

## IPSO FACTO RULES

Section 365 of the Bankruptcy Code prohibits enforcement of the once common '*ipso facto*' clause. This clause excuses the solvent party from the performance of the contract when the other party becomes insolvent. Without such a clause, the Debtor can exploit the inability of courts to assess expectation damages accurately to compel a solvent party to stay in a bad deal.

Put another way, a provision to a contract that the contract terminates if a party files for bankruptcy is known as an *ipso facto* clause.

More generally, an *ipso facto* clause is a clause in a contract or a lease that would seek to modify the relationships of contracting parties due to the filing of a bankruptcy petition.

See *In re Lehman Brothers Special Financing Inc. v. BNY Corporate Trustee Services Limited*, 2010: "It is now axiomatic that *ipso facto* clauses are, as a general matter, unenforceable."

An *ipso facto* clause would permit the solvent party to exit the bad deal costlessly. Further, an *ipso facto* clause improves the managers' incentives to exert effort to avoid financial distress.

Section 365(e)(1) states that *ipso facto* clauses are unenforceable in bankruptcy. But Section 365(e)(2) states that an *ipso facto* clause is not invalid "if 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 to an assignee of such contract or lease, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties ..."

The key to resolving the conflict between Section 365(e)(1) and Section 365(e)(2) is whether the court uses the actual test or the hypothetical test.

Actual test --> invalid  
Hypothetical test --> invalid

Section 365(f)(1) states that a debtor may assume and assign an executory contract or unexpired lease "notwithstanding a provision in the executory contract or unexpired lease of the debtor, or in applicable law, that prohibits, restricts, or conditions the assignment of such contract or lease."

Some courts have held that if a contract falls within the scope of Section 365(c)(1), the debtor is prohibited not only from assigning the contract to another party but also from assuming the contract for the benefit of the reorganized debtor.

Section 365(c)(1) states that unless the nondebtor party consents, a "trustee may not assume or assign any executory contract or unexpired lease of the debtor ... if the applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance or rendering performance to an entity other than the debtor or the debtor in possession."

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Section 365(e)(1) of the Code states that *ipso facto* clauses are unenforceable in bankruptcy.

Section 365(e)(2) states that an *ipso facto* clause is not invalid if "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 to an assignee of such contract or lease, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties ..."

Steps to determine whether an *ipso facto* clause is enforceable under Section 365(e)(2):

First, determine whether the contract falls under Section 365(c)(1)

This largely depends on the type of contract and whether a court applies the actual or hypothetical test

A court that applies the actual test would likely invalidate any *ipso facto* clause

One that applies the hypothetical test would likely find any *ipso facto* clause valid

Note that at least one court has held that debtors can continue to exercise their rights under executory contracts during the pendency of the bankruptcy even when the contracts or leases in question cannot be assumed under Section 365(c)(1).

If the Debtor is viewed as retaining its rights under an executory contract or unexpired lease during the bankruptcy, then the nondebtor party must first obtain relief from the automatic stay before it attempts to extinguish the debtor's contractual rights