

Information Technology Alert

ICT supplier insolvency, GITC & you

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It is critical in the current economic environment that each and every entity using GITC Customer Contracts v5.02 (**GITC Contract**) knows how to identify and quickly respond to ICT suppliers facing financial hardship. If you know what protections you already have in your GITC Contracts, you can use these mechanisms if the need arises.

When a supplier (referred to as the Contractor under GITC) is near to being insolvent and the risk of losing vendor support for your ICT systems, or the risk of having the supplier pull out of projects, is real then knowing what contractual tools are available is vital. It cannot be stressed enough that you must not delay when dealing with a supplier on the brink of going under.

It is important to know that whilst a supplier remains unquestionably solvent, the relationship is between you and the supplier. When insolvency, or even the prospect of insolvency, rears its ugly head then some, if not all, of your supplier's ability to deal with you is removed by law and an external party is appointed. The support you require will be prioritised last when compared to the sale of company assets, paying down debt and ensuring creditors are paid.

Key points discussed in this update

- If a supplier does not have the ability to pay its debts when due, they will be insolvent and it is likely new

management will be appointed by a legal process. If this happens, you will lose your supplier's ongoing goods and services.

- Government and related entities need to be pro-active about monitoring ICT supplier's financial health by engaging in regular contract 'health-checks' and watch for signs that a supplier is struggling.
- If issues are detected then quick reactions using the available protections in GITC Contracts can help to prevent bad outcomes in ICT projects and systems.

Supplier insolvency

The core concepts

Under Australian law, a company that cannot pay its debts as and when they fall due is by definition insolvent. It is important to note that it does not matter if a company has millions of dollars worth of assets that it owns, what is relevant is whether it has, or can easily obtain, the cash flow required to consistently pay its debts (i.e., could it quickly sell assets to generate cash flow?).

This concept is particularly important in ICT where a particular supplier has significant and valuable intellectual property assets but cannot readily convert them to cash to pay debts. These companies are more likely to face financial difficulty and should have more frequent health-checks performed on them.

Equally some suppliers might have large long term contracts with guaranteed future revenue but whether or not it is solvent comes down to whether that company has enough cash in the bank to pay, for instance, the electricity bill when it is due.

What happens when a company is insolvent?

The *Corporations Act 2001* (Cth) provides a number of mechanisms for what may happen when a company is insolvent or is about to become insolvent:

1. Receivership: This is a process usually commenced by a secured creditor of the company. The secured creditor appoints a receiver (or receiver and manager) who takes control over the assets of the company. A receiver will realise assets of the company to pay a secured creditor's debts, while a receiver and manager will not only realise the assets, but manage the affairs of the company (including trading it) whilst the assets are being realised.

2. Voluntary Administration: This is a process which is usually commenced by the directors of a financially troubled company who appoint a 'voluntary administrator' once they have resolved that the company is insolvent or likely to become insolvent, as there are penalties for trading while insolvent. The role of the voluntary administrator is to investigate the company's affairs, report to creditors and recommend whether the company should:

- a. go into liquidation (as to which kind, see below); or
- b. be returned to the directors (this rarely happens); or
- c. enter into a deed of company arrangement.

A deed of company arrangement is a binding arrangement approved by a majority of creditors, which is intended to allow the company to continue trading.

3. Liquidation - There are two main types of liquidation:

- a. Creditor's voluntary liquidation: where creditors vote for liquidation following a voluntary administration or a terminated deed of company arrangement; and
- b. Court liquidation: a liquidator is appointed by the court to wind up a company following an application, usually by a creditor. Typically, a creditor will serve on the company a 'statutory demand' for an unpaid debt. If the company does not pay that debt (or dispute the debt) within 21 days, then it will be insolvent and entitle the creditor to apply to wind the company up.

After a company goes into liquidation, unsecured creditors can no longer commence or continue legal action against the company unless the court permits.

If any of the above happens with your supplier, it will affect your GITC Contract.

Supplier insolvency in the GITC framework

When will an insolvent supplier be in material breach of its GITC contract?

Clause 1.1 of GITC Part 2 has its own definition of Contractor's Insolvency, including the supplier becoming unable to pay its debts as and when they fall due.

Under clause 9.10 of GITC Part 2, a supplier is required to give immediate notification in writing to you of an event of Contractor's Insolvency. If there is an event of Contractor's Insolvency, or a failure to notify of such an event, this gives rise to other contractual remedies that are discussed below.

What is the commercial consequence of Contractor's Insolvency?

