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## Can the Invalidity of *Ipsa Facto* Clauses Apply to Prepetition Termination?

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It is well known that an executory contract or unexpired lease may not, after a bankruptcy filing, be terminated or modified based on an *ipso facto* clause, *i.e.*, a contract or lease provision specifying that insolvency, a bankruptcy filing or a similar event will *per se* terminate or modify the contract or lease. Suppose a contract or lease is terminated under an *ipso facto* clause before the bankruptcy filing, however. Can the policy of invalidating *ipso facto* clauses in bankruptcy be extended to a contract or lease terminated before a bankruptcy case? Although courts have long held that a previously-terminated contract or lease cannot be revived in a bankruptcy case, a debtor can raise a number of arguments for the proposition that a contract or lease cannot be terminated prepetition under an *ipso facto* clause. This article briefly examines these arguments.

### Application of §365(e)(1)



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First, a debtor can argue that §365(e)(1) of the Bankruptcy Code prohibits the prepetition termination of a contract or lease under an *ipso facto* clause. Section 365(e)(1) provides that 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

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the commencement of the case solely because of a provision in such contract or lease that is conditioned on: (1) the insolvency or financial condition of the debtor at any time before the closing of the case; (2) the commencement of a bankruptcy case; or (3) the appointment of or taking possession by a trustee in a bankruptcy case or a custodian before such commencement. 11 U.S.C. §365(e)(1).

## Feature

At first glance, a number of factors would appear to prevent application of §365(e)(1) to a prepetition termination of a contract or lease under an *ipso facto* clause. For instance, §365(e)(1) expressly applies only to *executory* contracts and unexpired leases. *But see, e.g., Gen. Motors Acceptance Corp. v. Rose (In re Rose)*, 21 B.R. 272, 275-77 (Bankr. D. N.J. 1982) (opining that “there is simply no reason to assume that Congress intended to make [*ipso facto*] clauses enforceable only in non-executory contracts,” and thus, holding that *ipso facto* clause in nonexecutory retail sales contract for automobile was unenforceable). A contract or lease that was terminated prepetition generally fails to qualify as “executory” or “unexpired.” *See, e.g., In re C & S Grain Co.*, 47 F.3d 233, 237 (7th Cir.

1995) (holding that contracts that had terminated prepetition were no longer executory and could not be assumed under §365). *But see In re Morgan*, 181 B.R. 579, 583 (Bankr. N.D. Ala. 1994) (noting that while §365(c)(3) specifically prohibits assumption of unexpired lease of nonresidential real property that was terminated prior to bankruptcy, nothing in Code prohibits assumption of unexpired lease of residential real property that was terminated prior to bankruptcy, and thus, allowing chapter 13 debtor to assume unexpired residential lease despite prepetition termination of lease). Thus, one can argue that §365(e)(1) does not apply to a contract or lease terminated prepetition. *See, e.g., LJP Inc. v. Royal Crown Cola Co. (In re LJP Inc.)*, 22 B.R. 556, 558 (Bankr. S.D. Fla. 1982) (noting that “there is no provision

of the Code which permits assumption or the curing of defaults in a contract terminated before bankruptcy” and that “[t]he explicit provision for assumption of executory contracts [in Code §§365(a) and 1107(a)] convinces [the court] that there is no legislative intention to permit assumption or reinstatement of contracts which have expired or have been terminated before bankruptcy,” and as a result, dismissing chapter 11 debtor’s complaint seeking reinstatement of bottling agreement terminated prepetition based on insolvency).

Also, §365(e)(1) applies on its face only to postpetition termination or modification of a contract or lease. Thus, several courts have held that §365(e)(1) does not apply to a prepetition termination. *See, e.g., Comp III Inc. v. Computerland Corp. (In re*

*Comp III Inc.*), 136 B.R. 636, 638-39 (Bankr. S.D.N.Y. 1992) (finding that “where an executory contract has been terminated in accordance with its terms prior to bankruptcy, [§]365(e) (1) does not authorize the bankruptcy court to reach beyond the veil of the petition to reinstate the contract” and that “[n]or has Congress the ability, in the absence of bankruptcy or an effect in interstate commerce, to legislate such a matter, which is purely a state law concern,” and thus, enforcing prepetition termination of franchise agreement under *ipso facto* clause); *LJP*, 22 B.R. at 558 (finding that “[t]here is no provision in the Bankruptcy Code which prohibits the termination before bankruptcy of a contract on account of insolvency” and that “[t]he express provisions of [§]365(e)(1) convince [the court] that there is no legislative intent to invalidate the prepetition termination of a contract on the sole ground of insolvency,” and as a result, dismissing debtor’s complaint seeking reinstatement of bottling agreement terminated prepetition based on insolvency). See also *151 West Assocs. v. Printsiples Fabric Corp.*, 92 A.D.2d 76, 86-87 (N.Y. App. Div. 1st Dept. 1983) (Sullivan, J., dissenting) (opining that §365(e)(1) was inapplicable to lease terminated by landlord under *ipso facto* clause because no bankruptcy proceeding had been commenced; that Code is designed to foster rehabilitation of distressed debtors only, and tenant in question did not qualify; and that a nondebtor, such as tenant in question, cannot invoke the protections of Code), *aff’d*, 61 N.Y.2d 732, 460 N.E.2d 1344 (1984).

