Are the Bankruptcy Provisions in Your Executory Contract Enforceable?

By: Jennifer McLain McLemore

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Most every business relies on executory contracts, which often contain at least one bankruptcy provision. It is important for businesses to be aware of the common bankruptcy provisions that cannot be enforced in a bankruptcy setting, and thus may be ignored. Similarly, it is important to understand the provisions that may be enforced in a bankruptcy setting. In this alert, we identify the clearly unenforceable provisions and examine the provisions that may be enforced after a bankruptcy filing, and which, as a result, require careful scrutiny.

You Can Ignore *Ipso Facto* Clauses and Most Automatic Stay Waivers

Ipso Facto Clauses

Bankruptcy provisions often provide that ?upon a bankruptcy filing of any party to the contract, the bankruptcy filing itself is an event of default under the contract terms,? or, more aggressively, ?upon a bankruptcy filing of any party to the contract, the contract shall be deemed terminated and unenforceable.? These types of provision are unenforceable under the plain language of Section 365(e)(1) of the Bankruptcy Code, which provides that the mere occurrence of a bankruptcy filing or insolvency of a contract counterparty to an executory contract cannot be used by the non-debtor counterparty to terminate or modify the contract after a bankruptcy petition is filed. Bankruptcy Courts refer to such contract provisions as unenforceable, *ipso facto* clauses. If your contract includes such an *ipso facto* clause that is bankruptcy boilerplate, then that can be ignored.

Automatic Stay Waivers

Contractual waivers of the Automatic Stay (established by Section 362 of the Bankruptcy Code) are not *per se* unenforceable like *ipso facto* clauses, but the enforceability of such waivers is the exception, not the rule. Most people know that the Automatic Stay is intended to be a wide-ranging, all-encompassing injunction against creditor activity that could have been commenced before the bankruptcy filing or that a creditor might want to continue after a filing, to the extent such action is in the nature of a collection action or an attempt to enforce a claim, procure a lien or seek to exercise setoff rights. The Automatic

Stay creates this pause in such creditor collection activity to protect debtors and their creditors by halting the race to the courthouse and giving every creditor an equal opportunity to recover on its claim.

If a contract provision purports to eliminate the Automatic Stay by agreement, such a provision is very unlikely to be enforced as it eviscerates these protective powers of the Bankruptcy Code. However, an Automatic Stay waiver that is part of a forbearance agreement, wherein the creditor attempted to help the debtor avoid a bankruptcy proceeding altogether, could be enforceable as the creditor tried to work with the debtor when it was in financial distress. Bankruptcy Courts support such efforts and recognize the pre-petition sacrifices that may have been made by the creditor.

However, even if an Automatic Stay waiver is part of a forbearance agreement, the parties still should come to the Bankruptcy Court and ask for the waiver to be enforced before proceeding with any collection activity. This reality, applicable to all Automatic Stay waivers, adds a layer of uncertainty to their enforcement and makes all such provisions less helpful than they might appear.

In addition, even a well-crafted Automatic Stay waiver may end up being treated as unenforceable if allowing such relief would harm the debtor?s overall bankruptcy case goals. As such, unless you are crafting an Automatic Stay waiver in a forbearance agreement, the language used is unlikely to be tested. Given these challenges to their enforceability, in almost all instances Automatic Stay waiver provisions can be ignored.

You Should Review Most Other Bankruptcy Provisions in Your Contract

Beyond *ipso facto* clauses and Automatic Stay waivers, most references to the bankruptcy process in your contract should be scrutinized. Such provisions could inartfully invoke provisions of the Bankruptcy Code creating confusion at the time of enforcement, seek to avoid the requirements of the Bankruptcy Code in a way that will never be tolerated in a bankruptcy setting, or provide welcome clarity to a stressful bankruptcy situation. Regardless of what form your bankruptcy provisions take, you should understand the terms at the time of execution of the contract rather than trying to understand what you?ve agreed to after a bankruptcy filing occurs. At the very least, there is a chance you can optimize the provisions of your contract to better ensure a desired outcome.

Here are some general considerations when you find a bankruptcy provision in your contract:

1. The Bankruptcy Code is constantly being revised and interpreted by the Courts and Congress. Depending on the duration of your contract, the Bankruptcy Code provision you seek to invoke in your contract may be modified or reinterpreted in the future. If your contractual reference to the Bankruptcy Code becomes stale, your agreement may have an unintended ambiguity in its terms. There are ways to incorporate a current Bankruptcy Code concept into your contract while accounting for such future uncertainty. Careful drafting is required.
2. A contractual agreement *requiring a debtor to deliver a particular outcome* in a bankruptcy proceeding should be seen as a false promise. Debtors are bound by a fiduciary duty to serve the competing interests of many parties after a filing. That fact makes it challenging for a debtor to deliver a particular outcome for one creditor that it cannot deliver to all, or that

only benefits a single creditor and potentially harms other creditors.

3. Contractual agreements requiring a debtor to *request* certain relief from the Bankruptcy Court are likely more enforceable, but the debtor?s ability to deliver the ultimate outcome may be unreliable. Careful drafting of such a provision could provide meaningful value in the form of negotiating leverage, at the very least.
4. Contractual agreements requiring a debtor to seek to assume an executory contract or lease by a certain point in a bankruptcy case could be unrealistic as the Bankruptcy Code sets the deadlines for assumption and rejection of such agreements. A provision requiring assumption of an agreement at some point post-petition may be more realistically enforced, especially if the creditor took on meaningful burdens to ensure the assumption of the agreement. The chances of enforcement are much improved if your contract is truly essential to the debtor?s going-forward business plan.
5. While it may be difficult to enforce contractual agreements for a debtor to seek special treatment for a creditor?s claims or to pay such claims at a higher priority level than the Bankruptcy Code will permit, with such a provision in a contract, a creditor may be able to influence the budget and potentially get paid more rapidly under an approved budget. While it is possible that seeking such treatment may be met with fierce opposition by a lender or a committee, such a provision creates an opportunity for dialogue with the debtors and other parties with influence.
6. Attempts to draft provisions that seek to circumvent the Bankruptcy Code?s requirements should be approached with great care, and the parties must recognize that enforcement will require at least an argument before the Court.

As the Bankruptcy Code and its interpretation are always evolving, it is not improper to seek to contract for innovative relief in advance of a bankruptcy filing. Again, the parties to the contract will need to bring the issue before the Court to test the enforceability of such creative drafting.

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- Jennifer McLain McLemore ? 804.420.6330 ? jmclemore@williamsmullen.com

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