CLIFFORD

CHANCE

AUSTRALIAN INSOLVENCY LAW REFORMS

SAFE HARBOUR AND IPSO FACTO LAWS UPDATE

JULY 2018

CONTENTS

Introduction 2
Overview 3
Snapshot 3
Safe Harbour 3
Amendment to ASX Guidance Note 8 – Continuous Disclosure 4
Ipso Facto Stay 5
Contacts 10

INTRODUCTION

On 19 September 2017, the *Treasury Laws Amendment (2017 Enterprise Incentives No 2) Act 2017* (Cth) (the "**Amending Act**") became Australian law. The Amending Act will be supported by various regulations and other subsidiary legislation (together the "**Insolvency Law Reforms**").

The Insolvency Law Reforms aim to promote solvent restructurings in two ways:

1. **Introducing safe harbour provisions**

   Allowing directors breathing space and exemptions from personal liability for insolvent trading, so that they can consider restructuring solutions that may lead to a better outcome for a distressed company outside of a formal insolvency process. The safe harbour provisions commenced on 19 September 2017.

2: **A stay on ipso facto clauses and rights**

   Ipso facto clauses allow termination by a party if an insolvency event occurs in relation to the other party, where there is a scheme of arrangement, voluntary administration, receivership or appointment of a managing controller.

   In order to promote certainty in established contractual arrangements, there is a long list of exceptions to the stay on ipso facto clauses, including for syndicated loans, bonds, certain other financial markets products, derivatives, settlements systems, and set-off and netting rights. The stay will not apply to contracts entered into before 1 July 2018.

   There is a long list of types of rights excluded from the ipso facto stay, including the right to change the basis (including by the application of a different rate) on which an amount is calculated under a financing arrangement, or guarantee, indemnity or security related to a financing arrangement.

   The ipso facto stay reforms commenced on 1 July 2018.

Together, the Insolvency Law Reforms signify an important new era in the Australian restructuring market.

In this Briefing, we offer a snapshot of the Insolvency Law Reforms, examine their content and provide an overview of the likely legal and commercial effect of these landmark reforms.

OVERVIEW

The Insolvency Law Reforms amend the *Corporations Act 2001* (Cth) (the "**Act**") by creating new provisions designed to give greater certainty and flexibility to Australian businesses undergoing or entering into an insolvency process.

The ultimate aims of the Insolvency Law Reforms are to avoid unnecessary and premature administrations, receiverships and liquidations, drive cultural change amongst company directors, and promote the preservation of enterprise value to maximise shareholder and creditor returns. They do this by promoting entrepreneurship and innovation in two forms: (1) providing a 'safe harbour' for directors from the liability of harsh insolvent trading laws; and (2) giving companies breathing room where they are making efforts to trade out of difficult financial situations by preventing the enforcement of 'ipso facto' clauses in certain circumstances.

SNAPSHOT

1. The safe harbour provisions came into operation on 19 September 2017.
2. ASX Guidance Note 8 now clarifies that an entity's directors relying on the safe harbour provisions, in and of itself, is not something that the ASX would generally consider requires disclosure of to the market under ASX Listing Rule 3.1. Disclosure is likely to be required, however, if the course of action ceases to be confidential or a definitive course of action has been determined.
3. The Declaration received Royal assent on 20 June 2018 and the Regulations received Royal assent on 21 June 2018.
4. The new ipso facto stay reforms came into operation on 1 July 2018.

SAFE HARBOUR

Under ss 588G and 588M of the Act, a director of a company can be made personally liable, both criminally and civilly, for debts incurred by the company if the company is, or if by incurring that debt becomes, insolvent, and at that time there are reasonable grounds for suspecting that the company is insolvent or would become insolvent. The new s 588GA provides directors with a defence against liability under ss 588G and 588M if, after they begin to suspect that the company may become or be insolvent, they develop one or more courses of action that are reasonably likely to lead to a better outcome for the company.

In determining whether a course of action is '*reasonably likely to lead to a better outcome for the company*', there are **five key considerations** as to whether the person is:

1. properly informing themselves about the company's financial position;
2. taking appropriate steps to prevent any misconduct by officers or employees of the company that could adversely affect the company's ability to pay all of its debts;
3. maintaining the company's financial records;
4. obtaining advice from appropriately qualified entities; and
5. developing or implementing a plan for restructuring to improve the company's financial position.

