

IPSO FACTO LAW REFORM: PUBLIC CONSULTATION COMMENCES ON EXCEPTIONS TO THE STAY

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Legal Briefings - By **Paul Apáthy, Patrick Lowden, Rowena White and James Kirkpatrick**

On 16 April 2018, the Australian Federal Government (**Government**) [launched a public consultation](#) on proposed exceptions to the recently enacted stay on *ipso facto* clauses. These exceptions, which will be contained in a forthcoming declaration and regulations, will be critical to the operation of the new *ipso facto* regime, and its impact on stakeholders.

The *ipso facto* stay is likely to come into operation on 1 July 2018 and will impact a very broad range of contracts with corporate counterparties that are entered into on or after that date. We strongly encourage businesses of all types to familiarise themselves with the impact of the *ipso facto* law reform, review their contracts to see how they will be impacted by the new regime and make submissions as part of the public consultation process.

IN BRIEF

- The *ipso facto* stay provisions will take effect on 1 July 2018 (unless proclaimed to take effect at an earlier date - which we expect is unlikely). Unless excluded, the stay provisions will apply to all contracts, agreements or arrangements entered into on or after that date.
- The *ipso facto* stay will affect the ability of counterparties to exercise termination rights or other contractual rights under affected contracts once a company enters one of a number of specified insolvency or restructuring procedures.

- The Government has now released exposure drafts of the Corporations Amendment (Stay on Enforcing Certain Rights) Regulations 2018 (**Draft Regulations**) and Corporations (Stay on Enforcing Certain Rights) Declaration 2018 (**Draft Declaration**, together the **Draft Instruments**) for public consultation. These documents set out the types of contracts and rights that will be excluded from the operation of the stay on the enforcement of *ipso facto* clauses.
- The Government has also released exposure drafts of the explanatory statements to accompany the Draft Instruments. These explanatory statements provide some guidance as to the policy basis for the exceptions (**Draft Explanatory Statements**).
- The *ipso facto* reforms will affect contracts in all industries and segments of the market. It is therefore important that stakeholders consider how the reform will affect them and take the time to consider whether to make submissions on the exceptions contained in the Draft Instruments (or on other aspects of the *ipso facto* regime).
- The closing date for submissions on the Draft Instruments is 11 May 2018.

THE IPSO FACTO LAW REFORM PROCESS SO FAR

Two significant restructuring and insolvency law reforms were enacted in September 2017 by way of the *Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Act 2017* (the **Amending Act**), being the introduction of:

- a safe harbour for insolvent trading; and
- a regime restricting the operation of contractual '*ipso facto*' clauses in the context of certain insolvency and restructuring procedures.

Both of these reforms were intended to encourage and facilitate the turnaround and restructuring of financially distressed businesses. The safe harbour reforms are now in force, and have received significant attention in the market and media.

The *ipso facto* reforms are expected to take effect from 1 July 2018 (unless an earlier date is proclaimed). In contrast to the safe harbour reforms, the *ipso facto* reforms have to date received relatively little attention from the business and finance community.

The lack of focus to date on the *ipso facto* reforms is concerning, as the *ipso facto* reforms will have wide ranging and significant effects on contractual arrangements, and in many cases will overturn longstanding assumptions of the rights of parties upon insolvency.

THE NEW *IPSO FACTO* REGIME

The new *ipso facto* provisions are set out in the Amending Act that was enacted in September 2017. When it takes effect, Part 2 of the Amending Act will amend the *Corporations Act 2001* (Cth) by inserting a number of specific sections that provide for the operation of the *ipso facto* stay in the context of certain restructuring and insolvency procedures.

What are *ipso facto* clauses?

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 (or provides for this to occur automatically) upon the occurrence of a specified insolvency related event.

For example, a clause in a lease that entitles one party to terminate the lease if an administrator is appointed to the other party is an *ipso facto* clause. Similarly, an event of default under a loan agreement caused by a receiver being appointed to all of the borrower's assets is also an *ipso facto* clause. Clauses of these sort are very common in commercial contracts.

