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INSOLVENCY ALERT - RECENT AUSTRALIAN INSOLVENCY REFORMS

SAFE HARBOUR AND STAYING THE IMPLOSION OF CONTRACTS AFTER ENGAGING IN A FORMAL INSOLVENCY PROCESS

KEEPING SINKING SHIPS AFLOAT

DIRECTORS AND HOLDING COMPANIES PERSPECTIVES

Author: James Daniel | Partner | +61 7 3338 7519 | jdaniel@tglaw.com.au

OVERVIEW

Broadly, the big changes are:

First, don't have to be solvent to do a turnaround and trade on; and

Secondly, if undergo a formal appointment, contracts cannot be modified or terminated under ipso facto clauses in favour of suppliers or customers.

Valid concerns were that prior to these changes:

First, directors were incentivised to prematurely make formal insolvency appointments to the company instead of preserving value by trading through difficulties.

Secondly, suppliers and customers were incentivised to modify or terminate under ipso facto clauses in their favour to prevent further losses.

Thirdly, skilled investors were incentivised to decline becoming board members of start-up companies because of their personal exposure through potential insolvent trading risk.

The Government hopes that these reforms will tip the balance in favour of positive outcomes, for example:

First, informal commercial turnarounds and trade ons rather than formal insolvency appointments with the objective of producing a better outcome for the company and its stakeholders.

Secondly, formal turnarounds and trade ons through the VA, Scheme, Receivership and other like processes rather than Liquidations with the objective of staying the enforcement of Ipso Facto clauses.

Thirdly, the right people going on the boards of start-up companies with the objective of protecting them from insolvent trading risk.

When insolvency arrives 'Grim Reapers' swoop in uninvited like hungry seagulls fighting over a few discarded chips. Well you can gladly tell them to go because you do not need them. What you need are advisors who can advise you how to stabilise and resurrect a business (not gouge it). For example:

First, insolvency lawyers and accountants who can become part of the advisory team performing a central role in creating, monitoring and adjusting the turnaround plan seeking to produce a better outcome than under a formal appointment.

Secondly, insolvency accountants who could, as the VA, Scheme Manager, Receiver and Manager or other like appointee, seek to stay the enforcement of Ipso Facto clauses.

Thirdly, litigation lawyers who can push back and defend Liquidator claims against directors and a holding company, seeking recovery of loss through an insolvent trading claim when Safe Harbour protection has actually been engaged.

However, these reforms will not deliver as advertised because in many common situations what is gained through one reform measure is taken away in another. The most obvious examples of this are that to engage Safe Harbour protection there must be historic and ongoing:

First, payment of super on time and in the full amount; and

Secondly, compliance with reporting obligations to the ATO.

As things stood prior to these reforms such matters were rarely achieved by financially distressed companies.

Overall, the Australian insolvency regime must mature as the world becomes smaller and commercial practices, technology and macroeconomic forces constantly change. These reforms take up that challenge in a variety of ways to some degree. They are an important departure from the valid criticism of Australia's insolvency regime being too creditor focussed and penal. They embrace the notion that entrepreneurial risk taking should be encouraged (as in America) not stigmatised (as in Elizabethan England). With any luck this will be just the beginning and one day Australia may bring in reforms that fully embrace the efficient recycling of capital through a process not unlike Chapter 11 in America.

SAFE HARBOUR

A. The position prior to the amendments - A recap

Company directors have a duty under s.588G of the Act to prevent a company from incurring debt(s) at a time when broadly:

First, the company is insolvent or would become insolvent by incurring the debt(s); and

Secondly, there are reasonable grounds for suspecting that the company is insolvent or would become insolvent.

Subject to some difficult to make out defences, if a director breaches that duty, in any later liquidation of the company the director may be found personally liable for any **unpaid** debt(s) incurred by the company in contravention of s.588G.

There is a mirror regime for a holding company being liable if a subsidiary has been insolvently trading on in contravention of s588V and has unpaid debt(s).

I've emphasised the word 'unpaid' because it's important to recognise that personal liability under s.588G and s.588V only arises for "unpaid debts". If the debt is paid by the company before it's wound up, the creditor will not have suffered any loss by the company incurring the debt which is an essential element in any claim for compensation for insolvent trading liability.

You will know that it has historically been a strategy for directors and a holding company of financially distressed companies with sufficient cash to prioritise the payment of new debts and defer paying older debts that were incurred before the company was potentially insolvent so as to manage any insolvent trading risk.

