

## AUX002\_Company under financial stress? Safe Harbour rescue!

On 18 September 2017, the Australian Parliament passed a resolution to amend insolvency rules that have resulted in one of the most significant reforms in the Australian Corporation law history. This reform will come into effect on 1 July 2018 and aims to enhance the economy by supporting businesses to continue to trade through difficult times.

### 1 Introduction

In June 2017, the Australian Government introduced into the Parliament various proposed amendments to the *Corporations Act 2001* (Cth) (**the Act**) as part of its National Innovation and Science Agenda. The proposed changes passed both Houses of the Parliament on September 2017. These changes hope to set in motion a cultural shift to encourage entrepreneurs to take risks and to drive innovation and ambition. The new provisions also seek to reach a balance between encouraging entrepreneurship and protecting creditors.<sup>1</sup>

The proposed changes are:

- the introduction of a 'safe harbour' for directors from personal liability for insolvent trading if the company is undertaking a restructure; and
- Making ipso facto clauses, which allow contracts to be terminated solely due to an insolvency event, enforceable if a company is undertaking a restructure.

This article focuses on the ipso facto clauses and aims to clarify various consequential implications that may follow.

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<sup>1</sup> Exoplanetary Memorandum, Treasury Laws Amendment (2017 Enterprise Incentive No. 2) Bill 2017, 25-28.

### 2 Ipso facto clauses

Ipso facto is a Latin phrase which translates to "by the fact itself". This clause is found in many service or finance contracts, enabling one party to terminate the contract completely upon occurrence of a particular event despite the counterparty's ability to fulfil its obligation under the contract. For instance, under the current law, a supplier can terminate a supply agreement if the consumer business is experiencing financial difficulties or is restructuring the way it conducts its affairs.

A commonly used ipso facto clause is worded as follows:<sup>2</sup>

*It is an event of default and this agreement will terminate if:*

- (a) The company goes into administration, liquidation, provisional liquidation or receivership or a scheme of arrangement for the company's creditors is proposed;*
- (b) A step is taken in connection with any of the processes referred to in (a); or*
- (c) The company becomes insolvent.*

Ipso facto clauses are a major concern for new businesses at early stages of operation. For a start-up to take root in the market, it must take on relatively large risks which could result in financial distress.

<sup>2</sup> Lindsay Powers, Gerard Breen and John Melluish, 'Insolvency Law and Management: Ipso Facto Clause: a law reform challenge' (2016) 27 JBFLP 72, 73.

Termination of a supply agreement pursuant to an ipso facto clause could cause premature death of a business and consequently discourage individuals to take risks and test new ideas that could enhance economic prosperity. Furthermore, this can negatively impact other creditors who would have been in a much better position had the contract remained on foot.

### **3 What is the amendment and what does it mean?**

The new provisions provide that certain rights under the contract which allow for amendment or termination of an agreement are not enforceable when a company is undertaking a formal restructure except in certain limited circumstances.<sup>3</sup> The stay is to apply to both contractual and self-executing rights; as well as other clauses in a contract that have the same function as an ipso facto clause. However, the counterparty does maintain the right to terminate or amend an agreement with the debtor company for any other reason, such as breach involving a non-payment or non-performance.<sup>4</sup>

This reform places Australia, to some extent, in a similar position as England and USA. A more uniform approach could potentially strengthen international trade and encourage foreign business to branch into Australia.

The wording of the legislation does not clarify whether the Australian Parliament intended for this prohibition to apply to all contracts or only essential contracts and those which concern utility services. However, the Parliament has made it clear that certain agreements are exempted

and has granted the Court and Administrators discretion to enforce ipso facto clauses. These exceptions are as follow:

- Contracts specified in regulations or declared by the Minister;<sup>5</sup>
- Agreements made after the commencement of the formal restructure;<sup>6</sup>
- Government contracts;<sup>7</sup>
- Contracts of a nature where the ipso facto stay is not intended to operate because otherwise it would render the contract a nonsense.<sup>8</sup>

Leaving open the list of contracts to which the stay applied does take into account that businesses have different needs based on the goods or services they provide. Thus, narrowing the scope of the prohibition to utility services, as is the case in England, can prejudice some businesses. However, this also leaves room for argument that certain contracts are not necessary to the running of the business and thus can be terminated based on ipso facto clauses in the contract.

### **4 Period of Stay**

The right covered by the stay is only applicable to contracts entered into from 1 July 2018 and will only remain enforceable until the end of company's external administration pursuant to a court order to the company being wound up. An application can be made to the Court to extend the duration of the stay if the court is satisfied that it is in the interest of the justice.

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<sup>3</sup> Exoplanetary Memorandum, Treasury Laws Amendment (2017 Enterprise Incentive No. 2) Bill 2017, [2.16].

<sup>4</sup> Ibid,[2.11].

<sup>5</sup> Exoplanetary Memorandum, Treasury Laws Amendment (2017 Enterprise Incentive No. 2) Bill 2017, [2.26].

<sup>6</sup> Ibid.

<sup>7</sup> Ibid [2.32].

<sup>8</sup> Ibid [2.33]

## 5 Protection to secured creditors

As previously mentioned, the new amendments aim to reach a balance between protecting companies and protecting secured creditors. To achieve this, various other amendments are expected to appear in the Act. Sections 441A, 441B, 441C and 441E of the the Act will be amended to ensure that the rights of secured creditors to enforce their interests are not affected by the new amendments and that they can enforce their security interest despite the operation of stay under section 451E of the Act.

## 6 Commencement date

All contracts entered into from 1 July 2018 are subject to stay of ipso facto clauses.

## 7 Conclusion

These new amendments are welcomed by companies as well as insolvency practitioners. Many businesses fail to effectively restructure their affairs due to termination of contracts which are crucial to their operation. These changes will see an increase in the number of business that will successfully restructure their affairs and consequently boost the Australian economy. With that in mind, there is still room for improvement. Further clarifications on the type of contracts that fall within the scope of these new provisions is needed for business to identify which contracts can be relied on during financial struggle

## 8 Further Information

If you are a creditor or a director of a company and are concerned about how these amendments may impact yours or your company's rights and liabilities under contractual agreements, we would be pleased to meet with you to discuss matters in more detail. Auxilium Partners has extensive experience in advising on disputes related to partnerships and small to medium sized business in Western Australia.

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