The stay on *ipso facto* clauses

The new regime provides that during the period of a specified restructuring or insolvency procedure, a right in a contract, agreement or arrangement will not be enforceable, and 'self-executing provisions' will not apply, by reason only of:

- the company entering the specified procedure;
- the company's financial position;
- a prescribed reason; or
- a reason that is in substance contrary to the above.

However, according to the Explanatory Memorandum to the Amending Act, the stay is not intended to restrict a counterparty from enforcing a right (or disapply self-executing provisions) for any other reason, such as a breach involving non-payment or non-performance.

In addition, the *ipso facto* provisions also allow the relevant insolvency administrator to apply for an order expanding the stay to prohibit the exercise of rights (for example, a right to terminate for convenience), even where the right does not expressly operate on the basis of one of the prohibited reasons set out above, if the court is satisfied that a counterparty is likely to exercise those rights for a prohibited reason.

What procedures does the *ipso facto* stay apply to?

The *ipso facto* regime applies in respect of any of the following procedures:

- administration;
- schemes of arrangement (proposed for the purpose of avoiding an insolvent winding up); and
- managing controller appointments (including receiverships) over the whole or substantially the whole of a company's property.

However, the legislation does not (explicitly) apply to:

- receiver or other controller appointments that are not over the whole or substantially the whole of a company's property;
- deeds of company arrangement; or
- liquidations that do not immediately follow an administration or scheme.

New advances of money or credit

Critically, where a counterparty is restricted by the stay from exercising *ipso facto* rights against a company, there is a corresponding stay on the right of the company to require a new advance of money or credit from that counterparty. This is intended to protect lenders and other counterparties from being required to advance further funds to a company that has entered into a formal insolvency or restructuring procedure (in circumstances where the counterparty is prohibited from exercising contractual rights due to the *ipso facto* stay). However, a 'new advance of money or credit' is not defined and therefore the scope of this corresponding stay is not clear. For example, would an obligation to supply goods or services on credit or the extension of a rollover loan be considered a 'new advance of money or credit'?

What contracts does the *ipso facto* stay apply to?

The regime will apply to all contracts, agreements or arrangements entered into on and from 1 July 2018, in the circumstances outlined above (and subject to the exceptions outlined below).

The regime is not restricted to contracts governed by Australian law.

Exceptions to the *ipso facto* stay

The Amending Act contemplates that regulations or ministerial declarations will prescribe types of contract or types of right that will be excluded from the operation of the stay. Given the breadth of the statutory regime, the exceptions provided for in the regulations and declarations will be critical for delineating the scope of this new *ipso facto* regime.

The Government has now released the Draft Instruments setting out the proposed exclusions.

THE DRAFT INSTRUMENTS

As part of the public consultation process, the Government has released the Draft Instruments which contain proposed exceptions to the *ipso facto* stay.

The policy basis for exceptions to the *ipso facto* stay

The Draft Explanatory Statements which accompany the Draft Instruments provide some guidance as to the policy justification for excluding certain types of contracts and rights from the operation of the stay. The statements note that there are a variety of situations where staying the operation of *ipso facto* clauses would be either “*unnecessary or undesirable*”.

The Draft Explanatory Statements further indicate that:

- “...the *ipso facto* stay should not apply to certain kinds of arrangements where:
- arrangements are required or contemplated by Australia’s laws or where international obligations would be disturbed;
- markets have evolved to depend on established systems and expectations and the *ipso facto* stay would significantly disrupt those markets;
- sophisticated counterparties traditionally negotiate their own arrangements in relation to complex transactions or complex financial products and the *ipso facto* stay would undermine those arrangements;
- the *ipso facto* stay would lead to unintended consequences or would severely disadvantage some contracting parties;

- *parties have already entered into arrangements to attempt to alleviate a business' financial stress and staying ipso facto clauses would undermine or significantly change the terms of those arrangements; or*
- *the operation of an ipso facto clause is inherent to the operation of a contract and staying it would lead to a perverse outcome."*

These indications of policy may provide useful guidance as to the Government's potential receptiveness to comments on the draft exclusions.

