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CONTRACT TERMINATION

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Legal Briefings – By **Paul Apathy**, **Rowena White** and **James Myint**

The Government has proposed to restrict the ability of third parties to terminate contracts with companies that are either in administration, in receivership, subject to a deed of company arrangement or that have proposed a scheme of arrangement, in reliance on ipso facto provisions in the relevant contract.This article explores this aspect of the Government's proposed reform and gives suggestions on some aspects of the proposed ipso facto reform that we think the Government should consider further.

MAJOR INSOLVENCY REFORM: GETTING THE *(IPSO) FACTOS* STRAIGHT

IN BRIEF

- In its Improving Bankruptcy and Insolvency Laws Proposal Paper[1] (**Proposal**) released on 29 April 2016, the Federal Government (**Government**) proposed a number of significant reforms to Australia's insolvency laws.
- The proposed reforms include a proposal to restrict the ability of third parties to terminate contracts with companies that are either in administration, in receivership, subject to a deed of company arrangement or that have proposed a scheme of arrangement, in reliance on *ipso facto* provisions in the relevant contract.
- This article explores this aspect of the Government's proposed reform and gives suggestions on some aspects of the proposed *ipso facto* reform that we think the

Government should consider further.

SUMMARY

On 29 April 2016, the Government announced three major insolvency law reform proposals, including a proposal to restrict the enforceability of *ipso facto* clauses against companies subject to certain insolvency processes.

This aspect of Australia's insolvency laws has been the subject of fairly extensive criticism and debate, and the Government's willingness to progress reform now is definitely welcome. However, the detail of any reform ultimately implemented will need to be carefully considered to ensure an appropriate balance is struck between promoting successful corporate restructuring and protecting counterparty interests.

IPSO FACTO CLAUSES – WHAT ARE THEY AND WHY DO WE CARE?

In the insolvency context, an *ipso facto* clause is a contractual provision that allows one party to terminate or modify the operation of the contract upon the occurrence of an insolvency event. For example, a clause in a contract that entitles one party to terminate the contract if a voluntary administrator is appointed to the other party is an *ipso facto* clause.

These clauses are very common in all types of commercial contracts. However, the ability of commercial counterparties to terminate in these circumstances is often irreparably damaging to the value of a business which may require key contracts to continue to operate, and can undermine the ability to restructure, turn around or sell (as a going concern) a business within a formal insolvency process.

There is currently no general restriction on the enforcement of *ipso facto* clauses against companies undertaking a restructuring or rehabilitation in Australia.[2] This means, for example, that trade creditors may refuse to continue to provide goods and services following the occurrence of an insolvency event in reliance on *ipso facto* provisions even if the company is otherwise continuing to perform under the contract.

Australian restructuring professionals and other industry participants have been calling for reform in this area for some time. The ability of counterparties to terminate key contracts following the occurrence of an insolvency event is generally recognised as one of the most significant impediments to successfully implementing formal corporate rescues in Australia, particularly for contract based businesses where value is primarily concentrated in the company's contracts and not in its physical assets.

THE US POSITION

The position in Australia is often contrasted with the United States, where companies in Chapter 11 proceedings (or certain other proceedings) under the US Bankruptcy Code have the benefit, subject to certain exceptions, of a general prohibition on the enforcement of *ipso facto* clauses in so-called "executory contracts"[3] and unexpired leases during the course of the bankruptcy case.[4]

Section 365(e) of the US Bankruptcy Code prevents counterparties from terminating or modifying executory contracts or unexpired leases of the debtor at any time after the commencement of the bankruptcy case solely because of a provision in the contract or lease that is conditioned on:

- the insolvency or financial condition of the debtor at any time before the closing of the bankruptcy case;
- the commencement of a bankruptcy case, or
- the appointment of or taking possession by a trustee in a bankruptcy case or a custodian before such commencement.

The US *ipso facto* rule, which is subject to a number of exceptions, is part of an extensive and very complex regime applicable to the treatment of contracts and leases (and creditor rights generally) in US bankruptcy cases. As Australia's broader insolvency framework is very different from the US regime, any *ipso facto* reform adopted here will need to be carefully tailored to our existing law.

THE PROPOSED AUSTRALIAN REFORM

In the Proposal, the Government has proposed that any term of an agreement which terminates or amends any agreement (or any term thereof), by reason only that an 'insolvency event' has occurred would be void.

The Government has proposed that an 'insolvency event' would include:

- an administrator having been appointed in respect of the company,
- the company undertaking a scheme of arrangement for the purpose of avoiding administration or insolvent liquidation,
- a receiver or controller being appointed, and

- the company entering into a deed of company arrangement.

