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Termination-on-Bankruptcy Provisions: Some Proposed Language

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A fixture of many different kinds of business contracts is the termination-on-bankruptcy (or “ToB”) provision. It states that if the party in question experiences bankruptcy or any of a series of related circumstances, then depending on the contract, either the other party may terminate the contract or the contract will terminate automatically.

Such a provision is usually referred to as an “*ipso facto* clause,” *ipso facto* meaning “by the very nature of the situation.” The fewer obscure Latinisms in the practice of law, the better, hence our more straightforward label.

In the United States, bankruptcy law restricts enforceability of ToB provisions. Nevertheless, in certain circumstances they are enforceable; the purpose of this article is to propose model language for such circumstances, with the language following the guidelines in Kenneth A. Adams, [A Manual of Style for Contract Drafting](#) (3d ed. 2013). It also offers generic model language for contracts governed by a law other than the law of one of the U.S. states.

Context

As the name suggests, ToB provisions can provide for termination, but drafters also

use them to specify that any of the stated circumstances will constitute an event of default having specified consequences that might or might not include termination.

Furthermore, ToB provisions occur in contracts either as a stand-alone provision or as part of a broader provision stating other circumstances that can lead to termination or an event of default.

As regards whether a ToB provision gives rise to a right to terminate or causes the contract to terminate automatically, that depends on whether the party having the benefit of the provision prefers to retain control or whether it is sufficiently concerned at the prospect of any of the specified events occurring that it wishes to have occurrence act as an automatic trigger.

Enforceability

Due to operation of three provisions of the Bankruptcy Code, ToB provisions conditioned on insolvency of the debtor or its financial condition, or commencement of a bankruptcy case of the debtor, are generally unenforceable in bankruptcy.

First, section 541(c) of the Bankruptcy Code strikes down ToB provisions that in effect enable the nondebtor party to forfeit property of the bankruptcy estate.

Second, section 363(l) of the Bankruptcy Code overrides ToB provisions that prevent the debtor from using, selling, or leasing its property.

And third, section 365(e)(1) of the Bankruptcy Code states that a ToB provision in an executory contract – a contract with performance remaining due on both sides – is unenforceable in bankruptcy.

But section 365(e)(2) of the Bankruptcy Code, in conjunction with section 365(c)(1), provides that a ToB provision is not invalid if the debtor or trustee is not permitted by applicable law to assume or assign the executory contract. So if by law an executory contract cannot be assumed by the debtor or trustee without the other party’s consent, then the nondebtor party can use the ToB provision to force rejection of the contract. See Kenneth A. Adams, [The Bankruptcy Code’s Effect on a Drafter’s Ability to Restrict Assignment and Provide for Termination on Bankruptcy](#), Adams on Contract Drafting (Aug. 7, 2006).

This basis for enforcing a ToB provision is commonly referred to by bankruptcy lawyers as the “personal services” exception. The relevant caselaw is complex and beyond the scope of this article, but an example of a context where this exception

would apply is when the promised performance by the debtor is so distinctive that it wouldn't be reasonable to expect that another could render it. That might be the case if, for example, the debtor were a noted opera singer.

Furthermore, the Bankruptcy Code would render a ToB provision unenforceable only if a bankruptcy is actually filed. If a contract party is insolvent and no bankruptcy case is ever filed, it's possible that the other party could use an appropriately worded ToB provision to terminate the contract. See Robert L. Eisenbach III, [Are "Termination on Bankruptcy" Contract Clauses Enforceable?](#), In the (Red): The Business Bankruptcy Blog (Sept. 16, 2007).

Finally, safe harbors in sections 555, 556, 559, 560, and 561 of the Bankruptcy Code permit enforcement of ToB provisions in specified securities and financial market transactions.

Given that in certain contexts ToB provisions are enforceable, it would be best that they be clear and concise. That's the focus of the remainder of this article.

Proposed U.S. Language

The language proposed in this article doesn't include language addressing any of the contexts discussed above. Instead, it considers only the circumstances that trigger the provision. Also, it refers only to the party in question – referred to for our purposes by the defined term "the Company" – instead of also encompassing subsidiaries or affiliates of that party.

Here's our proposed language for use in contracts governed by the laws of one of the U.S. states. The four elements are linked by "and," as the provision would be triggered by occurrence of one or more of the four circumstances.

- (1) the Company commences a voluntary case under title 11 of the United States Code or the corresponding provisions of any successor laws;
- (2) anyone commences an involuntary case against the Company under title 11 of the United States Code or the corresponding provisions of any suc-

cessor laws and either (A) the case is not dismissed by midnight at the end of the 60th day after commencement or (B) the court before which the case is pending issues an order for relief or similar order approving the case;

- (3) a court of competent jurisdiction appoints, or the Company makes an assignment of all or substantially all of its assets to, a custodian (as that term is defined in title 11 of the United States Code or the corresponding provisions of any successor laws) for the Company or all or substantially all of its assets; and
- (4) the Company fails generally to pay its debts as they become due (unless those debts are subject to a good-faith dispute as to liability or amount) or acknowledges in writing that it is unable to do so.