The proposed exceptions

There are two categories of exceptions:

- **excluded types of contracts:** these will be contained in regulations. Where a contract is excluded, all rights under that type of contract will be exempt from the operation of the *ipso facto* stay; and
- **excluded types of rights:** these will be contained in a declaration. The excluded rights are more narrowly focussed on specific kinds of contractual rights that should be exempt from the *ipso facto* stay. However these will be excluded regardless of the type of contract in which they are contained.

Draft Regulations - excluded types of contract

The types of contract that are proposed in the Draft Regulations to be excluded from the operation of the *ipso facto* stay are set out in full in Appendix 1. However, these exceptions can be briefly summarised as follows:

- agreements that are subject to the Cape Town Convention on International Interests in Mobile Equipment;
- government licences or permits;
- derivatives;
- arrangements for underwriting the issuance or sale of securities or financial products;

- subscription agreements for securities or financial products;
- arrangements where an Australian company issues securities, or offers securities under a rights issue;
- business sale agreements and share sale agreements;
- arrangements for issuance of securities or financial products belonging to a pre-1 July 2018 class of fungible securities or financial products;
- margin lending facilities;
- arrangements for the issuing of covered bonds;
- arrangements to which a special purpose vehicle is a party;
- arrangements for the keeping of source code in escrow;
- certain arrangements for the commercial charter of international ships;
- subordination arrangements;
- flawed asset arrangements;
- factoring arrangements;
- financial market operating rules and certain arrangements relating to clearing and settlement facilities;
- certain arrangements relating to approved RTGS systems;
- certain close-out and netting arrangements; and
- contracts resulting from a novation, assignment or variation on or after 1 July 2018 of a contract entered into prior to that time.

Draft Declaration - excluded types of right

The types of right that are proposed in the Draft Declaration to be excluded from the operation of the *ipso facto* stay are in full set out in Appendix 2. These can be briefly summarised as follows:

- rights to change the basis on which an amount is calculated, including the charging of

default interest, under a financing arrangement or guarantee, indemnity or security related to a financing arrangement;

- rights to indemnities for costs, expenses, losses or liabilities arising from the preservation or enforcement of rights;
- termination rights in a standstill or forbearance arrangement;
- rights to change the priority in which amounts are paid;
- rights of set-off and netting, to net balances or combine accounts;
- acceleration rights exercised for the purpose of set-off, netting or combination of accounts;
- rights of assignment and novation;
- self-executing provisions in relation to the treatment of circulating assets and chattel paper in insolvency to ensure there is no conflict between the Amending Act and the *Personal Property Securities Act 2009* (Cth);
- certain step-in rights; and
- the right of a secured creditor to appoint a receiver or other controller to an asset, where another receiver or controller has been appointed.

PRELIMINARY COMMENTS ON THE DRAFT INSTRUMENTS

Given the broad scope of the *ipso facto* stay created by the primary legislation, the exceptions to be included in the regulations and declaration accompanying the Amending Act are extremely important.

The proposed lists of exclusions in the Draft Instruments are quite lengthy, and the exclusions range from the very general to the very specific and technical in nature. There is significant room for interpretation in relation to their scope. However, the Government has provided general policy guidance in the Explanatory Statements as to the basis upon which it considers contracts or rights should be excluded from the stay (as outlined above). In addition, it has also provided specific commentary in the Explanatory Statements explaining the reason for excluding each specific type of contract or right referred to in the Draft Instruments.

