CONSULTATION PROCESS ON IPSO FACTO INSOLVENCY REGULATIONS BEGINS

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Restructuring and Insolvency Alert

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In September 2017, the Australian government introduced the most significant reforms to Australia's insolvency regime for the past 30 years with the enactment of the *Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Act 2017* (Cth).

A key part of the reforms includes a stay on the enforcement of certain contractual rights (known as ipso facto clauses) when a contractual counterparty enters into an administration, a scheme of arrangement or compromise, or a receivership over the whole or substantially the whole of its assets. The stay also applies more generally to the enforcement of ipso facto clauses that are linked to the company's financial position while it is subject to one of these insolvency or reconstruction processes.

Because of the potentially wide-ranging impact of the reforms, certain types of contracts and certain types of rights were to be excluded from the operation of the stay by regulation and declaration.

The long awaited draft regulations and declaration have now been released. In this alert, we highlight some of the key exceptions and the potential impact on certain types of counterparties and transactions.

For more background on the new ipso facto laws, please see our previous Legal Insight: 'Navigating the Insolvency Reforms – Impending Changes to Contractual Termination Rights'.

THE DRAFT REGULATIONS AND CONSULTATION PROCESS

The draft regulations and draft declaration will amend the *Corporations Regulations 2001* (Cth) by inserting new provisions that prescribe the kinds of rights and contracts, agreements and arrangements entered into after 1 July 2018 that will not be subject to the stay on ipso facto clauses. Each of these documents (including the draft explanatory statements) is available for public comment on the Treasury website, with the consultation process due to end on 11 May 2018.

As outlined by the federal government in the accompanying draft explanatory statements, the exceptions are an acknowledgement that there are some situations where staying the operation of ipso facto clauses is either 'unnecessary' or 'undesirable'.

The purpose of the proposed amendments is to ensure that, in these circumstances, certain types of ipso facto clauses will remain enforceable against a counterparty despite the fact that it is in a formal insolvency or reconstruction process.

The proposed exceptions to the stay are categorised as follows:

1. Excluded types of contracts, agreements or arrangements: The draft regulations will prescribe the kinds of contracts, agreements or arrangements that are to be excluded from the stay. The effect of the exclusion is that all rights arising under the excluded contract, agreement or arrangement will not be subject to the stay.
2. Excluded rights: The draft declaration will prescribe the kinds of contractual rights that are to be excluded from the stay. Unlike the exceptions listed in the draft regulations, the prescribed rights will be excluded from the stay irrespective of the kind of contract, agreement or arrangement which gave rise to them.

INITIAL COMMENTARY ON THE EXCEPTIONS TO THE STAY

The list of exceptions proposed by the government include, to a large extent, the contracts and contractual rights which it initially indicated, and which industry participants anticipated, would be excluded from the stay. However, the list also goes beyond what was initially proposed and anticipated, and a number of the draft exceptions appear to be defined more broadly than what would arguably be required to fulfil the policy reasons set out in the explanatory statements.

Some of the additional contracts and rights that will be excluded are, in our view, commercially sensible and appropriately aimed at furthering the policy aims of the law reforms. Examples include:

3. Arrangements for the sale of a business: contracts for the sale of all or part of a business, including by way of the sale of securities or financial products, will be excluded from the application of the stay. The explanatory statement recognises that the sale of a business in a distressed situation is often an alternative to a formal insolvency process. Any curtailing of the rights of a purchaser under such a contract may impact on the availability of a sale as a business rescue alternative and may also impact on the price purchasers are willing to pay in distressed acquisitions.
4. Uplift clauses and indemnification: the declaration has clarified that financiers will continue to be able to enforce rights to charge a higher rate of interest upon an insolvency event of default to compensate for increased risk and also to rely on their indemnification rights to cover the additional increased costs faced by financiers in a distressed situation. If such rights were not excluded, financiers may have had to consider repricing their financial products to build in any additional risk they may face should the borrower become distressed, which is likely to have made financial products more expensive for many borrowers.
5. Termination rights in standstill and forbearance arrangements: financiers that have agreed to refrain from enforcing their rights upon the occurrence of an event of default will retain the right to terminate any such

standstill or forbearance arrangement. As noted in the explanatory statement, standstill and forbearance arrangements can be important restructuring tools that give counterparties breathing space to attempt to turnaround the business. Any curtailing of the rights of financiers under such arrangements could make them reluctant to offer this breathing space to a borrower and may therefore be counterproductive to the policy aims of the law reforms.

6. Rights of novation and assignment: secondary debt trading is often another tool that is used to facilitate restructuring in circumstances where one or more existing financiers do not wish to, or cannot, participate in the proposed restructuring and there are alternative financiers or funds who are willing to trade into the debt and have the ability to do so. Therefore, curtailing rights of novation and assignment would have been counterproductive to the aims of the law reforms.