S.588G and s.588V still apply, but there is now available to directors (s.588GA) and a holding company (s.588WA) a carve out from the risk of insolvent trading liability if the directors of the insolvent company can come within the Safe Harbour protection in s.588GA. This means that to manage the risk of an insolvent trading claim it is now merely optional for the directors and the holding company to cause the insolvent company to pay any new debt.

B. The reasons for amendments

A company **has never** had an obligation to appoint a VA even if the company's board resolves to the effect that in their opinion the company is insolvent or likely to become insolvent at some future time.

The relevant section, is s.436A. It states that the company "**may**" appoint an administrator in that event, **not must**.

Rather, as with all their decisions, directors need to consider their duties (under the well-trodden sections 180 to 184 and elsewhere) and make their decision accordingly. And when the company is in the throes of insolvency, a director's duties include having regard to the interests of the creditors. If there is a real risk that the creditors would suffer significant prejudice if the directors take a particular course of action, then that will be enough for a finding that the directors breached their duties if the course of action is taken and results in prejudice to creditors.

So provided that the directors have complied with their duties, it has always been the case that company directors could remain in control of an insolvent company to attempt a rescue strategy. However the risk that directors might be later found personally liable for debt(s) incurred by the company whilst insolvent is a factor identified by directors as forcing their hand to appoint a VA to avoid their personal liability risk.

The result is that many companies that may have been rescued from financial difficulty if the directors had taken reasonable steps to implement a turnaround plan and traded through have instead been put into VA and wound up.

The Safe Harbour protection is intended to encourage directors to:

First, closely monitor the financial position;

Secondly, engage early with financial distress;

Thirdly, engage even if companies are insolvent;

Fourthly, remain in control of financially distressed companies for a reasonable period to consider if their businesses can be rescued to produce a better outcome than a formal appointment;

Fifthly, if so, develop and implement a course of action to attempt to rescue the businesses;

Sixthly, if not, appoint a VA quickly and take advantage of the Ipso Facto reforms.

The amendments are designed to promote entrepreneurialism and attract the right people with appropriate skills to be directors without being deterred from taking the role because of the risk of personal liabilities for unpaid debts incurred whilst insolvent.

C. What are the amendments?

The Safe Harbour amendments

For directors, new sections 588GA and 588GB have been inserted into the Act.

The other relevant Safe Harbour amendment is new s.588WA which extends the safe harbour protection to holding companies in respect of liability for insolvent trading of its subsidiary if:

First, the holding company takes reasonable steps to ensure that the directors of its insolvent subsidiary engage the safe harbour protection for debts incurred by the subsidiary; and

Secondly, the safe harbour protection is in fact engaged by the subsidiary's directors.

These sections have been in force since 19 September 2017.

When are directors/holding companies protected by the Safe Harbour?

Under s.588GA(1) the Safe Harbour protection:

commences as soon as a director starts to develop one or more courses of action that are 'reasonably likely to lead to a better outcome for the company' than immediate VA or liquidation; and

ends:

First, if the director fails to take the course of action within a 'reasonable period', at the end of that reasonable period;

Secondly, when the director ceases taking the course of action;

Thirdly, when the course of action ceases to be 'reasonably likely to lead to a better outcome for the company'; or

Fourthly, when a VA or liquidator is appointed.

How long do directors have to take the course of action?

The duration of the '*reasonable period*' will depend on the size and complexity of the company and may range from a matter of days for a small scale company to weeks or months for larger companies or corporate groups. So relevant here will be factors such as the nature of the company's business operations, the corporate structure, the number of employees and the level of debt.

The period must give directors time to consider options, take appropriate advice, deliberate and implement. Importantly, directors must be able to demonstrate that they were taking active steps throughout the 'reasonable period' to move towards definite action for the safe harbour protection to apply. The Explanatory Memorandum explains that 'developing a course of action' is not an excuse to delay and there needs to be more than merely thinking about a problem.

What courses of action are reasonably likely to lead to a better outcome?

S.588GA(2) provides a non-exhaustive list of factors that the courts will have regard to when considering whether the course of action taken by directors was '*reasonably likely to lead to a better outcome*' than the immediate VA or liquidation. Those factors are:

First, was the director properly informing himself/herself about the financial position of the company?

Secondly, was the director taking appropriate steps to prevent misconduct by the company's employees and officers that could adversely affect the company's ability to pay all its debts?

Thirdly, was the director taking appropriate steps to ensure that the company was keeping appropriate financial records?

