Do prohibitions against *ipso facto* clauses push suppliers into the insolvency abyss?

David H. Conaway examines the impact of *ipso facto* clauses with reference to UK and Dutch insolvency proceedings by Simeon Gilchrist and Nicolaes Tollenaar

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Given the current global economic conditions, many companies are in severe financial distress or insolvent. There is a global emphasis on corporate rescues or restructurings, as opposed to a liquidation or traditional bankruptcy.

The US has a long-standing history of corporate rescues pursuant to Chapter 11 and its Bankruptcy Code. The UK and the Netherlands have recently modified their insolvency statutes to facilitate and expedite corporate rescues. In each case, such modifications include the unenforceability of so-called "*ipso facto*" clauses. The statutory provisions are designed to prohibit suppliers from terminating or modifying contracts, to support the corporate rescue. The question is, which stakeholders assume the risk of success or failure of the corporate rescue? The growing trend in the US is that suppliers are assuming a disproportionate amount of that risk, by virtue of the presence of *ipso facto* clauses in supplier contracts. It will be interesting to note how insolvency statutes regarding *ipso facto* clauses are intended to be addressed in UK and Dutch insolvency proceedings, and how they will actually be interpreted and enforced.

As originally conceived, Chapter 11 allowed insolvent companies to restructure their businesses, based upon a "breathing spell" from creditors and the payment of pre-Chapter 11 debt. While companies could use Chapter 11 to temporarily shelve pre-petition debt, the privilege of Chapter 11 required debtors to "pay as they go" during the Chapter 11 case. Pre-petition claims are generally unsecured claims ("GUCs") and "pay as you go," claims are deemed to be "administrative claims," which receive priority payment treatment under the Bankruptcy Code. The statutory basis or assurance for the "pay as you go" requirement is Section 1129 of the Bankruptcy Code which requires payment of administrative claims in full, as a condition to confirmation of a Plan of Reorganisation. While creditors may receive little or nothing on their GUCs, at least they would be paid for supporting the debtor customer during the Chapter 11 case to facilitate a successful restructuring.

Times have changed

In recent years, a high percentage of Chapter 11 cases are not resolved with a Chapter 11 Plan of Reorganisation. Rather, the main event of the Chapter 11 case is a Section 363 sale of all of the debtor's assets. Sometimes there is a mop-up Plan of Liquidation, which deals only with residual, post-sale assets, usually preference claims against vendors. A Section 363 sale has no corresponding requirement that administrative claims are paid in full. Rather, payment of administrative claims is dependent on sales proceeds in excess of secured debt and professional fees, or on the Section 363 sale buyer's willingness to assume administrative claim liabilities in the asset purchase agreement.

We note three recent examples of Chapter 11 cases where the main event involved a Section 363 sale and administrative claims were not paid in full:

- Toys "R" Us (claims paid less than 20%)
- Sears/Kmart (nominally paid 75%), and
- Dean Foods (claims paid 80%).

In Sears/Kmart and Dean, the estates also pursued preference actions against vendors to recover payments received 90 days prior to the Chapter 11 filing. As a result, suppliers suffered the trifecta of business insult from their customers: (1) write-off of pre-petition accounts receivable balances, (2) non-payment of invoices for supporting the debtor *during* the Chapter 11 case, and (3) disgorgement of payments received prior to the Chapter 11 case.

The non-payment of administrative claims in Chapter 11, and the use of "administrative protocols" to compromise administrative claims is a growing trend in the US. In a number of key US industries (e.g. automotive, aviation, dairy, energy, retail, hospitality), existing market conditions and/or COVID-19 consequences have caused significant disruptions in operations, roiling EBITDA and asset values, and restricting access to financial liquidity. Chapter 11 has become the ultimate zero-sum game with intense competition over allocation of value to stakeholders.

As a result of the growing trend of non-payment of administrative claims, the premise that Chapter 11 debtors must "pay as they go" has been

compromised. Yet, debtors (and perhaps their financiers behind the scenes) consistently assert that suppliers must continue to perform their end of the sales bargain unabated, which includes shipments of goods and extensions of credit terms.

This insistence is based upon Section 365(e) of the Bankruptcy Code which provides that an executory contract may not be terminated or modified, and any right or obligation under such contract … may not be terminated or modified solely based on the insolvency or financial condition of the debtor or the filing of Chapter 11. However, the foregoing does not apply if the applicable law excuses the supplier from accepting or rendering performance to the debtor.

US Bankruptcy Courts have prohibited suppliers from enforcing these "*ipso facto*" contract clauses that allow for termination or modification of a contract due to the filing of Chapter 11, the financial condition or insolvency of the debtor, or the failure to pay invoices as a result of the Chapter 11 filing. To do otherwise would, in theory, gut a debtor's rights regarding its ability to assume or reject contracts, as part of the restructuring process.

Yet, a supplier is at greater risk of non-payment of its administrative claims, especially when the financial condition of the customer is tenuous and there is uncertainty of outcome in Chapter 11.

