

NAVIGATING THE INSOLVENCY REFORMS - IMPENDING CHANGES TO CONTRACTUAL TERMINATION RIGHTS

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Financial Services Alert

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Last year the government introduced the most significant reforms to Australia's insolvency regime for over three decades. Among other changes, reforms that will come into effect on 1 July this year (or earlier by proclamation) will have a significant impact on the ability for counterparties to exercise certain rights under contractual provisions known as ipso facto clauses. Specifically, once the new laws are in force, parties to contracts will not be able to terminate their contract (or exercise certain other rights) for a period of time due to the other contractual counterparty entering into an insolvency process such as administration. For participants in the construction industry it will be important to understand how these reforms will impact on their contractual relationships going forward.

In this Legal Insight, we will explain how these new laws could impact on your contracts going forward including the areas that remain unclear or subject to Treasury guidance. We will also highlight an existing window of opportunity in relation to existing contracts.

WHAT IS AN IPSO FACTO CLAUSE?

Ipsa facto clauses in construction contracts are typically contractual provisions that allow one party (usually the principal or head contractor) to terminate or amend the contract on the occurrence of an 'insolvency event', a term usually defined to include the counterparty being insolvent (unable to pay debts as and when they fall due) or entering into, or taking preparatory steps towards entering into, receivership, administration or a scheme of arrangement. Such provisions are also commonly found in all types of commercial and financial contracts and are a risk mitigation tool designed to allow a contracting party the opportunity to avoid any formal or informal insolvency process that is being undertaken by its counterpart.

FOR CONSTRUCTION CONTRACTS, SUCH CLAUSES WOULD ALSO TYPICALLY ALLOW THE PRINCIPAL OR HEAD CONTRACTOR TO EXERCISE THE FOLLOWING IPSO FACTO RIGHTS:

- take work out of the hands of the builder or subcontractor (and suspend payment)
- take the place of the builder for the purposes of paying or engaging subcontractors directly in an effort to minimise loss

- reduce loss by setting-off their loss against any payment claims or calling upon a bank guarantee or other security.

HOW WILL THE REFORMS WORK?

The new laws come into effect on 1 July 2018 (or earlier by proclamation), amend the *Corporations Act 2001* (Cth) and seek to prevent or 'stay' certain termination and other ipso facto rights from being enforced against a counterparty which, as part of its genuine restructure, appoints an administrator or receiver of the whole or substantially the whole of its property or proposes a scheme of arrangement. The rights that will be subject to the stay are rights that arise by reason of the counterparty's entry into receivership, administration or a scheme of arrangement, or its financial position if the counterparty is subject to one of these insolvency processes. The stay will also apply to 'self-executing' provisions (ie automatic termination type clauses).

Any right that is subject to the stay will remain unenforceable to the extent the reason for seeking to enforce that right relates to circumstances that arose prior to the commencement of the stay. For example, where a party has a contractual right of termination which relies on a counterparty's financial position and which arose prior to that counterparty's entry into administration, the party cannot exercise that termination right if the counterparty successfully trades out of the administration.

To prevent attempts to 'draft around' or otherwise circumvent the operation of the new laws, the Federal Government will have broad powers to extend the stay by regulation.

CERTAIN RIGHTS AND CONTRACTS EXCLUDED

Certain rights and certain types of contracts will be excluded from the ipso facto stay provisions, including rights arising under contracts entered into after the commencement of an insolvency process such as administration and certain rights arising under contracts prescribed by regulation or declared exempt by the Minister responsible. The new laws will also not limit a party with security over the whole or substantially the whole of the property of its counterpart from enforcing its security interest during the initial 'decision period' (13 days) when a counterpart enters administration. However, the stay will likely extend to enforcing specific asset security.

Although regulations are yet to be released by the Federal Government, a list of contracts and contractual rights which are intended to exempt by regulation has been circulated and includes (among others):

- rights of set-off, flexible priority arrangements, and flawed asset arrangements
- securities underwriting agreements
- repurchase agreements, forward contracts, commodity contracts, swaps, rated securitisations and structured financings that include 'flip clauses'
- securitisation arrangements involving special purpose vehicles
- debt factoring agreements.

There is currently no proposal from the Federal Government for construction contracts or any rights specific to construction contracts to be exempted from the ipso facto provisions.

THE WINDOW OF OPPORTUNITY

The provisions that relate to the stay on the exercise of ipso facto clauses will commence on 1 July 2018 (or earlier by proclamation), and will only apply to rights or self-execution provisions that arise under contracts entered into at or after commencement. This means that ipso facto clauses in contracts entered into prior to the commencement of the regime will remain enforceable even if the term of the contract is say 10 years, and therefore two separate regimes in respect of these contractual rights will operate for a period of time.

There is no mechanism for 'contracting out' of the new laws. However, as the application of the new laws will only be to contracts entered into at or after commencement, there is a window of opportunity for contracting parties to enter, vary or extend existing contracts now (or prior to 1 July 2018, unless the legislation commences earlier) to delay or avoid the application of the reforms to some of their contracts. Although it is not clear whether the Federal Government will later pass a regulation seeking to extend the stay to contracts which pre-date the commencement of the ipso facto provisions, it would seem that for now this is a viable option available to contracting parties to manage the risk of a financially distressed counterparty.

In circumstances where a contract pre-dates commencement of the ipso facto stay provisions, it is currently uncertain as to whether the stay will apply to those contracts where extensions or variations are made after commencement. If the regulations (once available) do not directly address this issue, extending the term of an existing contract may be another avenue for parties to continue avoiding the application of the new regime to their existing contracts. However, parties taking this route will need to be careful around how any amendment or extension is documented so as not to inadvertently create a new contract.

WHAT SHOULD YOU DO?

Parties to construction contracts should consider whether it is in their commercial interests to take steps to extend or vary existing contracts prior to the commencement of the ipso facto provisions.

Once the draft regulations are released, principals and head contractors should also review existing contracts (including any template contracts) and have particular regard to the terms which relate to insolvency events, events of default, termination, security, and rights of indemnity and set-off, to ensure that there is a sufficient understanding of the impact of the new laws on those contracts and to ensure that they are able to act quickly to protect their position prior to and in an insolvency scenario. This may mean that principals and head contractors should reconsider the extent to which they rely on rights of set-off and indemnity, as it is expected that such protections will be excluded from the application of the new laws when they commence.

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