However, some of the exclusions will require close analysis by industry participants to determine the extent to which they achieve the government's policy aim of preventing ipso facto clauses from reducing the scope for a successful restructure or the sale of a business as a going concern. Examples include:

7. Contracts, agreements or arrangements to which a special purpose vehicle is a party: the government in its initial consultation process indicated that securitisation arrangements involving special purpose vehicles would likely be excluded from the operation of the stay. The commercial rationale behind the exclusion was that securitisation arrangements were the result of complex negotiations between sophisticated counterparties and therefore should not be 'undermined'. However, the proposed exclusion in the regulations is not on its face limited to circumstances involving securitisation arrangements. Whilst a 'special purpose vehicle' is not defined in the proposed regulations, its meaning is clarified in the accompanying explanatory statement where it is referred to as 'an entity such as a company, trust or partnership that is created to carry out a specific purpose or arrangement'. Such an entity is widely used for various commercial purposes outside of securitisation and a general exclusion for arrangements to which a special purpose vehicle is a party appears to provide considerable scope for structuring transactions to avoid the stay on ipso facto clauses.

8. Appointment of receivers without acceleration of the debt: in circumstances where a borrower has appointed an administrator, the ipso facto reforms currently allow a financier to appoint a receiver over the top provided that the receiver is appointed to the whole or substantially the whole of the company's property. However, if the principal debt cannot be accelerated because of the operation of ipso facto reforms, the receiver appointed to the company's assets will have to deposit any realisation proceeds from the sale of such assets into a suspense account (assuming the security document permits the receiver to do so) until a future event of default (such as non-payment or non-performance) occurs, allowing the financier who appointed the receiver to accelerate the principal debt.

9. Circulating security interests: the government has proposed a new exclusion to the stay for rights which are self-executing provisions to the extent that the right provides (among other things) that property that was subject to a circulating security interest automatically becomes subject to a non-circulating security interest, a floating charge over property automatically operates as a fixed charge or that a grantor's right to deal with certain property in the ordinary course of business comes to an end.
   In the context of the *Personal Property Securities Act 2009* (Cth), a circulating security interest extends to assets of a company, including its inventory, cash at bank and accounts receivable. As such, careful consideration will need to be given as to the extent to which this proposed exclusion promotes the aim of

the ipso facto law reforms, particularly where the automatic crystallisation of revolving assets such as inventory will likely have serious implications on the ability of the company to trade. In the case of administration, the administrator could presumably continue to rely on section 442C of the Corporations Act to trade assets in the ordinary course of the company's business.

10. Guarantees without acceleration of the principal debt: there are no general exclusions for rights of acceleration (a common ipso facto clause) other than a limited exclusion to allow for acceleration to the extent necessary to take advantage of set-off and netting provisions. While most guarantees are drafted as primary obligations, if there are no secured moneys owing because the financier does not have the ability to accelerate, there will be no utility in seeking to enforce against a guarantor even if that guarantor is not insolvent. Going forward, consideration should be given by financiers as to whether guarantees should be drafted to extend not only to accelerated primary debt, but to also provide that the guarantor must pay primary debt which would have been accelerated but for the inability of the financier to exercise its acceleration rights under the ipso facto clause.
11. Government licences and permits: the regulations exclude any contract, agreement or arrangement that is a licence or permit issued by a government authority or body. The purpose of this exclusion, according to the explanatory statement, is that the conditions placed on permits and licences are often there for public safety and the greater good of the community and therefore the government authority or body should be allowed to continue exercising termination (and other ipso facto) rights if those conditions are not satisfied. However, the exclusion in the regulations is framed widely, and not linked to any public interest argument. The revocation of a licence or permit could have an impact on the ability of a company to return to solvent trading.
12. Novation, assignment and variation: the regulations have clarified that a contract that is entered into prior to 1 July 2018 can be novated, assigned or varied and the resulting new contract or arrangement will continue to fall outside the scope of the new laws. This means that counterparties to existing contracts can extend the term of their arrangements, or assign/novate their rights to another party, and continue to rely on any ipso facto rights contained within those contracts. While the justification behind this exclusion is that the laws are not intended to change the contractual relationship that existed between parties prior to 1 July, this exclusion will result, at least in the medium term, in there being two different classes of contracts: those inside the regime and those outside. This in turn means that a company in administration, for example, will not get the full benefit of the new laws if a proportion of its contracts fall outside the regime.

Next steps

Once the consultation process has concluded, we expect that the finalised regulations and declaration will become available prior to the 1 July commencement of the new laws. Some of the issues we have noted above may well be ironed out during the consultation process. In any event, it will be interesting to see the scope and final list of excluded rights and contracts and the impact that these new laws will have on the financial services and restructuring sectors and beyond.