The Explanatory Statements therefore provide potential assistance in interpreting the extent and purpose of the exclusions contained in the Draft Instruments. They also provide a clearer statement of Government policy which will be important for stakeholders to consider (and where appropriate, reference) when formulating submissions on the Draft Instruments.

Many of the exclusions contained in the Draft Instruments were signposted last year in the indicative exclusions document accompanying the exposure draft of the Amending Act released in March 2017 (**Indicative Exclusions**). For example, it was clear from that document that the Government would seek to exempt payment and clearing systems and netting arrangements, as well as a number of more sophisticated types of financial product. The Draft Instruments have provided for this in further detail.

However, there are a number of exceptions that are either new or have been significantly modified from the Indicative Exclusions, including the following:

- **Arrangements to which a special purpose vehicle is a party:** This is an important exclusion. Whilst the term 'special purpose vehicle' has not been defined, on its face it would appear to include many of the entities used in securitisation arrangements and other complex financing transactions.
- **Business and share sale agreements:** Business and share sale agreements involving the sale of all or part of a business are now excluded from operation of the *ipso facto* stay.
- **Increased interest and indemnities:** The Draft Declaration allows a counterparty to change the basis for calculating an amount under financing arrangements, guaranties, indemnities and security. The Explanatory Statement notes that this is intended to allow a lender to charge increased interest as a result of the occurrence of an insolvency event. Similarly, the Draft Declaration allows indemnities to cover costs incurred by another person in, preserving or enforcing its rights following an insolvency event.
- **Acceleration to allow set-off and netting:** The Indicative Exclusions made clear that set-off and netting rights were to be excluded. However, such set-off and netting rights generally depend on there being due and payable debts owing by each party. Therefore in practice a right of acceleration will frequently also be required in order to allow the full amount of claims to be set-off or netted.
- **Termination rights under standstill or forbearance arrangements:** It is common for financiers to agree to enter into forbearance agreements with borrowers on terms where the forbearance terminates upon the occurrence of (among other things) an insolvency event. The exclusion is therefore important to ensure that these arrangements operate as intended, and lenders are not disincentivised from providing this type of support to borrowers.
- **Rights to assign, transfer or novate rights or obligations:** Rights to assign, transfer or novate rights or obligations are excluded from the stay. The Explanatory Statements indicate that this is primarily intended to ensure the enforceability of provisions in syndicated facility agreements that typically allow loans to become more freely tradable follow an event of default (including an insolvency event).

- **Step in rights:** There is an exclusion for rights to perform contractual obligations of, or enforce contractual rights of, the insolvent company. The Explanatory Statement indicates that this is intended to permit the operation of step-in rights in respect of certain contracts (such as construction contracts and long term services contracts).
- **Appointment of controllers:** There is an exclusion permitting a secured creditor to appoint a receiver or other controller to an asset, where another receiver or controller has been appointed. The Explanatory Statement indicates that this is intended to ensure that the appointment of a controller by a first ranking secured creditor is not prevented where another secured creditor has made such an appointment.
- **‘Grandfathering’ of contracts entered into prior to 1 July 2018:** Contracts resulting from a novation, assignment or variation on or after 1 July 2018 of a contract entered into prior to that time are excluded from the operation of the stay. The Explanatory Statements indicate that this is because the stay provisions are only intended to apply to *new agreements* entered into on or after 1 July 2018. It will be interesting to see whether this incentivises market participants to amend their contracts wherever possible, rather than entering new ones.

It is significant that the exclusions do not include a general exclusion of financing arrangements, nor any general exclusion of rights of acceleration. Importantly, rights of acceleration are not excluded even in circumstances where enforcement of security is permitted. Combined with the application of the *ipso facto* stay to self-executing provisions, this means the stay has significantly greater application to financing transactions in Australia relative to other jurisdictions that have adopted similar measures. For example, typically demand can only be made under a guarantee for an amount that is due and payable by the principal debtor. Therefore in circumstances where a lender is stayed from accelerating the principal debt, the lender may not be able to claim on their guarantee as a result of the entry of the principal debtor into the specified procedures or the financial position of the principal debtor, unless another default occurs under the loan that is not subject to the stay, or the amounts otherwise fall due.