Fourthly, was the director taking advice from an 'appropriately qualified entity' who was given sufficient information to give that advice?

Fifthly, was the director taking steps to develop and implement a plan for restructuring the company to improve its financial position?

None of these factors will necessarily be determinative. They don't all have to be satisfied for Safe Harbour to apply. They are designed to be useful signposts for the directors seeking to come within Safe Harbour and for the courts in assessing claims that the Safe Harbour protection applies. Directors would however be well advised to tick off as many of these factors as they can if they wish to rely upon Safe Harbour protection.

'*Reasonably likely'* does not mean greater than 50%. It means that the chances of achieving a better outcome are not fanciful or remote. That is a pretty low threshold. VAs must weigh up the various possible outcomes from any DOCA proposal versus liquidation/versus returning the company to the directors (including the likely dividend ratio for each relevant scenario) and express an opinion as to which is the best course of action to be taken. That type of rigour will not be applied to directors in attempting to gain Safe Harbour protection. Directors will not be expected to weigh up the various possible outcomes compared to a VA and prove that the course of action taken was better. Rather, they just have to show that there is a chance of a better outcome that could not be said to be hopeless or mere wishful thinking.

'*Appropriately qualified entity'* is not defined but means 'fit for purpose'. Whether or not the entity was 'fit for purpose' will vary depending upon the company's circumstances. Again, this ties in the factors I was referring to before, the nature of the business, structure, employees, debt levels etcetera. The Explanatory Memorandum also makes clear that whether an entity is appropriately qualified is not limited to having particular qualifications but includes factors such as the advisor's independence, good standing, professional memberships, level of experience and, perhaps transparently, whether the advisor has adequate levels of Professional Indemnity insurance to cover the advice! I would expect that for most scalable companies, a combination of advice is required. At the core would be turnaround, restructuring and solvency advice for the company and legal advice for the directors/holding company. In some instances the directors may wish to gain the protection of legal professional privilege over the restructuring, turnaround and solvency advice in case "Safe Harbour' protection is not engaged and/or they decide to defend the 'trading on' on other grounds such as the 'trading on' was performed in a solvent not an insolvent state or there were no unpaid debts incurred after the point of insolvency. If that is the case, then the lawyers for the directors would need to engage and deal with the turnaround, restructuring and solvency advisor and vice versa. Certainly, except for the provision of legal advice, insolvency accountants would be fit for purpose either in whole or in part in performing most aspects of Safe Harbour professional work as they are independent, members of ARITA, are covered by appropriate PI insurance and are appropriately experienced. In more complex/high value companies, specialist expert valuations, tax advice, employment advice, M&A advice, capital raising advice, regulatory advice, etc. might also be required.

Are there pre requisites for Safe Harbour protection to apply?

Yes. Under s.588GA(4), at the time when the unpaid debt(s) is (are) incurred, the company must have been <u>substantially</u> complying with its obligations to:

First, pay its employee entitlements (typically wages and superannuation) as they fall due; and

Secondly, comply with its reporting obligations to the ATO (as distinct from payment obligations).

If there was '*less than substantial compliance*' with either of these obligations, the directors/holding company will not engage Safe Harbour protection for any unpaid debt(s) incurred whilst the company was not substantially complying with its obligations.

Further, if there had been two or more failures by the company to comply with these obligations within the preceding 12 month period, the directors/holding company will remain liable for any unpaid debt(s) incurred by the company until that ceases to be the case.

This is important. As you will know when a company is nearing insolvency there is often the temptation to delay payments to employees (superannuation is the usual example) and defer lodgements with the ATO with a view to catching them up when finances improve. Two or more failures to that effect within the preceding 12 months will be fatal to any claim that Safe Harbour protection applies – even if the obligations have since been met. The Explanatory Memorandum explains that the purpose of these pre requisites is to ensure that Safe Harbour protection is only available to diligent directors who are ensuring that the company has complied with these essential obligations. I query why Federal bodies FEG and the ATO are the only creditors owed essential obligations compared to every other creditor who are not essential and are left out in the interests of the wider good served by Safe Harbour protection.

Furthermore if there is a contravention of the essential obligations this impacts adversely on all other creditors and directors as it means the status quo will remain unchanged in many instances. That is to say if the directors don't engage Safe Harbour protection, they and the holding company remain liable for the unpaid debt(s) incurred by the company under s.588G and s.588V (subject to defences) respectively and they are therefore incentivised to sink the ship not keep it afloat.