However, the "applicable law" exception mentioned above includes Article 2 of the US's Uniform Commercial Code ("UCC"), which is functionally a "federal" law on the sale of goods, as all US states (except Louisiana) have adopted Article 2 of the model law. In particular, UCC Sections 2-609 and 2-702 regarding anticipatory breach and cash before delivery shipments, can relieve suppliers from the obligations to ship or to extend credit.

In the Dean Foods Chapter 11 case, pending in Texas, the debtors filed a number of first day motions including approval of DIP financing, that was presented as providing sufficient "runway" for Dean Foods to achieve a successful Chapter 11 reorganisation or a "successful" Section 363 sale. Dean Foods also filed a first day motion to prohibit contract counter-parties from altering their contracts, including the obligations to continue providing goods and services, on credit terms, without regard for suppliers' rights under the UCC. Thus, on day one, vendors' rights to withhold shipment or credit terms were impaired, without regard to increased risk of payment later in the Chapter 11 case.

Fast forward to July, 2020, Dean Foods filed a proposed "administrative claims protocol" offering to pay administrative claims at a 20% discount, including the post-petition invoices that Dean Foods failed to pay, and the Section 363 sale buyer refused to assume such liabilities. The administrative protocol indicates that Dean Foods is or may become administratively insolvent, meaning it does not have or may not have sufficient assets to pay Section 503(b)(9) claims and unpaid post-petition invoices in full.

Suppliers have an easy fix to this dilemma: avoid a formal sales contract and only do business on a purchase order and invoice basis. Obviously a much less committed business relationship, but the supplier is able to "cut off" the debtor immediately upon failure to pay or the filing of Chapter 11, because there is no binding contract. Which is ironic because the supplier with a formal contract has every incentive to continue supporting the debtor customer, provided the supplier is assured of payment.

Bankruptcy Courts should not expand the prohibition on *ipso facto* clauses, and protect suppliers who want to support the debtor customer by recognising that the suppliers' rights under the Uniform Commercial Code, specifically including Section 2-609 and 2-702 constitute "applicable law" that may excuse the supplier from falling into the administrative protocol abyss. Fair is fair, creditors will not be paid on their GUCs, and will likely be sued for a preference. They should not also fund the debtor's Chapter 11 case without payment.

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the Dutch bill provides for the ability of a debtor to unilaterally terminate burdensome contracts

Dutch update

On 1 January 2021 the bill on the Dutch scheme will enter into force, also known under its Dutch acronym "WHOA" (*Wet homologatie onderhands akkoord*). The plan procedure can be implemented outside of formal insolvency and has been designed to be as efficient, fast and flexible as possible. The procedure provides for majority decision making with voting by class and cram-down of dissenting classes with reference to the applicable priority rules.

The bill contains certain supportive measures such as a generic or specific moratorium upon request, the protection of new money against claw-back risk, and the ability to continue using encumbered working capital in the ordinary course, subject to adequate protection.

The bill also contains provisions for dealing with contracts that are net-assets and should be preserved, and conversely, contracts that are net-liabilities and should be terminated and converted into an ordinary unsecured liability.

Section 373(1) of the Dutch bill provides for the ability of a debtor to unilaterally terminate burdensome contracts and convert them into an ordinary unsecured damages claim. Section 373 subsections (3) and (4) are aimed at ensuring continued performance, at least pending the procedure of those contracts, that are deemed necessary or beneficial to the business. As far as the continuation of contracts is concerned, the legislative notes make it abundantly clear that whilst liabilities that arose under the contract before the commencement of the procedure can be restructured, all liabilities that arise under a contract after the commencement of the procedure have to be paid in full in accordance with their terms ("pay as you go"). A director who allows the debtor to assume a liability pending the procedure, whilst he knew or ought to have known that the debtor would not be able to satisfy that liability in full, will be liable for the shortfall.

Section 373(3) of the Dutch bill addresses *ipso facto* clauses where the debtor has *not* defaulted under the contract. The key concept is that the sole fact that the procedure has commenced or a plan is being proposed does not constitute grounds to suspend or terminate further performance of the contract. The mere commencement of the procedure or the proposal of a plan does not necessarily lead to an increased risk of default. Indeed, a moratorium that stays pre-existing liabilities and/or a plan that de-leverages the debtor's balance sheet, can in fact *decrease* the risk of future non-performance by the debtor on its operational contracts. However, the general contract law remains in place. If the non-debtor party to the contract can demonstrate a material risk of non-performance on the debtor's part, it retains its right to suspend further performance or to terminate the contract under provisions of general contract law (anticipatory breach).

