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German Supreme Court renders ipso facto clauses invalid and unenforceable – *Roma locuta, causa finita?*

By Volker Gattringer

An *ipso facto* clause is a contractual provision which states that a contract or agreement automatically terminates or may be terminated by a party if bankruptcy proceedings have been instituted over the other party's assets. For a long time it was not clear whether such *ipso facto* clauses are valid and enforceable in Germany (see Sec. 119 of the German Insolvency Code). The German Supreme Court for civil law matters has now issued a decision saying that such *ipso facto* clauses are invalid and thus not enforceable when the counterparty is subject to German bankruptcy proceedings (BGH IX ZR 169/11 dated 15/11/2012 – ZInsO 2013, 292).

In this court case, a utility provider entered into a long-term contract over the delivery of electricity. The energy contract states that it automatically terminates if bankruptcy proceedings are instituted over the utility provider's customer or if the customer files a petition for bankruptcy. In its decision, the German Supreme Court held that such termination clause is invalid irrespective of whether the trigger is the institution of bankruptcy proceedings or the filing of a petition for bankruptcy. The court further indicated that a termination which is triggered by illiquidity or over-indebtedness of the debtor could also constitute invalid *ipso facto* clauses. According to the Court, in all of the above instances the bankruptcy estate would need to be protected from any value-deteriorating terminations which could jeopardize the chances of a successful plan restructuring of the debtor.

As the German Supreme Court pointed out, the invalidity of *ipso facto* clauses would typically apply to contracts for delivery of goods, services or energy. There is little doubt that *ipso facto* clauses in IP licenses, construction agreements, rental agreements, and financial and operating lease agreements will be equally affected. To the extent the statutory law itself already provides for an *ipso facto* termination right, however, such termination right is valid and enforceable. Accordingly, the *ipso facto* termination of a partnership contract has in the past been upheld by the German Supreme Court.

Is there anything contract counterparties and creditors can still do to protect their interests or must they now close their files because – *Roma locuta, causa finita* – the Supreme Court had its final say on the matter?

There are two things which can be done:

- Creditors and contract counterparties could resort to a termination clause which makes reference to vaguer circumstances such as good cause or material deterioration of the counterparty's financial condition. In the past, the German Supreme Court has upheld the termination of a software license for good cause because such clause would not constitute an *ipso facto* clause and because it considers the insolvency to be a sufficient cause for the termination. Chances are that the broader the language and the less specific the clause, the more likely it will be upheld.

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- If the contractual relationship with the insolvent counterparty is governed by German law the other party has the right to refuse to make payments or deliveries in advance, even if the contract explicitly provides otherwise, provided that its compensation is at risk. Clearly, that would be the case if the counterparty is already insolvent or if there is a material deterioration in the counterparty's financial condition. In the event the contractual relationship with the insolvent counterparty is governed by foreign law, the other party would have to make sure that it has an equivalent right under foreign statutory law or under provisions of the relevant contract.

It will be interesting to see how the German Supreme Court reacts if contract counterparties and creditors increasingly resort to the above described avoidance strategies. It may well be the case that the Supreme Court will then treat a broader termination clause to be equally invalid. Secondly, banks, financial investors and shareholders will now face more uncertainty whether the German Supreme Court's decision will also affect ipso facto clauses in their loan agreements, shareholder agreements or financial contracts. All that remains to be seen.

Author:

Volker Gattringer

volker.gattringer@klgates.com

+49.69.945.196.280

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