We would expect the *ipso facto* prohibition to only be available to the company actually affected by an insolvency event and not, for example, to affiliates or guarantors of the affected company (unless such other companies are themselves affected by an insolvency event).

ANTI-AVOIDANCE

The Proposal states that it would not preclude rights of termination or variations arising from other breaches under the agreement (e.g. non-payment of the contractor). It does, however, contemplate that any provision in an agreement that *in substance* is contrary to the prohibition would be void - a so-called ‘anti-avoidance’ provision.

The scope of the proposed anti-avoidance principle is not entirely clear. For example, if a company appointed an administrator, would a term of a contract permitting termination following the factual insolvency of the company (that is, general inability to pay debts) or a ‘material adverse change’ to its financial position fall within the prohibition? Companies in administration are in almost every case insolvent or near insolvent so the *ipso facto* rule would probably have little substantive effect if these types of termination events remained permissible in the administration context.

Given that the *ipso facto* prohibition will apply in circumstances where time and resources are limited and the stakes are high, the prohibition and any anti-avoidance principle incorporated in the reforms should be crafted so as to ensure that its operation is as clear as possible. In our view, this means that the operation of the *ipso facto* rule should vary depending on which type of ‘insolvency event’ has occurred, rather than one rule (and supporting anti-avoidance regime) applying generally to companies in a range of restructuring and insolvency scenarios as is currently contemplated by the Proposal.

It also needs to be recognised that an *ipso facto* rule will not be a silver bullet. The circumstances of company insolvencies vary significantly from case to case. It will not be possible to draft an *ipso facto* rule that covers all undesirable contract terminations without a rule that is very broad and/or uncertain in scope. In most administrations there are likely to be performance or other breaches under a number of the company’s contracts, and these issues will need to be worked through as a practical matter by the administrator. It should also be noted that the *ipso facto* rule does not address ‘ransom creditors’ who refuse to continue supplying essential services to a company in order to obtain payment of debts incurred prior to an administration (there is a separate essential services regime that addresses this in section 600F of the Corporations Act, but its scope is fairly narrow).

HOW SHOULD THE *IPSO FACTO* RULE WORK?

Our initial thoughts on how an *ipso facto* prohibition might apply to companies in various Australian insolvency-related scenarios are set out below.

- **Companies in administration**

The primary purpose of the administration regime is to facilitate the rehabilitation of distressed companies and enable them to continue trading.[5] It can be very difficult to achieve this in circumstances where the company's key suppliers and contractors are free to terminate their contracts with the company solely on the basis of the appointment of an administrator, including where the company is otherwise continuing to perform. There is widespread support in the restructuring community for the introduction of an *ipso facto* rule that would prevent this from happening (subject to appropriate safeguards and exceptions).

The Proposal would prevent counterparties from terminating or amending contracts solely based on the appointment of an administrator. As noted above, it probably needs to go a bit further than this to ensure the reform has the intended effect, given that companies in administration are in almost every case factually insolvent and generally suffering from obvious financial deterioration.

An appropriate regime for companies in administration might be one that prevented the termination or modification of contracts following the appointment of an administrator solely because of *either*: (i) the appointment of an administrator in respect of the company; or (ii) the insolvency or financial condition of the company at any time before or during the company's administration (with termination or modification still permitted for other events such as non-payment of the relevant contractor).

When a company is in administration, a further question is whether counterparties should also be prevented from terminating or modifying contracts due to the appointment of a receiver or controller to the company or its property. This question is further addressed below.[6]

Restrictions on the exercise of contractual rights can be more easily justified where a company is in administration (compared with, for example, a company that is undertaking a scheme of arrangement) because there is a regime in place to provide protection to creditors that continue trading with the company in administration - for example, an administrator is personally liable for certain debts incurred by the administrator following his or her appointment under s 443A of the Corporations Act. It may however be necessary to consider extending this protection in connection with the proposed *ipso facto* rule.[7]

- **Companies that have proposed a scheme of arrangement**

A creditors’ scheme of arrangement is a flexible restructuring tool that can be used to restructure one or more classes of a distressed company’s debt and other liabilities without the widespread (negative) effects of placing the company into formal insolvency proceedings. Their effectiveness would be enhanced if (as proposed by the Government) the risk of creditors and other counterparties terminating or amending their contracts with the scheme company solely because it has formulated, or proposed, a scheme was eliminated, and we support the Proposal in this respect.[8]

In the scheme context, it should not be necessary to extend the *ipso facto* prohibition by, for example, prohibiting contract terminations or modifications due to the scheme company’s factual insolvency or financial condition. Given their subjective nature, counterparties are generally reluctant to rely on these types of termination events where a company remains outside of a formal insolvency process in any event. Moreover, unlike the case of companies in administration, schemes generally will not affect all types of creditors and there are no additional economic protections available to parties that continue trading with a distressed company that has proposed a scheme.