Depending on when you become aware of a supplier's insolvency, there could be major commercial costs:

- Any payments you made or continue to make to the supplier may go into a general pool that will be disbursed amongst creditors. This means that those payments may **not** be recoverable, or at least will not be 100% recoverable, even if you have not received the Product or Services under the Contract.
- If the supplier is to be liquidated, its assets will be sold at the best possible price. Despite that fact that you may have already paid for the Product, you may not receive hardware that you purchased under the Contract.
- If the supplier is unable to pay its employees' or sub-contractor's wages, or is to be liquidated, you may be left without ongoing Service support or Updates for the Product.

The overall risk for you under GITC is that if your supplier becomes insolvent and you keep making payments, you may end up *'high and dry'* without the Services or Products you paid for, and with no way of recovering any or all of the payments you have already made. This is why it is important to be proactive with your suppliers, before insolvency is a concern.

Have your finger on the pulse – health-checks

By the time a supplier is insolvent it is likely that it is already too late. The adage *'a stitch in time...'* has never

been more appropriate than when considering the solvency of ICT suppliers.

It is always good practice to undertake contractual and commercial 'health-checks' of your main ICT suppliers. It is common to have an annual process which confirms suppliers have kept up their insurance, but when times are tough then increasing the scope and frequency of these actions could be the difference between life and death for your ICT projects and systems.

Health-checks should be undertaken at differing levels with simple corporate 'questionnaire' type checks being sent to many of your suppliers and 'in-depth' focus being applied to critical or suspect suppliers.

Importantly, the process and the supporting documentation for your supplier needs to take a broad view and cover at least:

- the supplier's current financial health;
- the likelihood of the supplier's continued performance under the Contract in the near to medium term; and
- any changes to the supplier from the time they were selected to become one of your suppliers (insurance, corporate structure etc).

Thomsons Lawyers can help with the creation of such processes and template documents.

Know the signs

Make sure your senior managers have visibility of suppliers who are showing signs of financial stress. In the current economic environment it would be prudent to establish business processes that allow rapid reporting of known 'triggers' to upper management. Such triggers might include a supplier:

- requesting early payments;
- requesting additional sources of revenue from your entity (e.g. a high level of funded change work for a project); or
- terminating the staff necessary to providing the services you consume.

Thomsons Lawyers can provide you with a tailored framework for your entity which matches the clauses found in your current GITC Contracts. Often the employees in your organisation who interact with a supplier will become aware of an issue first. It is important that your organisation establishes a process that allows direct reporting to senior management.

What should you do if a supplier becomes insolvent?

If it is too late and a supplier has become insolvent then you have a number of possible actions available under GITC Contracts Part 2 to limit the damage. Choices will be influenced by whether you want to keep the Contract on foot or not.

- Option 1: Suspend payments.
 - If you are aware that there has been an event of Contractor's Insolvency (as defined), or the supplier has failed to notify you of its insolvency, you can immediately suspend payments under the Contract. Clause 16.4 allows you to suspend any payment or payments during the period of the Contractor's Insolvency.
 - This has the benefit of keeping the Contract on foot, but you do not risk making payments for no value.
- Option 2: Terminate the Contract without Compensation to the supplier.
 - This can be utilised under Clause 16.7 where there has been an event of Contractor's Insolvency, and involves issuing a Notice of Termination.
 - This is a final and irrevocable step, so should not be taken lightly. Any ongoing Service obligations under the Contract would likewise come to an end.

There are other intermediate options, including suspending the Contract (Clause 16.5) or giving notice to show cause for material breach (Clause 16.6). These could be used where you are willing to allow the supplier the opportunity to become solvent again, or if there is commercial benefit in keeping the Contract on foot for at least a short period of time.

Escrow (of source code)

It is critically important to understand the position you have under your GITC Contracts in relation to escrowed source code. If the supplier is providing software under the Contract, you may have previously negotiated the inclusion of a Schedule 8 (escrow agreement). Clause 8.2(a) allows you to give notice to the Escrow Agent that the supplier is subject to any sort of insolvency administration and retrieve the code.

It is also common for contract negotiations to modify the standard GITC escrow agreement. Therefore, a close review of any available escrow agreement should be undertaken when considering the GITC Contract in light of insolvency. Thomsons Lawyers can assist with this task.

Conclusion

Prevention is better than the cure. Thomsons Lawyers can work with you to help review existing GITC Contracts, the associated business processes and develop a cost effective strategy that will involve regular 'health-checks' and hopefully avoid nasty surprises.

If it is too late for precautionary steps, then any action to be taken must be effective and without delay. When a supplier is facing insolvency they are facing losing the company and the ability to deliver your goods and services along with it. If you are presented with a supplier's insolvency or imminent insolvency then Thomsons Lawyers is able to assist you with the time critical process of determining what options are available and the best way forward for your business or organisation.

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