Are the Bankruptcy and Insolvency Provisions in My Contract Enforceable?

Parties often include bankruptcy and insolvency provisions in their agreements to protect themselves should the contract counterparty file for bankruptcy or take other insolvency-related steps. While many of these provisions are boilerplate, their common inclusion in contracts does not mean that they will be enforceable in a bankruptcy.

Key Issues

- **Bankruptcy Default Provisions.** Commercial contracts commonly contain a provision that makes certain solvency-related triggering events a default under the contract. These triggering events typically include the insolvency of the contract counterparty, the filing of a bankruptcy petition, the effectuating of an assignment for the benefit of creditors (which is the liquidation of a company under state law), the appointment of a receiver, or other events aimed at liquidating, dissolving, or winding up the affairs of the company. Some bankruptcy and insolvency default provisions provide that upon the occurrence of a triggering event, the non-defaulting party may terminate the contract. Other times, the default provision goes so far as to immediately terminate the contract upon the occurrence of a triggering event.

  While these bankruptcy and insolvency default provisions are standard, they are not necessarily enforceable in a bankruptcy. Section 365(e)(1) of the Bankruptcy Code provides that the filing of a bankruptcy is not a basis for the nondebtor party to the contract to modify or terminate the contract. Such bankruptcy and insolvency default provisions are referred to as *ipso facto* clauses, which is a Latin phrase meaning "by the fact itself." While such default provisions are not enforceable in bankruptcy, they can be relied on in other insolvency situations such as in an assignment for the benefit of creditors,[1] and may also be enforceable if a bankruptcy is commenced but later dismissed. Additionally, a default provision based on the insolvency of the contract counterparty would allow the contract to be terminated prior to a bankruptcy being filed.[2]

- **Anti-Assignment Provisions.** As part of this Creditor Toolkit series, we have written extensively on executory contracts and the treatment of executory contracts in bankruptcy.[3] Most contracts include language prohibiting the contract counterparty from assigning the contract to a third party

[1] *See* What Is an Assignment for the Benefit of Creditors and How Does It Differ From a Bankruptcy? tp_creditors-rights-toolkit_assignment-for-the-benefit-of-creditors.pdf (troutman.com)

[2] *See* Dealing With Financially Distressed Contract Parties: Should I Terminate My Contract Before They File for Bankruptcy? TP-Creditors-Rights-Toolkit-Dealing-With-Financially-Distressed.pdf (troutman.com)

[3] *See* Contract Issues Creditor's Rights Toolkit | Troutman Pepper

without obtaining consent. In general, anti-assignment provisions constitute unenforceable *ipso facto* clauses. This is intended to preserve the value of such contracts to the debtor's estate. Enforcement of anti-assignment provisions would mean that a debtor in bankruptcy would almost never be able to assign these contracts, which would in turn limit the debtor's ability to maximize recovery for its creditors.

While the general rule is that anti-assignment provisions are unenforceable in bankruptcy, there are exceptions to this rule. One exception is personal service contracts. A person cannot be forced to work for someone, and as such, a personal service contract cannot be assigned without consent in or outside of bankruptcy. Another exception relates to intellectual property licenses. In determining whether consent is required, many courts focus on whether the contract granted the debtor an exclusive or nonexclusive license or right of use. These courts then hold that a debtor may not assume or assume and assign a nonexclusive license without consent but may freely assume or assume and assign an exclusive license.

- **Automatic Stay Waivers.** The commencement of a bankruptcy case creates an "automatic stay" pursuant to Section 362 of the Bankruptcy Code, which is an injunction that prohibits, among other things, a creditor from seeking to collect amounts owed by the debtor, starting or continuing litigation against the debtor, seeking to foreclose on the debtor's property or creating, perfecting, or enforcing a lien on the debtor's property.[4] Sometimes a contract will provide an automatic right to relief from the automatic stay of Section 362 of the Bankruptcy Code. Such provisions are not per se unenforceable like *ipso facto* clauses. However, enforcement of such a waiver is extremely rare since the automatic stay is intended to provide the debtor with breathing room and stop a race to the courthouse by creditors. As such, except for the most unusual of situations, a creditor with an automatic stay waiver in its contract should assume that such waiver will not be unenforceable in a bankruptcy.

Takeaway

While bankruptcy and insolvency contract provisions are not the best way to protect yourself should a contract counterparty file for bankruptcy, you can take many other steps to address concerns related to a financially troubled contract counterparty. Examples include obtaining third-party guarantees, perfecting liens and security interests in the contract counterparty's assets, requiring payment in advance, COD payment, or deposits, or terminating agreements prior to the bankruptcy in accordance with the contract. As always, consult with experienced bankruptcy counsel to ensure that your rights are fully protected.

[4] *See* Automatic Stay: Why Can't I Just Keep Collecting on Pre-Bankruptcy Claims? tp_creditors-rights-toolkit_automatic-stay.pdf (troutman.com)