Drafting Points

Clause (1)

- The bankruptcy clause in the U.S. Constitution gives Congress the right to make bankruptcy laws for the United States. It follows that title 11 of the United States Code – generally referred to as the Bankruptcy Code – is capable of preempting state law insofar as state law allocation of rights has a bankruptcy effect. For purposes of a ToB provision that applies to a company incorporated in a U.S. jurisdiction, it's more economical to refer to title 11 instead of referring generically to the kind of proceeding involved.
- The reference to "successor laws" simply provides for the possibility of title 11 being replaced by another statute.

Clause (2)

- It makes sense that having someone commence an involuntary case against a company shouldn't by itself trigger a ToB provision – that case could be groundless. But it wouldn't be realistic to expect a party that has the benefit of a ToB provision to have to wait in every instance until the court issues an order approving the case – proceedings that drag on can harm business by creating uncertainty. So it's rea-

sonable to allow a party to invoke the provision if the case hasn't been dismissed within some grace period. The proposed language uses a 60-day limit, but a different period could be used if circumstances warrant it.

Clause (3)

- Title 11's definition of "custodian" covers a number of circumstances that routinely are spelled out in ToB provisions. It also incorporates different terms that usually feature in the strings of nouns one routinely sees in ToB provisions – "receiver," "trustee," "assignee," and "agent." So invoking in a ToB provision the definition of "custodian" allows you to be more economical. The downside is that it requires the reader to consult something outside the contract and it results in omission of the familiar assignment-for-the-benefit-of-creditors language, but that problem passes with familiarity. For reference purposes, here's the title 11 definition:

The term "custodian" means—

- (A) receiver or trustee of any of the property of the debtor, appointed in a case or proceeding not under this title;
- (B) assignee under a general assignment for the benefit of the debtor's creditors; or
- (C) trustee, receiver, or agent under applicable law, or under a contract, that is appointed or authorized to take charge of property of the debtor for the purpose of enforcing a lien against such property, or for the purpose of general administration of such property for the benefit of the debtor's creditors.

Clause (4)

- How many bills have to go unpaid, and for how long, before you can say that a company has failed to pay its bills? It's not clear – referring to a company's failure to pay its debts is a vague standard, as you have to take into account the context. But an absolute standard wouldn't work, so one has to live with a vague standard. By including the concept of "generally"

not paying debts as they become due, and excluding debts subject to a good-faith dispute as to liability or amount, the standard is similar to that in section 303 of title 11 governing involuntary bankruptcy filings, which gives this language some judicial gloss. (We've permitted ourselves to eliminate two unhelpful legalisms by using "that" instead of "such" and "good-faith" instead of the Latinism "bona fide.")

- Many ToB provisions differentiate between a debtor's inability to pay its debts and a debtor's actually not paying its debts. Referring to a debtor's inability to pay its debts is both unhelpfully overinclusive and underinclusive. Overinclusive, in that it would encompass circumstances in which the debtor is unable to pay its debts but doesn't yet need to – that's a nuance that would be hard to police. And underinclusive, in that one could get into an unhelpful discussion of whether a debtor is in fact able to pay its debts but simply elects not to.
- Some ToB provisions use as a trigger balance-sheet insolvency (debts exceeding assets). But a debtor can be balance-sheet solvent but have a liquidity problem. Or a debtor can be balance-sheet insolvent but still have enough cash on hand to stay current on its debts. Furthermore, unless you have access to the accounts it might well be difficult to prove that a debtor is balance-sheet insolvent. So using a standard based on cashflow insolvency – failure to pay one's debts as they become due – seems more in keeping with business considerations.

Clauses Omitted

- Another common ToB trigger refers to the debtor's seeking an informal financial accommodation with its creditors, as opposed to filing for bankruptcy or engaging in a formal procedure under state law for resolving its debts, such as an assignment for the benefit of creditors. Clauses of this type usually stipulate that the contract may be terminated if the debtor arranges, or takes steps to arrange, a composition, workout, adjustment, or

restructuring of its debts. Including such a clause would allow the contract to be terminated short of any formal proceeding or outright insolvency, but it might be perceived as overreaching if none of the other triggers occurs independently.

- Some ToB provisions include as a trigger failure to comply with financial covenants. But if the nondebtor party is a bank or financial institution, the contract would invariably specify that breach of financial covenants constitute an event of default, so it would be redundant to add it as a ToB trigger. If the nondebtor party is not a bank or financial institution, presumably the nondebtor would not be in a good position to assess compliance with financial covenants imposed in some other contract.

