

Bankruptcy's *Ipsa Facto* Principle

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ABSTRACT

We offer a general theory of when bankruptcy law should nullify arrangements that alter the contract or property rights of creditors contingent upon the fact of (“ipso facto”) their debtor’s insolvency or bankruptcy. A sound bankruptcy *ipso facto* principle would neutralize all strategic efforts by creditors to redistribute the losses occasioned by debtor insolvency. Loss-shifting is socially wasteful because the division of an insolvent firm’s assets is a zero-sum proposition; therefore, efforts to externalize insolvency losses reduce the joint surplus from credit arrangements. They also distort interest rates, encouraging overinvestment. Our *ipso facto* principle provides each unsecured creditor with a property-like interest in an aliquot share of the debtor’s estate that cannot be impaired without the creditor’s consent. We show that prevention of strategic loss-shifting explains not only the Bankruptcy Code’s prohibitions on specified *ipso facto* transactions, but also why judges hesitate to allow “make-whole” payments and similar bankruptcy-triggered claims.