WHAT NEXT?

With the release of the draft exceptions, market participants only have until 11 May 2018 to make submissions before the *ipso facto* stay regime comes into effect on 1 July 2018.

We strongly encourage anyone entering into significant contracts with Australian counterparties to become familiar with the effect of the new *ipso facto* regime. In particular, you should:

- review your contractual documentation;
- consider whether the *ipso facto* regime could interfere with your contractual rights where

a counterparty enters a restructuring or insolvency procedure;

- make any appropriate amendments to your contractual documentation, processes or policies to mitigate these risks or take advantage of any available exclusions; and
- consider making submissions on the Draft Instruments during the public consultation period. It may also be appropriate to raise any issues that arise under the primary legislation.

For more information about how the new *ipso facto* regime might affect your business please contact any of the key contacts below.

Appendix 1 - Excluded types of contracts contained in the Draft Regulations

(a) an agreement (within the meaning of the Convention defined in section 3 of the International Interests in Mobile Equipment (Cape Town Convention) Act 2013);

(b) a contract, agreement or arrangement that is a licence, or permit, issued by:

(i) the Commonwealth, a State or a Territory,

(ii) an authority of the Commonwealth or of a State or a Territory; or

(iii) a local governing body established by or under a law of a State or Territory;

(c) a contract, agreement or arrangement that is a derivative;

(d) a contract, agreement or arrangement for the underwriting of an issue, or sale, of securities or financial products;

(e) a contract, agreement or arrangement under which a party is or may be liable to subscribe for, or to procure subscribers for, securities or financial products;

(f) a contract, agreement or arrangement under which a body corporate incorporated in Australia issues, or may issue, securities or financial products;

(g) a contract, agreement or arrangement under which a body corporate incorporated in Australia offers, or may offer, securities under a rights issue;

(h) a contract, agreement or arrangement for the sale of all or part of a business, including by way of the sale of securities or financial products;

(i) a contract, agreement or arrangement for the issue of a security or financial product that belongs to a class of fungible securities, or class of fungible financial products, that were first issued before 1 July 2018;

- (j) a contract, agreement or arrangement that is a margin lending facility (within the meaning of Chapter 7 of the Act);
- (k) a contract, agreement or arrangement for issuing covered bonds (within the meaning of the Banking Act 1959);
- (l) a contract, agreement or arrangement of which a special purpose vehicle is a party;
- (m) a contract, agreement or arrangement for the keeping in escrow of source code, or object code, for computer software;
- (n) a contract, agreement or arrangement for the commercial charter of a ship if:
- (i) the ship is not an Australian ship (within the meaning of the Shipping Registration Act 1981); and
 - (ii) the charter is by an Australian national (within the meaning of that Act) for the purposes of exporting goods from Australia, or from an external Territory, to another country;
- (o) a contract, agreement or arrangement under which the priority of security interests in particular property is changed or can change;
- (p) a contract, agreement or arrangement that is a flawed asset arrangement;
- (q) a factoring arrangement (within the meaning of the ASIC Corporations (Factoring Arrangements) Instrument 2017/794);
- (r) a contract, agreement or arrangement that is the operating rules (other than the listing rules) of a financial market;
- (s) a contract, agreement or arrangement that is the operating rules of a clearing and settlement facility;
- (t) a contract, agreement or arrangement that confers rights on the operator of a financial market, or the operator of a clearing and settlement facility, in relation to the operation of the market or facility;
- (u) a contract, agreement or arrangement of which the parties include the Reserve Bank of Australia and the operator of a clearing and settlement facility;
- (v) a contract, agreement or arrangement under which participants (within the meaning of Chapter 7 of the Act) in a clearing and settlement facility may settle obligations on behalf of other participants (within the meaning of that Chapter) in the facility;