Proposed International Language

Here is our proposed language for use in contracts governed by the laws of a jurisdiction other than one of the U.S. states:

- (1) the Company commences a judicial or administrative proceeding under a law relating to insolvency for the purpose of reorganizing or liquidating the debtor or restructuring its debt;
- (2) anyone commences any such proceeding against the Company and either (A) the proceeding is not dismissed by midnight at the end of the 60th day after commencement or (B) any court before which the proceeding is pending issues an order approving the case;
- (3) a receiver, trustee, administrator, or liquidator (however each is referred to) is appointed or authorized, by law or under a contract, to take charge of property of the Company for the purpose of enforcing a lien against that property, or for the purpose of general administration of that property for the benefit of the Company's creditors;
- (4) the Company makes a general assignment for the benefit of creditors; and
- (5) the Company generally fails to pay its debts as they become due (unless those debts are subject to a good-faith dispute as to liability or amount) or ac-

knowledges in writing that it is unable to do so.

Drafting Points

Clause (1)

- This clause draws to some extent on the definition of "foreign proceeding" in article 2 of the UNCITRAL Model Law on Cross-Border Insolvency, incorporated as chapter 15 of title 11. The recurring pattern in the vast majority of jurisdictions is that insolvency laws offer a winding-up (or liquidation) option that is equivalent to chapter 7 of title 11 and many also offer a rescue or reorganization alternative that is equivalent to chapter 11 of title 11.
- In some jurisdictions, the insolvency proceeding is controlled or supervised by an official body other than the court. That is why this clause uses the phrase "judicial or administrative proceeding."

Clause (2)

- This serves the same purpose as clause (2) of the proposed U.S. language.

Clause (3)

- This clause reflects that in many jurisdictions outside the United States, lienholders are permitted to appoint a practitioner, commonly referred to as a "receiver," to administer or sell some or all of the debtor's property. In those jurisdictions, receivership is a mechanism for private enforcement by lenders of their security interests, rather than a collective bankruptcy proceeding, so it's important to distinguish "receivership" procedures from bankruptcy procedures and to ensure that both types are covered in an international ToB provision.
- The terms "trustee," "administrator," and "liquidator" are widely understood to refer to a practitioner appointed to preside over a collective bankruptcy proceeding and so are useful in distinguishing that function from receivership.

Clause (4)

- General assignment for the benefit of creditors is a uniquely U.S. concept. If

a ToB provision will not apply to U.S. debtors, this clause could be omitted.

Clause (5)

- Clause (5) serves the same purpose as clause (4) of the proposed U.S. language.

Using the Proposed Language

The authors of this article believe that the proposed language is an improvement, in terms of substance and clarity, over the ToB provisions one usually sees. The world of contract drafting is drastically slow to change, but lawyers might be relatively quick to accept the language proposed in this article, whether or not they are aware of its merits.

For one thing, instead of novelty, the proposed language offers a refined and explicated version of ToB provisions currently in use, so it shouldn't trigger alarm bells in those resistant to change.

Furthermore, the many transactional lawyers with little knowledge of bankruptcy practice might be willing to use the proposed language without worrying about nuances. We'll take any kind of progress, even if it's inadvertent.

*[Kenneth A. Adams](#) is a speaker and consultant on contract drafting and author of *A Manual of Style for Contract Drafting* (ABA 3d ed. 2013). He maintains the [Adams on Contract Drafting blog](#). [Adrian J. Walters](#) is [Ralph L. Brill Professor of Law at IIT Chicago-Kent College of Law](#). He maintains the blog [The Walters Way](#). [Robert L. Eisenbach III](#) is of counsel at [Cooley LLP](#). He maintains [In the \(Red\): The Business Bankruptcy Blog](#).*

ADDITIONAL RESOURCES

For other materials related to this topic, please refer to the following.

[ABA Web Store](#)

A Manual of Style for Contract Drafting, Third Edition

With *A Manual of Style for Contract Drafting, Third Edition*, Kenneth A. Adams has created a uniquely in-depth survey of the building blocks of contract language. First published in 2004, it offers those who draft, review, negotiate, or interpret contracts an alternative to the dysfunction of traditional contract language and the flawed conventional wisdom that perpetuates it. This manual has become a vital resource throughout the legal profession, in the U.S. and internationally. This is the third edition of *A Manual of Style for Contract Drafting*. One-third longer than the second edition (published in 2008) and in a larger format, it contains much new material and has otherwise been revised and supplemented, making it even more essential. This manual's focus remains how to express contract terms in prose that is free of the archaisms, redundancies, ambiguities, and other problems that afflict traditional contract language. With exceptional analysis and an unmatched level of practical detail, Adams highlights common sources of confusion and recommends clearer and more concise alternatives. This manual is organized to facilitate easy reference, and it illustrates its analysis with numerous examples. Consult it to save time in drafting and negotiation and to reduce the risk of dispute.