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Protecting Valuable Estate Interests through the Unenforceability of Ipso Facto Clauses

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Introduction

A trustee or debtor-in-possession is provided with a plethora of powers under title 11 of the United States Code (the "Bankruptcy Code"). A chapter 13 debtor-in-possession, pursuant to section 1322 of the Bankruptcy Code, may assume or reject any executory contract in connection with its plan.¹ The ability, however, to assume or reject an executory contract is limited by section 365, which in part prohibits the modification or termination of a debtor's interest in a contractual agreement on the sole basis that the debtor filed for bankruptcy, which is commonly known as an ipso facto provision.² This prohibition of ipso facto provisions is not limited to executory contracts or unexpired leases.³ Section 541(c)(1)(B), ensures any interest of a debtor in property becomes property of the bankruptcy estate.⁴ Courts are reluctant to enforce contract provisions contingent on the filing of bankruptcy, whether found in executory or non-executory

¹ 11 U.S.C. § 1322(b)(7) (2012).

² 11 U.S.C. § 365(e)(1).

³ 11 U.S.C. § 541(c)(1) (2012).

⁴ *Id.*

contracts, as these provisions tend to deprive the bankruptcy estate of valuable interests necessary to restore the debtor's financial solvency.⁵

A Washington District Court, in *In re Eustler*, upheld this longstanding history of finding ipso facto contract provisions unenforceable.⁶ In *Eustler*, the district court found shareholders of a corporation were not entitled to relief from the automatic stay to exercise their contractual right to buy back a debtor's shares.⁷ This is because the court found the shareholder's agreement, which was dependent on the debtor's financial condition, unenforceable.⁸

This memorandum discusses the rationale behind the prohibition against terminating equitable interests when debtors file for bankruptcy in three parts. Part I describes ipso facto provisions. Part II focuses on the courts' interpretations of ipso facto provisions and when contract provisions contingent on a debtor's financial state may be enforced. Part III examines the consequences of ipso facto provisions.

I. Ipso Facto Provisions Terminate a Debtor's Interest upon Bankruptcy Filing

Ipsso facto provisions are contract clauses that terminate, eliminate, limit, or otherwise modify a debtor's interest under a contract that existed at the commencement of a bankruptcy, on the sole basis that the debtor filed for bankruptcy.⁹ Section 365(e)(1)(A) provides:

(e)(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.¹⁰

⁵ *In re Lehman Bros. Holdings, Inc.*, 422 B.R. 407, 415 (Bankr. S.D.N.Y. 2010); *In re Yates Dev., Inc.*, 241 B.R. 247, 253 (Bankr. M.D. Fla. 1999); *In re Cole*, 226 B.R. 647, 652 (9th Cir. 1998).

⁶ *In re Eustler*, No. 15-00870-FPC13, 2017 WL 1157114, at *1 (Bankr. E.D. Wash. March 24, 2017).

⁷ *Id.*

⁸ *Id.* at *4

⁹ *In re Eustler* at *4 n.7 (quoting Black Law's Dictionary); *In re Lehman Bros. Holdings, Inc.*, 422 B.R. at 414.

¹⁰ 11 U.S.C. § 365(e)(1)(A).

While section 365(e)(1)(A) is limited to executory contracts and unexpired leases, the Bankruptcy Code extends the unenforceability of ipso facto clauses beyond contractual agreements.¹¹ Section 541(c)(1)(B) provides that “an interest of the debtor in property becomes property of the estate notwithstanding any provision in an agreement . . . or applicable bankruptcy law . . . that is conditioned on the insolvency or financial condition of the debtor.”¹² Section 541(c) was enacted to “invalidate restrictions on the transfer of property of the debtor” and ensure all of the debtor’s interest in property becomes part of the bankruptcy estate.¹³

In order for a provision to be considered ipso facto under the Bankruptcy Code, it must terminate or modify the debtor’s interest only because the debtor petitioned for bankruptcy.¹⁴ Although ipso facto provisions are drafted to automatically place a debtor in default at the filing of bankruptcy, such action cannot be compelled.¹⁵ A creditor cannot force a debtor into default on the mere existence of an ipso facto provision.¹⁶ Sections 365(e)(1)(A) and 541(c)(1)(B) generally render provisions that terminate or modify a debtor’s interest in the event of bankruptcy invalid as a matter of law.¹⁷

¹¹ 11 U.S.C. § 541(c)(1)(B); *In re Garrison-Ashburn, L.C.*, 253 B.R. 700, 709 (Bankr. E.D. Va. 2000).

¹² 11 U.S.C. § 541(c)(1)(B).

¹³ *In re DBSI, Inc.*, No. 1:15-CV-00025-RJB, 2015 WL 12683817, at *4 (D. Idaho July 24, 2015) (citing H.R. REP. NO. 95-595, at 368–69 (1977)).