There will also be circumstances where a separate moratorium on creditor enforcement action is appropriate where a company has proposed a scheme (for example an extension of the moratorium available under s 411(16) of the Corporations Act would be appropriate in some cases). We will discuss this in further detail in a separate article.

- **Companies in receivership or subject to security enforcement**

The Proposal would prevent counterparties from terminating or amending contracts solely based on the appointment of a receiver or controller to a company or its property. Receivership, a remedy available to secured creditors, is primarily focussed on allowing a secured creditor to realise assets in a manner that delivers the best return to the secured creditor. Whilst that may often be achieved through a going concern sale, receivership is technically not a regime that is designed to facilitate corporate rescues for the benefit of all creditors. Consideration should therefore be given as to whether the *ipso facto* rule should apply to receiverships (in isolation), given that related concepts such as the broad voluntary administration moratorium do not apply in this scenario.

However, in practice, it is common for companies in receivership to be subject to a parallel administration (either because the directors appoint an administrator following the receiver's appointment, or because a secured creditor holding all assets security chooses to appoint a receiver 'over the top' of an administrator following the administrator's appointment). Typically in this scenario the receiver will take primary control of the company for the benefit of the secured creditor and the administrator will take a 'back seat'. In this case the receiver effectively obtains the benefit of the voluntary administration moratorium and it may therefore also be consistent in these cases for the same *ipso facto* prohibitions to apply as would be the case for any company in administration in order to best facilitate value preservation (coupled with appropriate protections for counterparties that continue dealing with the company in receivership).

- **A company that has entered into a deed of company arrangement**

A deed of company arrangement, or 'DOCA' – essentially a restructuring plan between a company in administration and its creditors – is the means by which a company can successfully restructure and exit administration. It would make sense (as contemplated by the Proposal) for the *ipso facto* prohibition to prevent the termination or modification of contracts solely by reason of a company entering into a DOCA. No other *ipso facto* protections should be required in this context (for example, prohibiting contract termination based on a company's financial position) as, following its exit from administration, a restructured company should be solvent and operating on a stable financial footing.[9]

- **A company operating under an insolvent trading 'safe harbour'?**

One of the other (long awaited) reforms that has been proposed by the Government in the Proposal is the introduction of a 'safe harbour' for directors from personal liability for insolvent trading if they satisfy certain requirements. The safe harbour proposal (comprising two alternative options, one of which would require the directors to obtain the advice of a qualified restructuring adviser) is considered in detail in our previous article on the proposed insolvent trading reforms.

Depending on the form of any insolvent trading safe harbour ultimately enacted, it may be necessary to consider whether any *ipso facto* protection is desirable for companies operating within the safe harbour. For example, if 'Model A' (which has a trigger by the appointment of a restructuring adviser) is adopted, it may facilitate the operation of the safe harbour if counterparties are prohibited from terminating or modifying contracts with a company for the sole reason that the company or its directors have appointed such an adviser. It may not however be appropriate for the *ipso facto* rule to prevent a counterparty from terminating or modifying its contract for other reasons where a company is operating in safe harbour – for example, the factual insolvency of the company or a material adverse change in its financial condition. Many of the same considerations as are set out above in respect of schemes of arrangement, including lack of balancing creditor protections, would apply in this context.

BUT WAIT…EXCEPTIONS TO THE RULE

The Government has recognised that there are a number of circumstances where preventing the operation of *ipso facto* clauses would be undesirable, impractical or introduce unnecessary uncertainty into the market. Accordingly, it proposes to carve out certain contracts including 'prescribed financial contracts'. Such a carve out may extend, for example, to the following contracts:

- Contracts to provide further financial accommodation after a company enters administration or proposes a scheme of arrangement.
- Derivatives such as swaps, and other financial contracts and netting arrangements protected under the *Payment Systems and Netting Act 1998 (Cth)* (or foreign equivalents) where uncertainty in the ability to enforce the contract would represent a material risk to the operation of financial markets. The Government has already indicated it would consider excluding these specific contracts from the proposed regime.
- By extension, other financial instruments such as repurchase agreements, forward contracts, commodity contracts and securities contracts may also be excluded. Such contracts are covered in the financial market exclusions to the provisions of the US Bankruptcy Code that render *ipso facto* clauses ineffective. Similarly in the United States, the objective behind these financial market exclusions is to mitigate systemic risk and contagion.
- Contracts providing for enforcement rights of creditors holding security over all or substantially all of a company's assets.[10]
- Contracts providing for the acquisition of shares in, or the business of, a company.
- Lease contracts in respect of aircraft transactions. These are governed by the International Interests in *Mobile Equipment (Cape Town Convention) Act 2013 (Cth)* and the Protocol on Matters Specific to Aircraft Equipment and are already carved out of the

statutory moratorium for voluntary administrations.