At least one court, however, has interpreted §365(e)(1) to prevent prepetition termination. *Printsiples*, 92 A.D.2d 76. In *Printsiples*, the defendant tenant leased certain premises from the plaintiff lessor and sublet the premises to a defendant subtenant. The lease provided the lessor with the right to terminate the lease if, during the term of the lease, a bankruptcy petition was filed by or against the tenant, and within 60 days thereof, the tenant failed to secure a dismissal thereof, or if the tenant made an assignment for the benefit of creditors or petitioned for or entered into an “arrangement.” During the lease term, the tenant began to experience financial difficulties. Thereafter, a creditors’ committee was formed, the creditors assigned their claims to a third party and the tenant’s

shareholders transferred their stock to the third party. As a result, the lessor invoked its right to terminate under the “bankruptcy” provision and initiated an ejection action. *Id.* at 76-78.

*Although the Bankruptcy Code expressly invalidates only postpetition termination of a contract or lease under an ipso facto clause, a debtor can argue that prepetition termination is likewise invalid.*

After finding that the events at issue did not amount to an “arrangement,” and hence, that no default under the bankruptcy provision had occurred, the court addressed the defendants’ argument that enforcement of the provision would violate the public policy of §365(e)(1). Although it acknowledged that §365(e)(1) was technically inapplicable because no bankruptcy proceeding had been initiated, the court noted that Congress had intended, as a statement of public policy, that a contract or lease could not be terminated solely because of a lease forfeiture provision such as the bankruptcy provision at issue.<sup>1</sup> “If such a clause is not to be given effect after the commencement of a bankruptcy proceeding,” the court found, “there can be even less justification for doing so in the absence of a proceeding.” Indeed, the court observed, if the tenant had filed a bankruptcy petition, the landlord would have been precluded from invoking the bankruptcy provision. As a result, the court reasoned that strict interpretation of §365(e)(1) would have the undesirable result of forcing financially troubled tenants into a formal bankruptcy proceeding rather than negotiating an accommodation mutually beneficial to all parties. The court concluded that “sound public policy should encourage financially troubled businesses to devise means of staying in business, not assist them over the brink.” The court found its conclusion particularly applicable in

<sup>1</sup> In fact, the legislative history relating to §365(e)(1) does not distinguish between pre- and post-termination. House Report No. 95-959, 95th Cong., 1st Sess. 348-9 (1977); Senate Report No. 95-989, 95th Cong., 2d Sess. 59 (1978) (“Subsection (e) invalidates *ipso facto* [sic] or bankruptcy clauses. These clauses, protected under present law, automatically terminate the contract or lease, or permit the other contracting party to terminate the contract or lease, in the event of bankruptcy. This frequently hampers rehabilitation efforts. If the trustee may assume or assign the contract under the limitations imposed by the remainder of the section, then the contract or lease may be utilized to assist in the debtor’s rehabilitation or liquidation.”).

cases in which the plaintiff invokes an ambiguous forfeiture provision. In such cases, it concluded, a court should not strain to interpret the lease in a manner that would effect a forfeiture. *Id.* at 79-80.

In addressing whether ejecting the subtenant would effect a forfeiture in the *Printsiples* case, the court noted that the record did not reveal any actual harm suffered by the landlord; the subtenant had expended a substantial sum in connection with the move to and utilization of the premises; neither the tenant nor the subtenant had failed to perform any lease terms; the rent had been regularly and timely paid; and that following ejection, the landlord would likely allow the subtenant to remain in possession of the premises at a higher rental. Concluding that the landlord was merely seeking to use the lease-forfeiture provision as a means of canceling the lease in order to obtain a greater return on its property, the court found in favor of the defendants. *Id.*

Although the *Printsiples* court’s analysis of §365(e)(1) is arguably *dictum*, given the court’s initial finding of the absence of an “arrangement” under the lease forfeiture provision, *In re Gordon Car & Truck Rental Inc.*, 59 B.R. 956, 960 (Bankr. N.D.N.Y. 1985) (finding that “[a]lthough it appears to void insolvency termination clauses outside of bankruptcy, such language [in the *Printsiples*] opinion was not necessary for disposition of that case,” and thus, opting to enforce clauses authorizing termination of licensing agreements upon insolvency or bankruptcy), a debtor seeking to challenge a prepetition termination of a contract or lease under an *ipso facto* clause can cite the policy reasons articulated in *Printsiples*, especially in a case in which enforcement of the clause would cause a forfeiture.

### ***Application of §§541(c)(1) and 363(l)***

Second, a debtor can argue that notwithstanding the prepetition termination of a contract or lease under an *ipso facto* clause, its interest under the contract or lease is property of the estate under §541(c)(1) and the debtor can use such property under §363(l) of the Bankruptcy Code.

