Crucial Concepts in Drafting Contracts (Beyond the Basics)

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Contractual Disputes in Bankruptcy Cases – Did you think about this?

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A. Drafting agreements each with its own "standard clauses".

One of the contested disputes in *In re Refco, Inc.*[1] was whether or not an Exclusivity Agreement which required Cargill, Incorporated to exclusively use a broker's services for 5 years was able to be assumed and assigned (or sold) by Refco to Man Financial, Inc. ("Man"), the buyer of certain assets of Refco.

The Exclusivity Agreement was part of an earlier transaction in which Refco purchased a division of Cargill under a purchase agreement. Under the purchase agreement, Refco was not required to close without some contractual assurance from Cargill that Refco would retain the business that Cargill had been placing with the division after the sale. To satisfy that condition, Cargill executed and delivered the Exclusivity Agreement that required Cargill to place all of its commodity brokerage business with Refco for 5 years.

When Refco entered bankruptcy, it sold certain of its assets, including the Exclusivity Agreement to Man. Cargill objected to the assumption and assignment of the Exclusivity Agreement. Though having initially listed the Exclusivity Agreement as an executory contract, Debtor and Man ultimately took the position that the Exclusivity Agreement was not executory and thus could be sold under Section 363 rather than under Section 365 and the objection of Cargill was without effect. The Bankruptcy Court first determined that the Exclusivity Agreement was in fact not executory because though Cargill had an ongoing obligation to place all of its business with Refco (Man), Refco (Man) had no obligation to take the business, the only breach remedies were granted to Refco, and the Exclusivity Agreement was freely assignable without Cargill's consent.[2]

FIRST POINT – IS THE CONTRACT THAT YOU ARE WRITING CAPABLE OF BEING DRAFTED AS AN EXECUTORY CONTRACT SO THAT YOUR CLIENT HAS SOME CONTROL OVER ASSUMPTION AND ASSIGNMENT?

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[2] Cargill's argument that the Exclusivity Agreement was financially important and was tied to Cargill's expected earn-out payment rights under the purchase agreement did not prevail because there was nothing in the Exclusivity Agreement that said that or that required Refco to accept the Cargill business so as to increase the earn-out payment.

The Bankruptcy Court then determined that the Exclusivity Agreement was a "stand alone" agreement and not part of a single transaction with the purchase agreement. The Bankruptcy Court found the following determinative:

(a) each of the contracts was not ambiguous on its face and thus the determination was bounded by the four corners of the contract;
(b) the standard "merger/integration" clauses in each of the contracts (which were of different wordings) did not incorporate the other contract into each other and that merger/integration clauses are not the equivalent of incorporation clauses;

SECOND POINT—IS THIS AGREEMENT PART OF A LARGER INTEGRATED TRANSACTION? IF YES, THEN MAKE IT PLAIN. IDENTIFY THE STATE LAW CONTROLLING AND INCLUDE THE PROPER WORDS. UNDERSTAND THE DIFFERENCE BETWEEN MERGER CLAUSES AND INCORPORATION CLAUSES.

(c) the Exclusivity Agreement and the purchase agreement had different provisions and differently worded standard provisions such as
    a. One was governed by Illinois law and the other governed by New York law;
    b. The agreements were not executed (dated) at the same date;
    c. The agreements had different parties being bound, and though there was some overlap in the parties, the common parties were acting in different capacities under the two agreements (Cargill was seller under purchase agreement, but customer under Exclusivity Agreement);
    d. The agreements had different assignability clauses (purchase agreement required consent, no consent in Exclusivity Agreement); different merger clauses; different timing of performance (earn-out under purchase agreement for two years, but Exclusivity Agreement was for five years); while Refco included the Exclusivity Agreement as a condition to closing on the purchase agreement, it was not a Cargill condition to closing on the purchase agreement.
    e. No cross default provisions in the purchase agreement and Exclusivity Agreement.

THIRD POINT—CONFORM THE AGREEMENTS AMONG THEMSELVES. IF DIFFERENT LAWYERS ARE DRAFTING THE AGREEMENTS, SOMEONE NEEDS TO MAKE SURE THAT THE STANDARD CLAUSES AND CHOICE OF LAW, ETC. SHOULD BE THE SAME IF THE AGREEMENTS ARE INTENDED AS A SINGLE INTEGRATED TRANSACTION.

Parting shot – the standard severability clauses were used as an alternative argument that even if the agreements were an integrated transaction, the Exclusivity Agreement could be severed and sold.