Directors can subsequently lose their Safe Harbour protection

S.588GA(5) provides that Safe Harbour protection will be taken **never to have applied** where there is less than substantial compliance by the director with statutory obligations to provide assistance to appointees to the company in any later formal insolvency process (i.e. liquidators, VAs). This is yet another way for Liquidators to pursue an insolvent trading claim despite these reforms. So here I am talking about obligations such as providing a directors report as to affairs, delivery up of the books and records etcetera following the appointment of an external administrator to the company. If directors don't substantially comply, they will lose their Safe Harbour protection.

What is substantial compliance?

'*Substantial compliance*' is not defined but typically means compliance with the purpose or objective even though the formal requirements are not complied with.

For example, a company:

First, paying employee entitlements two days late is likely to be substantial compliance with the section, but not strict compliance;

Secondly, missing the payment of wages for one fortnight but paying all other fortnightly pay runs during the Safe Harbour period will not be substantial or strict compliance.

In particular, the entitlements of employees must be being paid by the time they fall due. If a Liquidator is looking to bring an insolvent trading claim, their position will be that a director can't cause a company to pay all the obligations up to date later on and then claim Safe Harbour protection in relation to debts incurred earlier on when the obligations were outstanding.

Only those employee entitlements which fall due for payment, need to be paid on time – a director doesn't need to cause a company to put aside money for leave or other entitlements which have accrued, but are not yet payable.

Other than paying employee entitlements when they fall due, the company does not have to pay its tax obligations, such as GST or income tax; it just has to have reported them to the tax office on time.

Whilst we must all await case law to be decided on what is 'substantial compliance', (at least in the view of one commentator - and I agree with him) it is reasonable for you to operate on the following basis:

First, substantial compliance means meeting the obligation within a short period of time after the due date. The longer the delay, the greater the chance of not substantially complying; and

Secondly, a company could never be substantially compliant with its obligations to pay employees their entitlements by not paying them in full (i.e. paying 95% of what is due would not meet the test).

If a company has entered into a repayment arrangement with the ATO and it includes payments for outstanding PAYG or superannuation, that will mean that the company is (in relation to the liabilities the subject of the repayment arrangement) paying those by the time they fall due (if the company has complied with the repayment arrangement). However, a company just paying all the entitlements when they fall due (even under a repayment arrangement with the ATO) and ensuring all lodgements are up to date won't automatically allow a director to enter into Safe Harbour protection if the company has historically failed two or more times to do these things during the previous 12 month period (which is likely if it is in a repayment arrangement). Therefore, at most, a company can afford one failure to pay entitlements or lodge tax documents when due within the preceding 12 months.

Evidence is not admissible to engage Safe Harbour protection if inspection by a Liquidator is prevented

To guard against the risk that documents may be fabricated after the event by directors seeking to engage Safe Harbour protection, new s.588GB provides that:

First, if an insolvency appointee is appointed to the company and the director fails to comply with the obligation to deliver up or permit inspection of the company's books and/or give information to the appointee; then

Secondly, subject to court order, the books of the company and/or information that was not given to the insolvency appointee is inadmissible in any later court proceeding in which the director seeks to establish Safe Harbour protection.

For these reasons and to make an assessment of the position, it is important to provide information to a Liquidator when he or she conducts their own Safe Harbour due diligence to help them to make an informed decision about whether or not directors/holding companies have engaged and/or lost Safe Harbour protection.

The director may apply for a court order permitting the evidence, including where the director proves that he or she did not possess the book or information at the relevant time and there were no reasonable steps that the director could have taken to obtain the book or information.

Who bears the onus?

Because the evidence will be within the director's knowledge and not that of the liquidator, the Act provides that the director bears the 'evidential burden', meaning that the director must adduce or identify the evidence to suggest that he or she was developing and implementing the relevant course of action during the relevant period.

Once the evidence is adduced or identified, the liquidator bringing the insolvent trading claim bears the legal burden, meaning that they will have to prove, on the balance of probabilities that Safe Harbour protection does not apply.

D. Practical application and tips?

Ensure pre requisites have been met – If Safe Harbour is not available (which must be thoroughly assessed by an accounting advisor and separately by a legal advisor), appointing a VA will be the safest option. Directors might want to consider paying out any new debts incurred post the point of potential insolvency, which has its own risks to be considered, before appointing the VA to further manage their own and the holding company's insolvent trading liability exposure.

