contracts represented a departure from the Bankruptcy Act, which permitted enforcement of *ipso facto* clauses.[26] *Rose* did not explain why the Bankruptcy Code singled out only executory contracts and unexpired leases for special treatment under § 365(e)(1).[27] In other words, if Congress wanted to invalidate all *ipso facto* clauses in all contracts except for those expressly permitted elsewhere in the Code, it could have easily "covered the waterfront" with a blanket prohibition, but Congress chose not to do so.

Citing *Riggs*, the *GGP* court observed that courts have declined to enforce a bankruptcy-default clause where it may impede a debtor's ability to enjoy a fresh start. Since the *GGP* debtor and its affiliates were highly solvent, had confirmed a reorganization plan and had successfully emerged from bankruptcy, this was not a legitimate basis to invalidate the bankruptcy default clause in *GGP*.[28]

More recently, the court in *American Airlines*[29] stated that it was persuaded by Judge Gropper's reasoning in *GGP* and held that a bankruptcy default clause contained in a nonexecutory contract was not an unenforceable *ipso facto* clause. Similarly, Hon. **Elizabeth S. Stong** of the U.S. Bankruptcy Court for the Eastern District of New York has also upheld the enforceability of a bankruptcy default clause.[30] In so holding, Judge Stong permitted an oversecured mortgagee to collect post-petition interest at the default rate set forth in its mortgage.

11 *Id.* at 984-85.
12 21 B.R. 272, 276 (Bankr. D.N.J. 1982).
13 *See id.*
14 *Id.* (citations omitted).
15 *In re W.R. Grace & Co.*, 475 B.R. 34 (D. Del. 2012).
16 *Id.* at 154.
17 451 B.R. 323 (Bankr. S.D.N.Y. 2011).
18 *Katzenstein v. VIII SV5556 Lender LLC (In re Saint Vincent's Catholic Medical Centers of New York)*, 440 B.R. 587 (Bankr. S.D.N.Y. 2010).
19 440 B.R. at 601.
20 Applying the *Countryman* test (*see supra* n.4), the court concluded that none of the obligations of the lender under the mortgage was so material that a breach would excuse the debtor's obligation to perform. *See In re Saint Vincent's*, 440 B.R. at 601.
21 *See id.* at 601-02.
22 451 B.R. 323 (Bankr. S.D.N.Y. 2011).
23 *Id.* at 329.
24 21 B.R. 272, 276 (Bankr. D.N.J. 1982).
25 451 B.R. at 330, n.12.
26 *See id.*
27 *See id.*
28 *See id.* at 330-31.
29 *In re AMR Corp.*, 485 B.R. 279, 296-97 (Bankr. S.D.N.Y. 2013).
30 *20 Bayard Views LLC v. W Financial Fund LP (In re 20 Bayard Views LLC)*, Case No. 09-50723 (Bankr. E.D.N.Y. Aug. 11, 2010) (unpublished oral decision).

Statutory Construction Rules Should Govern

The U.S. Supreme Court has repeatedly stated that the starting point in discerning congressional intent is the existing statutory text.[31] It is well established that when the statute's language is plain, the sole function of the courts — at least where the disposition required by the text is not absurd — is to enforce it according to its terms.[32]

There is no room for doubt that Congress invalidated *ipso facto* clauses that would effectuate a forfeiture (§ 541(c)) or prevent the debtor from using its property (§ 363(l)). Congress also rendered unenforceable *ipso facto* clauses contained in executory contracts, subject to certain exceptions (§ 365(e)). In contrast, as noted above, Congress expressly provided that *ipso facto* clauses contained in securities contracts, forward contracts, repurchase agreements and other specified contracts are enforceable notwithstanding § 365(e)(1).[33]

It is evident that Congress decided not to include a provision in the Bankruptcy Code that invalidates all *ipso facto* provisions. That decision is particularly significant because *ipso facto* provisions were enforceable before the Code was enacted.[34] The Court has stated the following:

> When Congress amends the bankruptcy laws, it does not write on a clean slate. Furthermore, the court has been reluctant to accept arguments that would interpret the Code, however vague the particular language under consideration might be, to effect a major change in pre-Code practice that is not the subject of at least some discussion in the legislative history.[35]

When the Bankruptcy Act was amended to add anti-*ipso facto* provisions applicable only in specified circumstances, Congress made those amendments with the knowledge of pre-Code practice. Congress is generally presumed to be "knowledgeable about existing law pertinent to legislation it enacts."[36] The prohibition against *ipso facto* provisions contained in § 365 addressed the forfeiture of potentially valuable leases through operation of § 70(b) of the Bankruptcy Act. The amendment clearly does not signal a wholesale invalidation of all *ipso facto* provisions wherever found. As the Third Circuit Court of Appeals stated in a different context, "Congress's creation of what appears to be a statutory exception to a common law rule strongly suggests its acknowledgment and acceptance of the general rule. Mindful that Congress does not, one might say, hide elephants in mouseholes, we believe that had Congress intended to abrogate *Barton* in its entirety, it would have done so explicitly."[37]

Had Congress intended to bar all *ipso facto* clauses, a clear and simple provision would have been included in the Code. The argument that one can glean such an intent by piecing together various specific provisions (§§ 363(l), 365(b)(2), 365(e)(1) and 541(c)) and combining them with the legislative history to § 365(e) is strained at best, ignores the plain language of the statute and should be rejected. The Supreme Court has stated that "claims enforceable under applicable state law will be allowed in bankruptcy unless they are expressly disallowed."[38] That rule should apply to claims for default-rate interest based on bankruptcy default clauses contained in nonexecutory contracts. abi

Reprinted with permission from the ABI Journal, Vol. XXXII, No. 7, August 2013.

31 *Lamie v. United States Trustee*, 540 U.S. 526, 534 (2004); *Hughes Aircraft Co. v. Jacobson*, 525 U.S. 432, 438 (1999).

32 *Lamie*, 540 U.S. at 534; *Hartford Underwriters Ins. Co. v. Union Planters Bank NA*, 530 U.S. 1, 6 (2000); *United States v. Ron Pair Enterprises Inc.*, 489 U.S. 235, 241 (1989).

33 *See supra* n.6.

34 *See In re Queens Blvd. Wine & Liquor Corp.*, 503 F.2d 202, 207 (2d Cir. 1974) (discussing pre-Bankruptcy Code practice under § 70(b) of Bankruptcy Act, which expressly enforced *ipso facto* provisions, and noted that "[b]ankruptcy forfeiture provisions are necessary for the protection of landlords and generally are enforceable").

35 *Dewsnup v. Timm*, 502 U.S. 410, 419 (1992) (internal quotations and citations omitted). While the legislative history of § 365 discusses *ipso facto* clauses, the provision relates only to *ipso facto* clauses contained in executory contracts.

36 *Goodyear Atomic Corp. v. Miller*, 486 U.S. 174, 184-85 (1988).

37 *See In re VistaCare Group LLC*, 678 F.3d 218, 227 (3d Cir. 2012).

38 *Travelers Cas. Sur. Co. of Am. v. P. Gas & Elec. Co.*, 549 U.S. 443, 452 (2007).