(w) a legally enforceable arrangement referred to in paragraph 9(1)(b) of the Payment Systems and Netting Act 1998 that supports an approved RTGS system (within the meaning of that Act);

(x) an approved netting arrangement (within the meaning of the Payment Systems and Netting Act 1998);

(y) a contract, agreement or arrangement that confers rights on:

(i) the operator of an approved RTGS system (within the meaning of the Payment Systems and Netting Act 1998); or

(ii) the coordinator of an approved netting arrangement (within the meaning of that Act); in relation to the operation of that system or netting arrangement;

*(z) a contract, agreement or arrangement under which the parties to an arrangement covered by paragraph (w) or (x) (the **main arrangement**) may settle obligations on behalf of other parties to the main arrangement;*

(za) a close out netting contract (within the meaning of the Payment Systems and Netting Act 1998);

(zb) a contract, agreement or arrangement under which security is given over financial property (within the meaning of the Payment Systems and Netting Act 1998) in respect of eligible obligations (within the meaning of that Act) of a party to a contract covered by paragraph (za);

(zc) a netting market (within the meaning of the Payment Systems and Netting Act 1998);

(zd) a market netting contract (within the meaning of the Payment Systems and Netting Act 1998);

(ze) a contract, agreement or arrangement under which security is given, in accordance with a market netting contract covered by paragraph (zd), in respect of obligations of a party to the market netting contract;

(zf) a contract, agreement or arrangement entered into or renewed on or after 1 July 2018 as a result of either of the following:

(i) the novation of, or the assignment of one or more rights under, a contract, agreement or arrangement entered into before 1 July 2018;

(ii) a variation of a contract, agreement or arrangement entered into before 1 July 2018.

Appendix 2 - Excluded types of rights contained in the Draft Declaration

(a) a right to change the basis on which an amount in respect of or under any of the following is calculated, including due to a different rate applying:

(i) a financing arrangement;

(ii) a guarantee, an indemnity or security related to a financing arrangement (whether or not the guarantee, indemnity or security is limited in any way);

(b) a right to payment as indemnity for any liability or loss arising from, and any charges and expenses incurred by another person in, preserving or enforcing its rights (whether or not the indemnity is limited in any way);

(c) a termination right under a standstill or forbearance arrangement;

(d) a right to change the priority in which amounts are to be paid under a contract, agreement or arrangement;

(e) a right of set-off or a right of combination of accounts;

(f) a right to net balances or other amounts;

(g) a right to take an action to enforce a right referred to in paragraph (e) or (f), including:

(i) a right to accelerate or otherwise vary a date for payment of an amount; and

(ii) a right to convert or exchange amounts denominated in different currencies, for the purposes of enforcing a right referred to in paragraph (e) or (f);

(h) a right to:

(i) assign or otherwise transfer rights or obligations; or

(ii) novate rights or obligations,

(whether or not the right, or its enforcement, requires a person's consent (however expressed) and including where any of the rights referred to in subparagraph (i) or (ii), or the enforcement of them, does not require any consent (however expressed));

(i) a self-executing provision to the extent that it provides that:

(i) property that was subject to a circulating security interest automatically becomes subject to a non-circulating security interest; or

(ii) a floating charge over property automatically operates as a fixed charge; or

(iii) in the case of property that is accounts or chattel paper, the property is automatically transferred to a secured party by way of security; or

(iv) the grantor of a security interest in property may no longer deal with the property;

(j) a right to perform obligations of the specified person under the contract, agreement or arrangement or a right to enforce a right under the contract, agreement or arrangement that would be enforceable by the specified person.

...

[A right to appoint a controller where:]

(a) the right is to be enforced by a person who has a security interest in property of the specified person; and

(b) in relation to property of the specified person:

(i) a controller has been appointed; or

(ii) a right to appoint a controller has been enforced.

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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