- Contracts entered into by special purpose vehicles (**SPVs**) in structured finance or project finance transactions. Such SPVs are typically not trading businesses and their contracts generally constitute an agreed framework entered into by all relevant parties (‘flip clauses’ commonly utilised in rated securitisation and structured financings to subordinate payments to swap counterparties upon certain events, including insolvency, are one example of the contractual rights that might fall within this exception).

Realistically, given the different nature and objectives of each insolvency regime, it is likely that different carve outs should apply to each separate insolvency event. For instance, while creditors holding security over all or substantially all of a company’s assets should be exempted from the *ipso facto* prohibition upon the appointment of a voluntary administrator, this may not be appropriate in the context of a scheme of arrangement. In the latter situation, the scheme process provides an alternate course of action for creditors which should not be undermined by the *ipso facto* prohibition.

OTHER ISSUES

We anticipate that additional details of the proposed *ipso facto* prohibition will need some further consideration so that it can fit into Australia’s existing insolvency regime in a practical and effective manner. Other issues for the Government to consider include:

- Should *ipso facto* clauses be void as proposed, or should they simply be unenforceable in specific circumstances and/or for a specified period of time? As noted above, this raises a broader query as to how the proposed amendments will be structured. It may be that each prescribed insolvency event will provide for its own regime as to the treatment of *ipso facto* clauses (and related exemptions) rather than a ‘one size fits all’ approach.

- Should the proposed prohibition be limited only to restricting termination rights and amendments, or should it extend to a broader range of rights (for example, rights to accelerate loans)?

- Will additional creditor protections be necessary to balance the limitations in the ability of creditors to contractually manage debtor insolvency risk?

- Should the rule have retrospective operation on contracts entered into prior to the amendment taking effect?

WHAT NEXT?

The Government has invited interested parties to comment on the proposed *ipso facto* prohibition and the other aspects of the Proposal by 27 May 2016. We encourage all stakeholders to consider the Proposal carefully and submit their views for further consideration.

The next steps, following receipt of submissions by the Government, remains unclear particularly given the upcoming federal election on 2 July 2016. We hope that whatever the outcome of the election, the proposals and other aspects of insolvency law reform will be actively progressed.

ENDNOTES

1. Improving Bankruptcy and Insolvency Laws Proposal Paper.

2. The *Corporations Act 2001 (Cth)* (**Corporations Act**) does contain some limited restrictions on the termination of essential services contracts (electricity, gas, water, telecommunications) with companies under external administration and some limitations on the enforcement of security or repossession of property and leased premises of a company following the appointment of an administrator to the company, but no general prohibition on the enforcement of *ipso facto* clauses.

3. The term 'executory contract' is not defined in the US Bankruptcy Code, but has been interpreted by the courts as meaning a contract where material obligations remain unperformed by both parties at the time of commencement of the bankruptcy case.

4. United States Bankruptcy Code, 11 USC s 365.

5. See *Corporations Act s* 435A(a).

6. The US *ipso facto* rule extends to termination or modification rights premised on the occurrence of certain types of enforcement-style remedies in respect of the company and its assets, but the US and Australian regimes are so different in this respect that the analogy is not a helpful one.

7. Indeed, it may be appropriate to consider the introduction of an 'administration expenses' regime as exists in UK administration and US Chapter 11 cases, rather than simply relying on the personal liability of the administrator.

8. The Proposal refers to schemes of arrangement 'for the purpose of avoiding

administration or insolvent liquidation'. This purposive element may be difficult to apply in practice, so it may be clearer to simply cover all creditors' schemes. It may also be appropriate to cover members' schemes where they are proposed in connection with a parallel creditors' scheme.

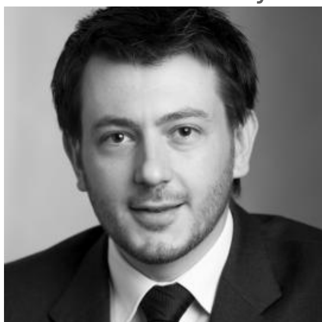
9. Unless the company has entered into a 'holding DOCA'.

10. Such creditors are permitted under existing law to enforce their security (including by appointing a receiver to the company) following the appointment of an administrator to the company: see Corporations Act s 441A. This is a fundamental secured creditor protection under the existing insolvency framework and we assume the Government did not intend to modify it via the proposed *ipso facto* reforms.

The views expressed in this publication are the authors' personal views and do not necessarily represent the views of Herbert Smith Freehills or any of its clients.

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.



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