Realistic plan – Stakeholder support (from banks, customers, suppliers etc.) is essential to any successful turnaround plan! Consider the likelihood of negotiating ongoing stakeholder support for the turnaround plan and contractually document the support of major stakeholders if that is possible. The company must maintain 'warts and all' communications with stakeholders through a trusted intermediary advisor. The company's point of contact with stakeholders must continuously update the Board regarding material developments and monitor stakeholder attitudes.

If actions by stakeholders reveal that it is no longer realistic to expect their support, directors should strongly consider the appointment of a VA as it is likely that the plan has ceased to be reasonably likely to achieve a better outcome. We frequently see blind optimism by directors who put a lot more stock in their negotiation skills than stakeholders apparently do. Stakeholders may have lost trust and confidence in the senior management and board of the company or it may be that those who are accountable for past decisions are rightly or wrongly perceived as simply carrying too much 'baggage' or as being too defensive in the eyes and minds of stakeholders.

Hindsight test – Liquidators and creditors will be looking at the action taken by directors after the fact. Documentation will be very important. Don't only document what the plan is, record why the directors consider that the plan is reasonably likely to lead to a better outcome. As a further risk mitigation strategy, directors might wish to engage lawyers to work with them to provide advice and document the plan. Done the right way, the documentation will be cloaked with legal professional privilege. This might become important if it is later discovered that Safe Harbour protection does not apply and the directors wish to resist handing over the documentation to a liquidator to be used against them. If Safe Harbour protection does apply, directors can waive privilege at an appropriate time and rely upon the documents.

Ongoing monitoring – Directors need to regularly review their turnaround plan and ensure that it remains reasonably likely to lead to a better outcome or if otherwise modify it. There is a tendency in turnarounds for directors to put the plan in place and forget about it until management raise further issues. That won't cut it. Directors need to keep on top of the material issues and continually ask the question, is this still reasonably likely to lead to a better outcome and why? Directors should document each review and the reasons why they consider that the turnaround plan still meets the Safe Harbour test or if otherwise modify it.

Pick the right horse for the course – Get advice from an 'appropriately qualified entity' early. This could range from the local accountant for a company with a small business to a specialist insolvency lawyer/practitioner (or team) for larger more complex company businesses. The Explanatory Memorandum explains that beyond smaller businesses with simple structures, it is expected that directors will often obtain advice about solvency and the turnaround options when determining the course of action to be taken. If this type of advice is obtained, it should be given by a 'true professional', meaning formal educational qualifications, relevant experience, adequate insurance, independent and bound by a professional code of conduct. Best practice would be to engage an insolvency accountant and a lawyer to undertake a solvency and litigation report and give legal advice about realistic options to achieve better outcomes than undertaking a formal insolvency process. The advisor needs to ensure the directors are being full and frank with the advisor. If directors withhold material information, they could lose Safe Harbour protection.

Financial records – Maintain good records and monitor them closely. For complex businesses, best practice will be a 13 week rolling cash flow updated daily and provided to the directors and the advisory team. Set financial benchmarks against which the success of the turnaround plan may be tested and keep checking that the desired outcome from the plan is being achieved.

Corporate governance – Take steps to cover off on misconduct risk and document what those steps are. If misconduct is later discovered by a liquidator, evidence of the steps that the directors took to prevent it will be critical. Examples here include senior management and/or dual signoff on bank accounts, approvals for debt payments, limiting access to financial information, peer reviews etc.

Provide assistance – Know what obligations directors have to assist the insolvency practitioner, what the timeframes are in order to comply. Failure to comply will be fatal for engaging Safe Harbour protection.

Continuous disclosure – Safe Harbour protection does not affect the company's continuous disclosure obligations if a disclosing entity. If these disclosure obligations apply, then directors need to consider whether the steps taken to engage Safe Harbour protection needs to be disclosed and, if so, make the disclosure. Obviously this can have its own problems for the company. A guidance note from the ASX about safe harbour disclosure requirements has been released. In the Note, the ASX has indicated that it does not require a company to disclose to the market that its directors intend to rely on the safe harbour regime to develop a course of action which would result in a better outcome than a formal insolvency process. However, the company nonetheless remains subject to its continuous disclosure obligations in respect of the fact that it is generally in financial distress. The ASX notes that investors would fully expect directors to be considering such plans as a matter of course. However, disclosure would be required when a definitive course of action has been determined or if the planning process is no longer confidential.