¹⁴ 11 U.S.C. § 365(e)(1)(A); *Summit Inv. & Dev. Corp. v. Leroux*, 69 F.3d 608, 611 (1st Cir. 1995) (finding a partnership agreement depriving bankrupt partner’s right to manage, without remaining partners’ approval, after filing for bankruptcy invalid by operation of law); *In re Siegel Co.*, 51 B.R. 159, 164 (Bankr. E.D. Mich. 1985) (holding insurance agreement cancelling debtor’s policy after debtor petitioned for bankruptcy unenforceable).

¹⁵ *In re FLYi, Inc.*, 377 B.R. 140, 147 (Bankr. D. Del. 2007); *In re Auto Int’l Refrigeration*, 275 B.R. 789, 811 (Bankr. N.D. Tex.) *aff’d in part, rev’d, & remanded in part*, *Mims v. Fid. Funding, Inc.*, 307 B.R. 849 (N.D. Tex. 2002); *In re Chateaugay Corp.*, No. 92 CIV. 7054(PKL), 1993 WL 159969, at *5 (S.D.N.Y. May 10, 1993).

¹⁶ *In re Pak*, 252 B.R. 215, 216 n.1 (Bankr. M.D. Fla. 2000).

¹⁷ *In re DBSI Inc.*, 2015 WL 12683817, at *4 (stating “[t]he Bankruptcy Code generally disapproves of statutory and contractual provisions affecting the bankruptcy estate that are triggered by a bankruptcy”); *In re FLYi, Inc.*, 377 B.R. at 147.

II. Contract Provisions Contingent on a Debtor's Solvency are Generally Unenforceable

In most circumstances, ipso facto provisions are held unenforceable in an effort to protect the debtor's financial stability.¹⁸ However, not all bankruptcy clauses are unenforceable.¹⁹ Enforcement of provisions contingent on a debtor's financial state may depend on the possible occurrence of non-bankruptcy events, the nature of the underlying contract, or the actions of a trustee.²⁰

A. Ipso Facto Provisions Deprive Debtors of Valuable Assets

There is a strong presumption against the enforcement of ipso facto provisions.²¹ The Bankruptcy Code and the courts expect a bankruptcy estate to extend as far reaching as possible, to encompass all of a debtor's assets, without losing its value due to restrictive contract provisions.²² Consequently, courts are reluctant to enforce ipso facto provisions for several reasons. First, these provisions tend to deprive the bankruptcy estate of valuable assets necessary to restore the debtor's financial solvency.²³ A debtor's interests under a contract are often the debtor's only significant remaining assets and, thus, are necessary to reorganize.²⁴ Taking these assets from the debtor because of bankruptcy "hampers [these] rehabilitation efforts."²⁵ Enforcing these clauses prevents the debtor's ability to reorganize, "frustrate[ing]" the policy behind the Bankruptcy Code, persuading courts to reject ipso facto provisions.²⁶ Thus,

¹⁸ *In re Eustler*, No. 15-00870-FPC13, 2017 WL 1157114, at *4 (Bankr. E.D. Wash. March 24, 2017); *In re Yates Dev., Inc.*, 241 B.R. 247, 253 (Bankr. M.D. Fla. 1999); *Summit Inv.*, 69 F.3d at 610; *In re Nemko, Inc.*, 163 B.R. 927, 935 (Bankr. E.D.N.Y. 1994); *In re Lafayette Radio Elec. Corp.*, 7 B.R. 189, 192 (Bankr. E.D.N.Y. 1980).

¹⁹ *In re Auto*, 275 B.R. at 811; *In re Yates*, 241 B.R. at 257; *In re Schweitzer*, 19 B.R. 860, 867 (Bankr. E.D.N.Y. 1982).

²⁰ *In re Auto*, 275 B.R. at 811; *In re Yates*, 241 B.R. at 257; *In re Bell*, 15 B.R. 859, 860 (E.D. Mich. 1981).

²¹ *In re Lafayette*, 7 B.R. at 192.

²² *In re Garrison-Ashburn, L.C.*, 253 B.R. 700, 709 (Bankr. E.D. Va. 2000).

²³ *In re Yates*, 241 B.R. at 253.

²⁴ *In re Nemko, Inc.*, 163 B.R. 927, 935 (Bankr. E.D.N.Y. 1994); *Summit Inv.*, 69 F.3d at 610.