Section 373(4) addresses situations where the debtor *has* defaulted on its obligations under the contract. When a stay has been ordered, a breach of performance by the debtor *before* the stay has commenced does not constitute grounds for amending, suspending, or terminating obligations owed to the debtor, provided security is granted for the performance of new obligations arising under the contract during the stay. The security must be more than just "assurance" and must properly ensure full performance. If adequate security for future performance is not provided, the non-debtor party to the contract may suspend further performance on the basis of the pre-existing default. The result of this is that the non-debtor party cannot "hold-out" on the basis of a pre-existing default to procure preferential treatment of its pre-commencement claim. At the same time, it cannot be forced to incur further risk in supporting the debtor going forward.

UK[1] update

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Set against the back-drop of the global pandemic, Royal Assent was given on 25 June 2020 to the snappily titled Corporate Insolvency and Governance Act 2020 ("**CIGA**"). The Act came into force the following day. This is a complicated piece of legislation that is home both to short term measures seeking to address the insolvency ramifications of the pandemic, and to more structural shifts in both the insolvency and corporate governance legislative frameworks: CIGA contains transitional provisions and measures with sunset dates alongside structural changes to existing legislation, principally the Companies Act 2006 and the Insolvency Act 1986. CIGA is not only complicated but it is also controversial in its use of so-called "Henry VIII powers" by which the executive is given the ability to modify certain of its provisions using only secondary legislation.

The reform to the law of contract and the supply of goods and services complements the introduction of the pre-insolvency moratorium and the new restructuring plan. Although English contract law holds sacred the ability to contract freely, this latest reform was but the latest step in the gradual curtailment of *ipso facto* clauses. Section 233 of the Insolvency Act 1986 required monopoly utility providers to continue their supply to insolvent companies whilst depriving the supplier of leverage to force settlement of unpaid accounts.

The 1986 statutory curtailment to monopoly suppliers was further developed by reforms in 2015[2] as a consequence of which "essential goods and services" could no longer be the subject of *ipso facto* clauses where the debtor had entered administration or a company voluntary arrangement ("**CVA**"), the rationale no doubt being that both processes are ostensibly rescue mechanisms. The 2020 reform can be seen as an extension to the meaning of "essential supplies and services", as opposed to a paradigm shift of itself.

CIGA's new section 233B of the Insolvency Act 1986 addresses the protection of supplies of goods and services. The expanded *ipso facto* prohibition applies to a "relevant insolvency procedure", which ranges from the new moratorium through administrative receivership, CVA, administration and the new restructuring plan to include, interestingly, provisional liquidation and liquidation itself. It does not include traditional Companies Act schemes of arrangement, which is also interesting if the prohibition was intended to support turnaround or restructuring mechanisms.

Subject to exceptions, the new section 233B works in two ways: first, there is a permanent prohibition against a supplier's termination right on the grounds of insolvency or non-payment of historic debt, or in amending payment terms to suit the supplier. Second, there is a temporary prohibition against enforcing pre-insolvency grounds of default until the relevant insolvency procedure comes to an end or the debtor progresses into a further insolvency procedure. However, there are three safeguards that enable termination: the consent of the debtor entity; upon approval of the court; or on a post-insolvency non-payment of a new supply. Approval of the court requires that the supplier establishes "hardship", an entirely novel term to the legislation that will no doubt be the subject of much jurisprudence.

The exceptions to the application of the prohibition fall broadly into two categories, both of which were foreseeable: permanently excluded from the reach of the prohibition are suppliers of insurance, banking, payment infrastructure, financial services and the financial markets on the one hand and, on a temporary basis, "small suppliers". The temporary nature of the exclusion has been extended to 30 March 2021 as a consequence of the pandemic, whereas the meaning of "small" is engaged on two of three conditions: turnover of not more than £850,000 per month in the preceding 12 months; a balance sheet of no more than £5.1M; and fewer than 50 employees.

The reform may well have far reaching consequences for the drafting of supply contracts but it is far from all-encompassing as presently enacted. Questions remain as to the scope of the prohibition in terms of what are "essential goods and services" and applicability to sole traders, who remain vulnerable to an *ipso facto* clause irrespective of the nature or size of their business. Although supposedly necessary as an adjunct to the new pre-insolvency moratorium and restructuring plan in levelling up to the ubiquitous Chapter 11, the purpose of the reform ("*the policy intention*") was said to have been to allow companies to trade through restructuring or insolvency procedure. There is an open question however as to how much value will be preserved at the expense of suppliers' prior freedom to withdraw and the actual cost to them in further lost supplies. As in all things, time will tell. ■

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Footnotes:

1 The writer never tires of underlining to overseas readers that "the UK" is three separate but often co-dependent legal jurisdictions: England and Wales; Scotland (which together form Great Britain); and Northern Ireland. Although a broad brush may generally be applied, the extent of any legislative provision must be verified on a case by case basis. In the present instance, the legislation makes separate provision for Great Britain and Northern Ireland. With apologies to all Welsh, Scottish and Northern Irish friends, the writer approaches this topic from an English perspective.

2 Insolvency (Protection of Essential Supplies) Order 2015(SI 2015/989)