Section 541(c)(1) provides in relevant part that an interest of the debtor in property becomes property of the estate, notwithstanding any provision

in an agreement, transfer instrument or applicable nonbankruptcy law that is conditioned on the insolvency or financial condition of the debtor, on the commencement of a bankruptcy case or on the appointment of or taking possession by a trustee in a bankruptcy case or a custodian before such commencement, and that effects or gives an option to effect a forfeiture, modification or termination of the debtor's interest in property. 11 U.S.C. §541(c)(1).

Likewise, §363(1) provides in relevant part that subject to the provisions of §365, a debtor may use, sell or lease property under subsection (b) or (c) of §363, notwithstanding any provision in a contract, lease or applicable law that is conditioned on the insolvency or financial condition of the debtor, on the commencement of a bankruptcy case concerning the debtor or on the appointment of or the taking possession by a trustee in a bankruptcy case or a custodian, and that effects, or gives an option to effect, a forfeiture, modification or termination of the debtor's interest in such property. 11 U.S.C. §363(1).

Unlike §365(e)(1), §§541(c)(1) and 363(1) are not limited to cases involving postpetition termination of a contract or lease. Thus, a debtor seeking to challenge a prepetition termination of a contract or lease under an *ipso facto* clause can argue that §541(c) requires that the bankruptcy estate include the debtor's interest under the contract or lease despite the clause and that §363(1) permits the use of such interest despite such clause. *See, e.g., EBC I Inc. v. Am. Online Inc. (In re EBC I Inc.)*, 356 B.R. 631, 639-40 (Bankr. D. Del. 2006) (holding that debtor's interest in online advertising services contract became property of chapter 11 estate under §541(c)(1), notwithstanding service provider's purported prepetition termination of contract based on debtor's insolvency); *Mumpfield v. Leavell (In re Mumpfield)*, 140 B.R. 578, 580-81 (Bankr. M.D. Ala. 1991) (holding that debtor's interest as vendee under contract for sale of real property constituted estate property under §541(c)(1), and hence, setting aside prepetition termination of contract, where vendor, in seeking to terminate contract, had effected forfeiture under terms of contract and applicable state law). *Cf. Riggs Nat'l Bank of Wash., D.C. v. Perry (In re Perry)*, 25 B.R. 817, 820 (Bankr. D. Md. 1982) (refusing to give effect

to clauses in nonexecutory installment sales contract which mandated default upon filing of bankruptcy, where motor vehicles implicated under contract had become property of estate under §541(c)(1) and enforcement of clauses would deprive debtors of opportunity for fresh start and would result in forfeitures contrary to spirit of the Code). *See also EBC I*, 356 B.R. at 639-40 (holding that debtor's interest in online advertising services contract that was terminated prepetition constituted property of chapter 11 estate because §541(b)(2) expressly excludes from property of estate any interest in a lease that was terminated prepetition at expiration of its term, and thus, property of estate must include any interest of debtor in lease that expired prepetition for reasons other than expiration of its term; and on basis that property of estate generally includes any property, including contract rights, that would have been part of estate had it not been transferred before commencement of bankruptcy proceedings).

### **Termination as Fraudulent Transfer**

Next, a debtor can argue that the prepetition termination of a contract or lease constitutes an avoidable fraudulent or preferential transfer. *See, e.g., EBC I*, 356 B.R. at 637-38, 641 (holding that online advertising service provider's prepetition termination of contract with debtor resulted in avoidable fraudulent transfer of property of debtor, namely advertising services for which debtor had pre-paid). *But, see, e.g., In re Egyptian Bros. Donut Inc.*, 190 B.R. 26, 29 (Bankr. D. N.J. 1995) (holding that avoidance of termination of leases and franchise agreements "requires an overly broad application of §§547 and 548, violates the express language of Code §365(c)(3) and significantly and adversely affects ordinary commercial contractual relationships").

### **State Law**

Last, a debtor can invoke state or other applicable law that renders an *ipso facto* clause invalid. *See, e.g., In re Ernie Haire Ford Inc.*, 403 B.R. 750, 757-60 (M.D. Fla. 2009) (holding that termination by automobile finance companies of contract purchase agreements with chapter 11 debtor-automobile dealer under agreements' terminable-at-will provisions, solely because debtor had filed chapter 11 petition, violated implied covenant of

good faith and fair dealing under Florida law and constituted impermissible exercise of companies' discretion); *Rose*, 21 B.R. at 278-79 (holding that *ipso facto* clause in retail sales contract for automobile was unenforceable on basis, among others, that "New Jersey would refuse to enforce bankruptcy-default clauses where consumers would suffer a great detriment and the creditors a benefit"). *But, see, e.g., First Nationwide Bank v. Brookhaven Realty Assocs.*, 223 A.D.2d 618, 621, 637 N.Y.S.2d 418, 421 (N.Y. App. Div. 1996) (finding "bankruptcy default" provision in mortgage nonrecourse agreement enforceable under New York law).

### **Conclusion**

Although the Bankruptcy Code expressly invalidates only postpetition termination of a contract or lease under an *ipso facto* clause, a debtor can argue that prepetition termination is likewise invalid. ■

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