Weigh up the benefits of the ipso facto reforms – If counterparties are threatening or likely to exercise ipso facto rights if they become aware that the company is financially distressed and the subject of a turnaround plan, then directors should consider the benefits of appointing a VA to engage the Stay on enforcement of these rights.

Directors personal guarantee exposure – Directors of SMEs often give personal guarantees. Safe harbour does not affect that liability and directors who have given PGs should strongly consider appointing a voluntary administrator early or limiting any new debt incurred with the creditor to reduce their personal exposure (which of course comes with other risks). The appointment of a VA engages the statutory moratorium on creditors taking steps to enforce directors personal guarantees giving directors valuable breathing space to work with the VA to restructure the business through a DOCA and pay the creditor a discounted amount to discharge the debt and remove the risk of the PG being called.

IPSO FACTO

A. The position prior to the amendments - A recap

The current position is that there is no general stay on enforcement of ipso facto clauses - contractual rights may be exercised according to their terms.

B. The reason for the amendments

The exercise of rights under ipso facto clauses can decimate the value of the insolvent company's business and destroy any ability for the insolvency practitioner to rescue the business or sell the business as a going concern to the benefit of the creditors and other stakeholders.

The ipso facto reforms are designed to 'lock in' counterparties to their contracts during an insolvency event to preserve value in the business whilst the company is restructuring and attempting to recover.

C. What are the amendments?

The amendments will provide a stay on the enforcement of contractual ipso facto clauses triggered by certain insolvency events but **are not expected to commence until 1 July 2018**. The amendments will not apply to contracts entered into before 1 July 2018.

An overview of the amendments follows.

INSOLVENCY PROCESS	WHEN DOES THE STAY PERIOD START?	WHEN DOES THE STAY PERIOD END?
VA	When the VA is appointed	When VA ends (subject to court order extending the Stay period if appropriate in the interests of the justice) <u>unless</u> the reason that the VA ends is because of a resolution or order that the company would be wound up - in which case, when the company's affairs are wound up.
Receiverships and other managing controllers	When the receiver or other managing controller is appointed	When the receiver or other managing controller's role ends (subject to the court order extending the stay period if appropriate in the interest of justice).
Scheme of arrangement	When the public announcement or application for approval of the scheme is made	1. If the company makes a public announcement but fails to make the application within 3 months, at the end of that 3 months (subject to court order extending that period); or 2. If the s.411 application is made, when the application is withdrawn or dismissed by the court; or 3. At the end of any scheme approved under Part 5. 1 (unless 4 below applies); or 4. If the scheme ends because of a resolution or order that the company be wound up, when the company's affairs are wound up.

Under each process, there are anti avoidance provisions that provide for the Stay on enforcement of rights to also apply if the ipso facto clause is triggered by:

the company's financial position if the Stay otherwise applies	to avoid a situation where a contractual term such as a '*material adverse change in the financial position of the company*' could be relied upon to exercise the right
a reason that is '*in substance*' contrary to the Stay on enforcement provisions if the right arises by express provision (however described) of the contract	for example, an express clause permitting termination upon the resolution of the directors to appoint a voluntary administrator - as opposed to the actual appointment of the voluntary administrator which would be Stayed - would be caught by this provision, or [NB. the '*in substance*' trigger events are designed to cover off any new drafting techniques in contracts that give rise to ipso facto rights but do not strictly meet the other trigger events that apply under each of the insolvency processes].
reasons prescribed by regulation	the Minister has broad powers to respond to clauses that seek to avoid the operation of the Stay. The Explanatory Memorandum explains that the broad regulation making power is necessary to ensure that the government can respond quickly to clauses that are drafted in such a way as to circumvent the amendments before they become widespread and negate the reforms.

The Stay will also apply to '*self-executing*' ipso facto clauses. This means a clause that takes effect automatically and is not subject to any decision being made or step being taken by the counterparty. An example would be, "*upon an event of default (usually including an insolvency event), this agreement shall be terminated*". The ipso facto amendments also Stays the operation of these clauses throughout the Stay period.

To avoid the situation where a company effectively recovers from an insolvency event but is then exposed to the consequences of ipso facto clauses at the end of the Stay period the Act provides that any rights Stayed will be unenforceable indefinitely after the end of the Stay period to the extent that the reason for seeking to enforce the right is:

First, the company's financial position before or during the Stay period; or

Secondly, the fact that one or more of the trigger events occurred in respect of the company; or

Thirdly, a reason prescribed by regulation.