²⁵ *Id.*

²⁶ *Queens Boulevard Wine & Liquor Corp. v. Blum*, 503 F.2d 202, 205 (2d Cir. 1974).

contract clauses contingent on a debtor's financial solvency are generally unenforceable as it impedes on the debtor's benefit of starting fresh after filing for bankruptcy.²⁷

In addition, retaining interests may be necessary to ensure bankruptcy payment plans.²⁸ For example, in *Eustler*, a company formed an agreement that included a clause creating an option for shareholders to purchase shares in the company from a shareholder that filed for bankruptcy.²⁹ Upon one shareholder's filing of bankruptcy, the non-bankrupt shareholders attempted to exercise the option.³⁰ If the court approved the non-bankrupt shareholders' option of purchasing the debtor's shares, the non-bankrupt shareholders would become majority owners of the company, putting the debtor's employment at risk.³¹ The court denied the petition to exercise the option, emphasizing the fact the debtor's continued employment and income was essential for him to make payments according to his Chapter 13 plan.³²

B. Certain Contract Provisions Terminating a Debtor's Interest May Still be Enforced

Pursuant to section 365(e)(1) of the Bankruptcy Code, executory contracts and unexpired leases cannot be modified or terminated on the sole basis that a debtor filed for bankruptcy.³³ While this section of the Bankruptcy Code is strictly applied, it is subject to exceptions.³⁴ A contract provision that alters a debtor's interest will be enforced if the interest is altered for a reason other than bankruptcy.³⁵ An ipso facto provision may similarly be enforced if a loan was made for the debtor's benefit.³⁶

²⁷ *In re W.R. Grace & Co.*, 475 B.R. 34, 152 (D. Del. 2012).

²⁸ *In re Eustler*, No. 15-00870-FPC13, 2017 WL 1157114, at *4 (Bankr. E.D. Wash. March 24, 2017).

²⁹ *Id.* at *1.

³⁰ *Id.*

³¹ *Id.* at *4.

³² *Id.*

³³ 11 U.S.C. § 365(e)(1).

³⁴ 11 U.S.C. § 365(e)(2)(B) (2012); *Mims v. Fid. Funding, Inc.*, 307 B.R. 849, 858 (N.D. Tex. 2002); *In re Yates Dev., Inc.*, 241 B.R. 247, 257 (Bankr. M.D. Fla. 1999).

³⁵ *In re Yates*, 241 B.R. at 257.

³⁶ *Mims*, 307 B.R. at 858.

A contract provision or unexpired lease that terminates or modifies a debtor's right under the contract for non-bankrupt reasons will not receive section 365(e)(1)(A)'s protection.³⁷ Even if the debtor's rights are altered because of bankruptcy, so long as the rights could have been altered by some other reason unrelated to bankruptcy, the provision is not considered ipso facto.³⁸

Moreover, an ipso facto provision may be enforced if it is limited by section 365(e)(2)(B).³⁹ Section 365(e)(2)(B) of the Bankruptcy Code provides:

(2) Paragraph (1) of this subsection does not apply to an executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if –

(B) such contract is a contract to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor, or to issue security of the debtor.⁴⁰

Hence, a contract or unexpired lease will be enforceable "if [the] contract is a [] loan or [extension of] other debt financing . . . for the benefit of the debtor or to issue security of the debtor."⁴¹ Pursuant to section 365(e)(2)(B), a debtor's right under a contract may be terminated or modified if the debtor is provided a loan secured by a debt and subsequently files for bankruptcy.⁴² Enforcing a loan agreement is meant to protect secured creditors.⁴³ Consequently, an ipso facto provision will be enforced where a loan is made for the debtor's benefit.⁴⁴

³⁷ *In re Yates*, 241 B.R. at 253.

³⁸ *In re Yates*, 241 B.R. at 253 (explaining an increased purchase price pursuant to an agreement to buy land was not ipso facto and thus enforceable because such clause was not automatically modified on the sole basis of the debtor bankruptcy petition).

³⁹ *Mims*, 307 B.R. at 858.

⁴⁰ 11 U.S.C. § 365(e)(2)(B).

⁴¹ *Mims*, 307 B.R. at 858 (citing 11 U.S.C. § 365(e)(2)(B)).

⁴² *Id.* (finding debtor's obligations automatically accelerated upon bankruptcy pursuant to a loan agreement).

⁴³ See *In re Schweitzer*, 19 B.R. 860, 868 (Bankr. E.D.N.Y. 1982) (discussing a balance between secured creditors' rights pursuant to security agreements and debtors' rights pursuant to ipso facto provisions).

⁴⁴ *Mims*, 307 B.R. at 858.