B. Executoriness of Contracts.

In *In re Hawker Beechcraft, Inc.*, Case No. 12-11873, United States Bankruptcy Court for the Southern District of New York (2012), the Court issued an opinion on debtor's motion to reject certain warranty and maintenance contracts in connection with the sale of certain aircraft. The decision does not really plow new contract ground[3], but provides an illuminating discourse on whether a contract is executory and thus could be rejected. I include the Court's dissertation on executoriness below (with citations omitted):

"The current dispute fulfills the prophecy, at least in the case of a rejection motion, that the time expended searching for executoriness can be spent more fruitfully doing almost anything else. Rejection signifies that the debtor will breach the contract and not perform. If the contract is executory and the debtor rejects it, the non-debtor party is left with a pre-petition unsecured claim for breach of contract. If, on the other hand, the contract is not executory and the debtor chooses not to perform, the non-debtor party gets the same pre-petition claim for breach of contract. In other words, the rejection of an executory contract is the economic equivalent of the debtor's refusal to perform a non-executory contract giving rise to the same unsecured claim. The only practical difference concerns the deadline for filing the non-debtor contract party's unsecured claim. If the breached contract is not executory, the non-debtor party must file its breach claim by the general bar date. If the contract is executory and rejected, the non-debtor party will get additional time to file its rejection damage claim if the bar date has already expired. Ironically, a non-debtor contract party who convinces a bankruptcy court that its contract is not executory and had not yet filed a proof of claim may find that its claim is time-barred." *Docket No. 1223*, January 28, 2013.

FOURTH POINT – IF YOU BELIEVE THAT YOUR CONTRACT IS NOT EXECUTORY, FILE A CLAIM FOR BREACH BY THE BAR DATE. AND REMEMBER THAT AN INDEMNIFICATION CLAUSE CAN MAKE YOUR CONTRACT EXECUTORY.

[3] Although, it was surprising to me that the court determined the warranty agreements to be executory in part on the basis of indemnification obligations by the airplane buyer to debtor.

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Beware the "Boilerplate"
(or, Boilers Are Hot and Will Burn You)

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The parties to a contract will often spend days, weeks and even months negotiating and drafting the terms of their agreement. Many of the provisions that are considered boilerplate are typically found at the end of the contract in a "Miscellaneous" section and are often subject to little or no consideration. However, as some of the examples below will show, a careful review of these provisions is important to avoid unnecessary, and sometimes costly, disputes.

I. Boilerplate provision: No Third Party Beneficiaries

"The parties do not confer any rights or remedies upon any Person other than the parties to this Agreement and their respective successors and permitted assigns."

In re Quincy Medical Center, Inc.[1]

- Conflicting provision in APA under which the parties agreed that the buyer agreed to continued employment of certain employees of the seller following the closing date.

- Court relied on tenet of contract interpretation – "the more specific clause prevails over the more general clause"

TAKEAWAY: A general boilerplate provision may be trumped by a more specific, conflicting provision. It is important to consider the general provision in connection with the other negotiated provisions of the contract.

II. Boilerplate provision: Merger/Integration Clause

"This Agreement, [together with [NAME OF OTHER DOCUMENTS] [any other documents incorporated herein by reference] [and all related Exhibits and Schedules] constitutes the sole and entire agreement of the Parties with respect to the subject matter of this Agreement [and therein], and supersedes all prior and contemporaneous understandings, agreements, representations and warranties, both written and oral, with respect to the subject matter. [In the event of any inconsistency between the statements in the body of this Agreement, [OTHER

[1] *In re Quincy Med., Ctr., Inc.*, 479 B.R. 229 (Bankr. D. Mass. 2012)

DOCUMENTS] [and the related Exhibits and Schedules (other than an exception expressly set forth as such in the schedules)], the statements in the body of this Agreement shall control.] [The Parties have not relied on any statement, representation, warranty or agreement of the other Party or of any other person on such Party's behalf, including any representations, warranties, or agreements arising from statute or otherwise in law, except for the representations, warranties, or agreements expressly contained in this Agreement.]"

Town Bank v. City Real Estate Development LLC[2]

- A merger clause providing that the loan agreement was intended "as a final expression" of the agreement between the bank and the borrower "and as a complete and exclusive statement of its terms" prohibited the borrower from introducing evidence of the bank's commitment to make additional loans to the borrower pursuant to a prior commitment letter.

In re Duckworth[3]

- Parol evidence could not be introduced to show that a promissory note incorrectly identified in a security agreement was secured by the collateral. Although this case involves a drafting mistake (the security agreement referenced a promissory note dated December 13, while the promissory note at issue was dated December 15), the bank may have prevailed had the promissory note been attached as an exhibit to the security agreement notwithstanding the incorrect date.