Courts will have the discretion:

First, upon application by the counterparty, to order that a right otherwise Stayed may be enforced against the insolvent company in the interests of justice; and

Secondly, upon application by the relevant party (i.e. the appointee under the insolvency process), to order that a contractual right that is not drafted as an ipso facto clause is nevertheless not enforceable (or enforceable subject to terms) if the court is satisfied that the right is being exercised merely because of one of the trigger events. For example, termination for convenience clauses.

When the Stay on enforcement applies:

First, the counterparty's other contractual rights remain unaffected. The counterparty will still be able to exercise rights for other breaches of the contract that are unrelated to the trigger event (for example, non-performance or failure to pay).

Secondly, the insolvent company cannot enforce any right under the contract for a new advance of money or credit for the duration of the stay period so COD is permissible.

Secured parties' rights in VAs are preserved. To the extent that the secured party is exempt from the moratorium in respect of certain enforcement action that may be taken during VA, the amendments make clear that those rights are not affected by the Stay on ipso facto clauses. This will be relevant for secured parties who:

First, have a security interest over the whole or substantially the whole of the company's property and act before or during the decision period (13 business days) – i.e. an ALLPAP general security interest that has rights to appoint a receiver upon the insolvency of the company will be able to exercise that right despite the stay;

Secondly, had begun to enforce their security interest before the voluntary administration; or

Thirdly, has a security interest in perishable property.

Draft regulations and declarations released by the government on 16 April 2018 proposed when the Stay would not apply to certain types of arrangements and rights. The most relevant commonly encountered arrangements and rights excluded from the Stay are as follows:

Arrangements

First, Government licences or permits

The ipso facto stay does not apply to arrangements that are licences or permits issued by the Commonwealth, a State or a Territory, an authority of the Commonwealth or of a State or a Territory, or a local government, such as a council.

Secondly, arrangements for the sale of a business

The ipso facto stay does not apply to arrangements for the sale of all, or substantially all, of a business. This paragraph clarifies that a purchase by way of the sale of securities or financial products in the entity being purchased is also captured. The sale and purchase of a business in financial trouble is often negotiated as an alternative to a formal insolvency process. If the stay was to operate, the sale price would be lower to take into account a purchaser having to complete the purchase of a business that is subject to a formal insolvency process rather than being able to terminate the agreement. This will significantly impact the inflow of capital into a business in financial trouble and make it more difficult to extricate an otherwise performing business from an insolvency or restructuring process.

Thirdly, arrangements to which a special purpose vehicle is a party

The ipso facto stay does not apply to contracts, arrangements or agreements to which a special purpose vehicle ("SPV") is a party. Arrangements to which an SPV is a party are typically agreed between sophisticated counterparties who arrange for, and agree on, a bespoke set of rules to apply in the event that a party becomes insolvent. In those instances, it is preferable that the agreed rules, which may provide for the operation of ipso facto clauses, continue to apply, and for that reason such arrangements are excluded from the stay.

Fourthly, subordination arrangements

The ipso facto stay does not apply to subordination arrangements. It is not the purpose of the ipso facto stay provisions to affect either the statutory waterfall of agreed priorities in insolvency, or any contractual arrangement between a company's creditors which may change their respective priorities. For this reason it is appropriate to exclude such arrangements from the scope of the stay.

Fifthly, factoring arrangements

The ipso facto stay does not apply to debt factoring agreements. Where parties have already entered into arrangements to attempt to alleviate a business' financial stress, such as factoring arrangements, staying ipso facto clauses would undermine or significantly change the terms of those arrangements and so these arrangements are excluded.

Sixthly, novating and assigning rights from pre-1 July 2018 arrangements, varying pre-1 July 2018 arrangements

The ipso facto stay does not apply to arrangements entered into on or after 1 July 2018, where those arrangements are a novation or an assignment of rights under an arrangement entered into before 1 July 2018.

It was not intended for the ipso facto stay to capture arrangements entered into as a result of rights exercised in arrangements on foot prior to the commencement of the stay provisions. On that basis, new arrangements entered into on or after 1 July 2018 as a result of exercising novation or assignment rights in arrangements entered into before 1 July 2018, will not be captured by the ipso facto stay.

On the same basis, where contracts entered into before 1 July 2018 are varied by subsequent arrangements entered into on or after 1 July 2018, the subsequent arrangements will also not be captured by the stay.

Rights

First, uplift clauses and indemnification

The ipso facto stay does not apply to financing arrangements, insofar as they entitle the lender to charge a higher rate of interest following a relevant insolvency event or to enforce an indemnity for costs, expenses, losses and liabilities incurred as a result of the other party experiencing a relevant insolvency event.