C. A Trustee's Action May Allow Enforceability of Ipso Facto Provisions

Section 541(c)(1)(B) is intended to invalidate restrictive contract provisions that attempt to terminate property interests merely because of a debtor's insolvency, beyond such restrictions found only in executory contracts or unexpired leases.⁴⁵ Similar to section 365(e)(1)(A), section 541(c)(1)(B) should be strictly construed.⁴⁶ Accordingly, courts invalidate such restrictive contract provisions that affect a debtor's interest in property when facing bankruptcy, "in most, if not all," cases.⁴⁷

Section 541(c)(1)(B)'s effectiveness, however, depends on actions taken by the trustee of the bankruptcy estate.⁴⁸ A debtor's property becomes property of a bankruptcy estate by operation of law once a bankruptcy is filed.⁴⁹ Though property automatically becomes part of the bankruptcy estate, a trustee of the estate has the power to abandon that property.⁵⁰ If a trustee utilizes the power of abandonment and does not seek to retain or redeem the property, then the abandoned property is no longer protected by section 541(c)(1)(B).⁵¹ An ipso facto provision may be enforced against property that is subject to the contractual provision and abandoned by the trustee.⁵² Similar to section 365(e)(2)(B), courts are concerned with protecting the interests of secured creditors.⁵³

⁴⁵ 11 U.S.C. § 541(c)(1)(B); *In re* DBSI, Inc., No. 1:15-CV-00025-RJB, 2015 WL 12683817, at *4 (D. Idaho July 24, 2015); *In re* Garrison-Ashburn, L.C., 253 B.R. 700, 709 (Bankr. E.D. Va. 2000).

⁴⁶ See *In re* W.R. Grace & Co., 475 B.R. 34, 153 (D. Del. 2012).

⁴⁷ *In re* DBSI, 2015 WL 12683817, at *4; *In re* W.R. Grace, 475 B.R. at 153 (maintaining a longstanding precedent of depicting ipso facto clauses as "invalid in all types of contracts, without limitation").

⁴⁸ *In re* Bell, 15 B.R. 859, 860 (E.D. Mich. 1981).

⁴⁹ 11 U.S.C. § 541(c); *In re* Bell, 15 B.R. at 861.

⁵⁰ 11 U.S.C. § 554(a) (2012) ("the trustee may abandon any property of the estate that is burdensome to the estate or that is of inconsequential value and benefit to the estate.").

⁵¹ *In re* Bell, 15 B.R. at 861–862 (discussing trustee's abandonment of debtor's van used as collateral).

⁵² *Id.* (explaining creditor's right to reclaim debtor's abandoned van pursuant to their loan agreement).

⁵³ See *In re* Schweitzer, 19 B.R. 860, 868 (Bankr. E.D.N.Y. 1982) (balancing "secured creditors loss of the debtor's personal liability on the obligation . . . against the reality that enforcing the provisions will not necessarily deprive the debtor of his vehicle").

III. The Severability of Ipso Facto Provisions

It is unlikely an entire contract will be unenforceable because it contains an ipso facto provision. When examining issues regarding ipso facto provisions, courts generally look only to the provision in question rather than the contract as a whole.⁵⁴ While there is strong policy against enforcement of ipso facto provisions, there also exists a sound policy of maintaining parties' rights to freedom of contract.⁵⁵ Due to these competing policies, courts typically sever the ipso facto provision from the remainder of the contract.⁵⁶

IV. Conclusion

The enforceability of ipso facto provisions against a debtor after filing a petition for protection under the Bankruptcy Code is far and few in between. In most circumstances, contract provisions that are contingent on a debtor's financial state are invalidated by operation of law; although courts have established a few exceptions.⁵⁷ Still, in bankruptcy cases, most ipso facto provisions will be held ineffective as courts are concerned with restoring a debtor's financial stability.⁵⁸ Acknowledging and respecting the policy of maintaining the right to freedom of contract, when holding an ipso facto provision unenforceable courts will typically sever the ipso facto provision from the subject agreement, leaving the remaining portion of the agreement otherwise unaffected.

⁵⁴ *In re Warner*, 480 B.R. 641, 655 (Bankr. N.D. W. Va. 2012); *Summit Inv.*, 69 F.3d at 614.

⁵⁵ *Tree Top Inc. v. Starr Indem. & Liab. Co.*, 280 F. Supp. 3d 1206, 1211 (E.D. Wash. 2017).

⁵⁶ *See e.g., In re Warner*, 480 B.R. at 655 (court isolated a provision in an operating agreement that dissolved a company upon a debtor's petition for bankruptcy from the rest of the contract); *Summit*, 69 F.3d at 614 (clause in agreement modifying debtor's interest in a partnership upon filing for bankruptcy held ineffective, without invalidating the entire partnership agreement).

⁵⁷ *See* 11 U.S.C. §§ 365(e)(1)(A), 541(c)(1)(B); *In re W.R. Grace & Co.*, 475 B.R. 34, 153 (D. Del. 2012); *Mims v. Fid. Funding, Inc.*, 307 B.R. 849, 858 (N.D. Tex. 2002); *In re Yates Dev., Inc.*, 241 B.R. 247, 253 (Bankr. M.D. Fla. 1999); *In re Bell*, 15 B.R. 859, 861–862 (E.D. Mich. 1981).

⁵⁸ *Summit*, 69 F.3d at 610; *Blum*, 503 F.2d at 205.