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AMR Decision Highlights Bankruptcy Court Split on Enforceability of Ipso Facto Clauses

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A recent ruling in the American Airlines bankruptcy case enforcing an automatic acceleration upon bankruptcy provision serves as a reminder that the enforceability of so-called *ipso facto* provisions in debt instruments remains an unsettled, forum-dependent question.

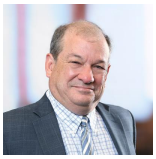
In the American Airlines case, the question of the enforceability of an automatic acceleration upon bankruptcy provision arose in an unconventional context: the invalidity of the provision was argued not by the debtor but by the indenture trustee. The issue in dispute was whether a refinancing of certain taxable debt would require the debtor to pay (i) a make-whole premium due upon an optional redemption of the debt or (ii) par per the indenture provisions automatically accelerating the debt at par upon a bankruptcy. The U.S. Bankruptcy Court for the Southern District of New York held that the automatic acceleration provision had been triggered and controlled the amount due, so that the amount payable to satisfy the debt would be par, not par plus the make-whole premium. The indenture trustee is in the process of appealing the court's ruling, which also involved an interpretation of a specialized Bankruptcy Code provision relating to debt secured by aircraft. .

The indenture trustee argued that the automatic acceleration upon bankruptcy provision in the indenture should be disregarded as an invalid *ipso facto* clause. The court disagreed, quoting the language of Section 365(e)(1) of the Bankruptcy Code, which precludes enforcement of contractual modifications triggered by a bankruptcy only if the relevant contractual provisions are located in "an executory contract or unexpired lease of the debtor." As all parties agreed that the applicable debt instruments were neither executory contracts nor leases, the court found no basis for invalidating the *ipso facto* acceleration provisions in such debt instruments.

The federal bankruptcy court in New York declined to follow a 2012 decision by a federal bankruptcy court in Delaware in the W.R. Grace bankruptcy that the prohibition of *ipso facto* clauses is not limited to the specific types of instruments referenced in Section 365(e)(1). The New York court found precedents in other Southern District of New York bankruptcy cases more persuasive than the reasoning in *In re W.R. Grace & Co.,* and also distinguished the W.R. Grace holding on the facts.

Except in special circumstances such as the ones presented in the American Airlines case, the enforceability or unenforceability of an automatic acceleration upon bankruptcy clause in a debt instrument should not make much of a difference to litigants, as generally debt is accelerated for claim purposes upon a filing in any event. However, the potential enforceability in at least some jurisdictions of bankruptcy-triggered provisions in debt instruments may encourage creditors to require other types of *ipso facto* provisions in debt documents just in case they prove both enforceable and beneficial to such creditors in the event the borrower becomes a bankruptcy debtor.

Authors



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Leonard Weiser-Varon is a Mintz Member who handles municipal and corporate debt transactions. Len represents state sponsors and private program managers of Section 529 and 529A savings programs. He often speaks on securities and constitutional law matters.