In re Trinity Corp.[4]

- A debtor was unsuccessful in attempting to reject two ancillary documents in a transaction involving a master agreement and sixteen ancillary documents where the ancillary documents were attached as exhibits to the master agreement and the integration clause defined the "entire agreement" as the master agreement and all schedules and exhibits.

In re Trackwell[5]

- An integration clause prevented a successful bidder at a bankruptcy auction from claiming that a particular asset was part of the assets purchased under the purchase agreement based on representations made by the auctioneer.

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[2] *Town Bank v. City Real Estate Dev. LLC*, 2010 WI 134, 330 Wis.2d 340, 793 N.W.2d 476

[3] *In re Duckworth*, 776 F.3d 453 (7th Cir. 2014)

[4] *In re Trinity Corp.*, 514 B.R. 526 (Bankr. E.D. Ky. 2014)

[5] *In re Trackwell*, 520 B.R. 788 (Bankr. W.D. Mo. 2014)

Judson Atkinson Candies, Inc. v. Kenray Assoc., Inc.[6]

- Notwithstanding an integration clause, the parol evidence rule restricting courts from considering parol or extrinsic evidence for the purpose of varying or adding to the terms of the written contract may not apply in the case of fraud in the inducement, where a party was 'induced' through fraudulent representations to enter into a contract.

- A non-reliance provision that states the parties have not relied on any statement, representation or warranty other than as explicitly set forth in the agreement increases the likelihood the court will apply the parol evidence rule.

TAKEAWAY: (1) Pay close attention to integration clauses to make certain all documents intended to form the transaction are referenced or attach all documents intended to be included as exhibits. (2) Make sure that the written agreement clearly and specifically includes your client's understanding of the terms of the deal. (3) A carefully drafted, comprehensive integration and non-reliance clause will provide more assurance that interpretation of the intent of the parties will be limited to the language of the written agreement.

III. Boilerplate provision: *Ipso Facto* Clause (providing for default and termination of an agreement due to a company's bankruptcy, insolvency or financial condition)

"Upon the occurrence of any of the following events, [Buyer] will be in material breach under this Agreement and [Seller] shall be entitled to terminate this Agreement: (1) any proceeding under any bankruptcy or insolvency laws is commenced by or against [Buyer] or [Buyer] makes an assignment for the benefit of creditors, or (2) [Buyer] shall generally not, or shall be unable to, or shall admit in writing its inability to, pay its debts as they become due and payable."

- The Bankruptcy Code generally restricts the enforceability of *ipso facto* clauses in certain contracts based on the operation of three sections:

  Section 541(c) – contract provision would effectuate a forfeiture, modification or termination of the debtor's interest in property

  Section 363(l) – contract provision would prevent the debtor from using, selling or leasing its property

  Section 365(e)(1) – a termination on bankruptcy provision in an executory contract is unenforceable in bankruptcy

[6] *Judson Atkinson Candies, Inc. v. Kenray Assoc., Inc.*, 719 F.3d 635 (7th Cir. 2013)

- Exceptions:

  Section 365(c)(1) – Contracts non-assignable without consent under non-bankruptcy statutory or common law (i.e., personal services agreements)

  Sample language: "This Agreement is a contract for personal services under which applicable law excuses [Buyer] [Seller] from [accepting performance from] [rendering performance to] [Seller] [Buyer] within the meaning of sections 365(c)(1) and 365(e)(2)(A) of the Bankruptcy Code."

  Section 365(c)(2) – Contracts to loan money, issue securities or make other financial accommodations (i.e., financial services agreements)

  Sample language: "This Agreement is a contract to [make a loan] [extend debt financing] [extend financial accommodations] [issue a security] within the meaning of sections 365(c)(2) and 365(e)(2)(B) of the Bankruptcy Code."

  Sections 555, 556, 560 and 561 – Contracts for certain securities and financial market transactions (i.e., securities contracts, commodities contracts, swap agreements)

TAKEAWAY: (1) Although generally unenforceable in executory contracts, an *ipso facto* clause should still be included and drafted to be triggered by certain events other than bankruptcy, including insolvency, and may be enforced before a bankruptcy. (2) If a contract is intended to be a personal services contract or another type of contract that may be subject to the bar against *ipso facto* clauses, make sure to include specific language stating such, including, for example, detailed descriptions of the personal nature of the relationship (the buyer has a specific need for a product or service and the seller has the unique ability to provide such product or service).