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Ipso Facto Clauses in Bankruptcy

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Decisions recently issued in the Bankruptcy Court and affirmed upon appeal to the United States District Court for the Eastern District of Michigan, Southern Division, should be of interest to those faced with questions related to "ipso facto" clauses, as well as anyone seeking to construe whether an insurance policy is a distinct separate contract from its "tail" or optional renewal as its original term approaches expiry. The decisions also highlight the concept of an "executory contract" - which is a pre-petition contract not fully completed such that failure to perform on either side would constitute a breach of the contract.

In CMH Liquidating Trust v. National Union Fire Insurance Company of Pittsburgh, PA, Adv. Proc. No. 14-2082, the Debtor, CMH Liquidating Trust ("CMH"), had purchased, in the ordinary course and prior to filing bankruptcy, a Directors and Officers Liability insurance policy.

As is customary with policies of this type, it contained an option allowing the insured to renew the policy prior to its expiration. Following the filing of CMH's petition, it elected to renew said policy.

Two issues arose relating to this contract: the renewal issue, and the terms contained therein.

First, the court was faced with determining whether an addition to the post-petition renewed policy, or "tail", constituted a separate and distinct policy, or whether the renewed policy, together with the "tail", was really just part of one contract (the initial policy) which had been entered into pre-petition and continued post-petition as an executory contract.

Finding in favor of Debtor CMH, United States District Court Judge, Mark Goldsmith held that there was but one contract which had been extended in the ordinary course after concluding that the contracts were essentially identical.

Secondly, the Court dealt with the issue of whether an "ipso facto" clause - which provides for the termination of an agreement due to the insolvency or bankruptcy of one of the parties - was enforceable. Section 365(e) of the Bankruptcy Code finds such contractual provisions to be unenforceable.

The Court discussed this issue pointing out that, if the post-petition extension of the insurance policy was a separate, independent contract, the "ipso facto" clause would be enforceable.

However, if the contract was construed as one contract entered into pre-petition and simply continued post-petition, the “ipso facto” clause would be void and unenforceable because It would have been an executory contract.

Given Judge Goldsmith’s determination that the renewal was a continuation of the pre-petition contract, the “ipso facto” clause at issue here was voided.

In light of these recent decisions, we advise our clients to consider that contractual terms which purport to void a contract in the event of a subsequent bankruptcy filing are unenforceable.

Moreover, at least in the Eastern District of Michigan, where our Bankruptcy team is active, insurance “tail” policies are considered part of the original policy.

Please note that this is a general overview of developments in the law and does not constitute legal advice. Nothing herein creates an attorney-client relationship between the sender and recipient. If you have questions regarding these provisions, or any other aspect of bankruptcy law, please contact Michael Traison at 312.860.4230

Practices

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