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The Nuts & Bolts of Ipso Facto Clauses and Golden Share Arrangements That May Sidestep the Bankruptcy Code's Prohibition

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/ By Laura Davis Jones and Jonathan Kim

When are *Ipso Facto* Clauses and Golden Share Arrangements Enforceable in Bankruptcy?

"Termination on bankruptcy" provisions—*ipso facto* clauses—are commonly used in many types of business contracts, providing for the termination of the contract (either automatic or at the non-debtor party's election) upon the obligor's filing of bankruptcy or the occurrence of similar events or conditions. However, generally, such clauses are not enforceable in the bankruptcy context, because as a matter of policy, debtors should be allowed access to the protections accorded to debtors under the Bankruptcy Code. In some types of contracts, though, such clauses are enforceable, because:

- The applicable contract is not an "executory contract" where material performance obligations remain on the part of both the debtor and creditor; or
- The contract is an executory contract, but it falls within certain significant statutory exceptions as discussed below.

Because of the broad scope of unenforceable *ipso facto* clauses in executory contracts, not surprisingly, creditors and other parties in interest have looked to mechanisms other than contractual *ipso facto* clauses to effectively impede or control the debtor from filing for bankruptcy. One such mechanism is the party in interest owning "golden shares" or other equity interest in the debtor, as discussed further below. However, many bankruptcy courts are hesitant to approve such mechanisms for the basic reasons underpinning the general unenforceability of ipso facto clauses.

Ultimately, a creditor may have to rely on negotiating other contractual provisions (such as additional financial/business operations reporting and other covenants by the debtor to the creditor) to better protect itself prior to and in the case of the debtor's bankruptcy filing.

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Definition and Purpose

Section 365(e) of the Bankruptcy Code expressly invalidates ipso facto and other bankruptcy related termination clauses that might otherwise prevent the debtor from receiving the benefit of an executory contract or unexpired lease.[1] Under section 365(e), a clause providing for the termination or modification of an executory contract or lease conditioned on the debtor's insolvency or financial condition, the commencement of a bankruptcy case or the appointment of a receiver or custodian (either voluntarily by the debtor or involuntarily by creditors or other parties in interest, whether with notice or without notice) (referred to herein as "*Ipso Facto* Actions") is inoperative in a bankruptcy case.

The broad language of section 365(e) is intended to address provisions in contracts or leases that lead to the same effect as a clause triggered by bankruptcy, without referring to bankruptcy. Thus, a provision conditioned on the debtor's insolvency or financial condition, or on the appointment of a trustee or receiver, will commonly be held invalid as an *ipso facto* clause. The non-debtor party to the applicable contract wants an ipso facto clause to allow it to avoid a contractual relationship with a financially unstable counterpart.

Generally, bankruptcy courts do not enforce *ipso facto* clauses. Defaults covered under ipso facto clauses are usually impossible or impracticable to cure—a debtor cannot readily cure insolvency, the filing of a bankruptcy case, or an assignment for the benefit of creditors. Enforcement of *ipso facto* clauses, given

how prevalent they are in contracts, would mean that the debtor or trustee could almost never assume ongoing contracts or leases, including those critical to the debtor's reorganization. In short, enforcement of *ipso facto* clauses undermines public policy promoting a debtor's rehabilitation. The general rule against the enforceability of ipso facto clauses protects debtors, and by extension, their bankruptcy estates and creditors.

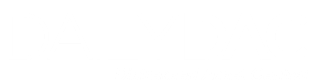
Limited Exceptions

Section 365(e)(2) recognizes limited exceptions to the general rule against enforcement of *ipso facto* clauses. First, ipso facto clauses may be enforced 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 an assignee of such contract;" and
- The non-debtor party does not consent to the assumption or assignment.

Second, *ipso facto* clauses may be enforced where the contract "is a contract to make a loan, or extend other debt financing or financial accommodations" for the benefit of the debtor, or "to issue a security of the debtor." Thus, these types of contracts may be terminated by the insolvency or bankruptcy of a party to the agreement, provided that, typically, the non-debtor party must seek relief from the automatic stay under bankruptcy law to exercise its termination rights.

Applicable state and other non-bankruptcy laws render various contracts non assignable without consent,



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though on the specific contractual language, the court reviewing the language (some jurisdictions may treat this issue differently), and other case-specific circumstances.

Golden Share Arrangements and Bankruptcy Blocking Rights

Definition

In light of the broad protections provided to debtors through the *ipso facto* clause prohibition, lenders and other creditors may look to other mechanisms to try to better control or influence a corporate debtor choosing to file for bankruptcy or taking other *Ipso Facto* Actions. For example, "golden shares" have been increasingly used. And with the adverse economic effects caused or exacerbated by the COVID-19 pandemic, lenders and other creditors may negotiate for such protections with distressed companies. However, depending on the applicable facts and jurisdiction involved, there is a significant risk that such a mechanism will not be enforced by the bankruptcy court on one or more grounds.

In the bankruptcy context, a "golden share" is an equity interest (often, preferred stock) that gives its holder certain blocking rights, which may include the right to block a company's bankruptcy filing. Typically, a golden share (or shares) is implemented through an amendment to the debtor's organizational

document (articles of incorporation, LLC agreement, etc.), providing for the golden share, or alternatively a unanimous consent requirement to commence a bankruptcy case or to take similar action.