A financing arrangement refers to any contract, agreement or arrangement under which a person provides financial accommodation to a company. The concept of 'financial accommodation' is broader than a loan and includes arrangements under which bonds, notes, debentures and other debt securities are issued by a company.

Financing arrangements may provide that on an insolvency event, a lender may begin to charge a higher rate of interest to reflect the increased credit risk faced by a borrower entering into formal insolvency. Such provisions typically begin to apply automatically on the occurrence of a formal insolvency.

These arrangements may also include indemnities for various costs which the lender incurs as a result of the borrower experiencing an insolvency event. For instance, they may require the borrower to cover the cost of any legal advice the lender obtains on its enforcement options when the borrower becomes insolvent.

The ipso facto stay does not apply to the right of indemnity (covering, for instance, the cost of any legal advice a lender may obtain on its enforcement options when the borrower becomes insolvent) for similar reasons.

Secondly, termination rights in a standstill or forbearance arrangement

The ipso facto stay does not apply to rights to act on earlier defaults suspended or reserved under standstill or forbearance type arrangements that are triggered on the occurrence of a relevant insolvency event.

Forbearance arrangements are an agreement under which a lender agrees to refrain from exercising their enforcement rights on a default event. These are an important restructuring tool and give the debtor breathing space to assess their financial position and to arrange a workout or restructure.

Additionally, not excluding standstill and forbearance agreements from the operation of the ipso facto stay would be a disincentive to entering into such agreements which would potentially result in earlier enforcement activity.

Thirdly, rights of set-off and acceleration of such rights

The ipso facto stay does not apply to a contract insofar as it contains a right of set-off, a right to net balances (or other amounts) or a right to take an action to enforce such rights.

Acceleration rights override the previously agreed maturity date of a loan (or similar agreement) where the borrower defaults and allows the lender to demand immediate repayment of all amounts owing. This exclusion preserves rights to accelerate or crystallise a debt upon a relevant insolvency event, but only to the extent that this is necessary to fully exercise a right of set-off protected by this declaration.

Fourthly, rights of assignment and novation

Rights of assignment and novation are excluded from the ipso facto stay.

Fifthly, self-executing provisions

Certain self-executing provisions are excluded from the ipso facto stay in order to provide certainty around the treatment of circulating assets in insolvency and ensure that there is no conflict between the operation of the Act and the Personal Property Securities Act 2009.

Sixthly, step-in rights

A right to perform obligations of an entity (being the body, corporation or company which would have the benefit of the ipso facto stay) under a contract, agreement or arrangement or a right to enforce a right under a contract, agreement or arrangement that would be enforceable by that entity (commonly known as step-in rights) are excluded from the ipso facto stay.

Certain contracts, for example construction contracts and long-term services contracts, will generally include provisions which allow, on the occurrence of any insolvency event in relation to one party, for another entity to 'step-in' to the shoes of that party and enforce certain rights or perform obligations of that party.

Seventhly, other

First, for a right to appoint a controller to be excluded from the ipso facto stay, the person who enforces the right must have a security interest in the property of the company.

Second, a controller must have been appointed in relation to property of the specified person, or the right to appoint a controller to the property of the company has been enforced.

D. Practical application and tips?

Not retrospective – The Stay applies to ipso facto clauses in contracts entered into after 1 July 2018. Consider whether your company or counterparties are varying/extending existing contracts and entering into contracts now so that the Stay does not apply.

Review contracts now – Are counterparties 'Beefing up' other rights exercisable upon breach of the contract. E.g. removing the requirement to give notices to remedy non-insolvency breaches of contract before termination (where possible) so that the counterparty may terminate immediately for breach rather than being locked in to a contract with an insolvent company until the notice period expires. Related to this is that counterparties that receive notice of the financial distress of a company and who wish to get out of the contract before the company sinks will need to monitor the contractual defaults under their contract and not grant indulgences/forbearances in the lead up to the trigger event but act quickly to enforce the contractual rights.

Ipso facto clauses will be a shield, not a sword – Are counterparties keeping ipso facto clauses in the company's contracts! Enforcement of them might be Stayed but they act as valuable protection against the counterparty's contractual obligations to make new advances of money or credit to the insolvent company during the Stay period.

Consider court application – The court could Stay the enforcement of other contractual rights. From the perspective of the counterparty, the court can permit enforcement if persuaded that it is in the interests of justice.