Examples of when golden shares may be issued is when a lender requires a golden share structure in connection with a loan restructuring, or where a private equity sponsor/investor takes both equity and debt positions in a portfolio company and requires blocking rights to try to manage or limit access to bankruptcy relief.

Court Treatment

Depending on the specific circumstances, some courts may refuse enforcement of the blocking rights of a golden share.[2]

In contrast, the Fifth Circuit Court of Appeals, interpreting Delaware law, came to a different conclusion when the golden share was held by a preferred shareholder. In *In re Franchise Services of North America, Inc., 891 F.3d 198 (5th Cir. 2018)*, a preferred shareholder agreed to make a $15 million investment in a company provided that the company reincorporate in Delaware and amend its corporate charter to include a golden share provision. When the company filed a chapter 11 case, the preferred shareholder sought to dismiss the case, arguing that the petition could not be authorized without a shareholder vote. The company alleged that the shareholder's argument was a pretext for its true motivation—to secure undue leverage for repayment of its $3 million claim for unpaid consulting fees. In dismissing the bankruptcy case, the Fifth Circuit Court of Appeals agreed with the preferred shareholder and upheld the right of a bona fide preferred shareholder to exercise its golden share, because nothing under Delaware corporate

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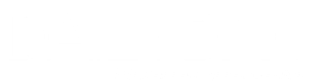

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debtor from filing for bankruptcy will likely not be successful, whether or not the minority equity holder is also a creditor.[3]. In *Pace Industries*, focusing on the debtors' clear financial deterioration and need for bankruptcy relief that would benefit most stakeholders, the court determined that the preferred equity holder's blocking rights created a fiduciary duty, and enforcement of the blocking rights would violate federal public policy by interfering with a company's Constitutional right to seek bankruptcy protection.

Takeaways For Now

Some courts have approved of golden share provisions, notably where the equity holder-creditor appears to have acted properly and not been motivated by a desire to enforce its claim against the debtor. For instance, in the Franchise Services case, the Fifth Circuit concluded there was no evidence that the golden share arrangement was "merely a ruse to ensure" the debtor would pay the equity holder's claim. In that case, the court found "no evidence that would allow us to set aside our incredulity and conclude that [the equity holder] invested $15 million in [the debtor] to ensure payment of a $3 million bill." However, a number of courts—particularly, the Delaware bankruptcy courts dealing with debtors organized under Delaware law—have refused to sanction the exercise of golden share provisions in the particular cases.

In these extraordinary times due to the COVID pandemic, although the state of the law on golden share arrangements is not settled, bankruptcy courts across the country may be more wary of enforcing such arrangements where the debtor is clearly in need of bankruptcy relief (as in the Pace Industries case).

Depending on the creditor's, lender's or investor's goals, it may be the case that golden share provisions, as well as *ipso facto* provisions (which are more predictably held invalid), should not be treated by the creditor, lender or investor as an imperative or higher priority drafting/negotiating item. More effective control and mitigation of risk can possibly be achieved by focusing more so on other provisions and mechanisms such as increased reporting and monitoring and other covenants and contractual rights.

[**Editors' Note**: To learn more about this and related topics, you may want to attend the following webinars: The Nuts & Bolts of a Chapter 11 Plan and Bad Debtor Owes Me Money!]

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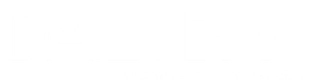
1. Section 365(e) has also been held to preempt contrary provisions of state law that purport to release the nondebtor from a contract upon bankruptcy filing. Consequently, the trustee or debtor in possession may deal with such a contract or lease under section 365, notwithstanding a clause triggered by these events. ↩
2. See, e.g., In re Intervention Energy Holdings, LLC, 553 B.R. 258 (Bankr. D. Del. 2016) ("A provision in a limited liability company governance document obtained by contract, the sole purpose and effect of which is to place into the hands of a single, minority equity holder the ultimate authority to eviscerate the right of that entity to seek federal bankruptcy relief, and the nature and substance of



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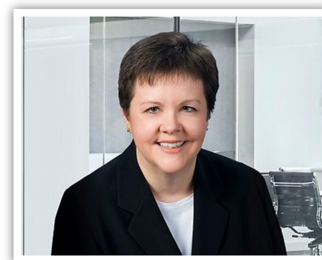
contrary to federal public policy."). ↩
3. See, e.g., In re Pace Industries, Case No. 20-10927-MFW (Bankr. D. Del. May 5, 2020) (Judge Mary Walrath) ↩

About Laura Davis Jones



Laura Davis Jones is a named and managing partner of Pachulski Stang Ziehl & Jones LLP, a national law firm specializing in restructurings. Laura began her career as a law clerk in the Bankruptcy Court (D. Del.), and has been very active representing debtors, creditors' committees, noteholder groups, purchasers, and other substantial parties in national…

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About Jonathan Kim

Jonathan Kim is an attorney at Pachulski Stang Ziehl & Jones LLP. He has represented both debtors and creditors on a wide range of issues in chapter 11 cases, bankruptcy litigation, and federal court appeals, with substantial experience in plan, corporate/transactional, and litigation matters. He is a graduate of Duke University and received his J.D.…

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