Key reforms

- New provisions have granted directors a 'safe harbour' to take courses of action *'reasonably likely to lead to a better outcome for the company'* in situations where insolvency is reasonably suspected.
- Companies may be protected from 'ipso facto' clauses (which at times allow for a premature and disproportionate termination of contracts) when a company is in voluntary administration, under a scheme of arrangement, or when a receiver/controller has been appointed.
- Carve-outs for specified rights, contracts, agreements and arrangements, to which the ipso facto reforms do not apply are in the Regulations and Declaration.
- These reforms will drive cultural change amongst directors and allow companies a greater chance to restructure.
- Secured creditors who have security over all or substantially all of the assets of a company may still appoint managing controllers.

Operation of safe harbour exceptions

- The safe harbour protections cannot be relied upon by a director where the company has failed to pay the entitlements of its employees, and supply returns, notices, statements, applications or other documents required by the *Income Tax Assessment Act 1997* (Cth).
- The same consequences result where a director has failed to substantially comply in relation to maintaining proper company books and records, including providing books to liquidators, controllers and receivers (s 588GA(4)-(5)). Information and books are not admissible to support a safe harbour application if the director failed to allow inspection of, or deliver any books of the company to, the liquidators and receivers (s 588GB).
- The Court has the power to overlook these failures in exceptional circumstances or if it is otherwise in the interests of justice (ss 588GA(6) and 588GB(4)).

Impacts and observations

The safe harbour provisions came into operation on 19 September 2017. They have a number of beneficial effects:

- The harshness and stigma associated with company failure and the value destruction of entering a formal insolvency process can be avoided by entering safe harbour, allowing company directors breathing space in which to make properly thought-out decisions and implement plans to turn around the business and improve the financial position of the company.
- The provisions will alleviate the threats of personal liability for insolvent trading, combined with alleviating the uncertainty over determining the precise moment a company becomes insolvent. This is especially relevant because there are often inadvertent breaches by directors of the insolvent trading duties.
- Directors have the ability to openly seek advice from *'an appropriately qualified entity'* that may actively assist directors to trade out of or implement other courses of action to avoid insolvency. The Explanatory Memorandum notes that *'"appropriately qualified" ... is used in the sense of "fit for purpose" and is not limited merely to the possession of particular qualifications.'*
- The person who appoints the adviser must determine whether the adviser is suitable given the nature, size, complexity and financial position of the business, and the adviser's experience and specialisation, amongst other things. These 'entities' may include financial advisers, banks, law and accounting firms and other consultants.

We note that the Insolvency Law Reforms have incorporated a review period of two years, whereby the Minister will conduct a review of the impact of the laws on creditors, directors and employees (commencing 19 September 2019).

AMENDMENT TO ASX GUIDANCE NOTE 8 – CONTINUOUS DISCLOSURE

In March and May 2018, the ASX amended Guidance Note 8 (the "**Note**"). The Note assists listed entities with understanding their continuous disclosure obligations (under Listing Rules 3.1, 3.1A and 3.1B). The amendments offer further guidance in relation to information to be disclosed concerning market-sensitive agreements for acquisitions or disposals of businesses and guidance on announcements relating to the entry into market-sensitive agreements. Clients operating in Australia and their key personnel should be aware of their obligations in relation to continuous disclosure.

In particular, the ASX reminded listed entities that any entry into, or variation or termination of material agreements, any material acquisition or disposal is to be disclosed, and also reminds that continuous disclosure obligations apply to a listed entity in financial difficulty. The note clarifies that in the ASX's view, the fact that an entity's directors are relying on the insolvent trading safe harbour provisions to develop a course of action that may lead to a better outcome for the entity than an insolvent administration, in and of itself, is not something that the ASX would generally consider requires disclosure under this Rule. Disclosure is likely to be required, however, if it ceases to be confidential or a definitive course of action has been determined.

IPSO FACTO STAY

Ipso facto clauses

"Ipso facto" clauses are those that permit a contracting party to vary or terminate a contact (amongst other actions) where an "insolvency event" occurs in relation to the counterparty. Such clauses are very common in contracts in many industries, including banking and construction, where the mere fact that an insolvency event occurs can trigger termination, even where the party continues to otherwise perform the contract. The main argument in favour of ipso facto clauses is that they safeguard the rights of vulnerable creditors in situations where their counterparties are facing insolvency risk.

However, such clauses often impede a successful restructure for an insolvent entity because they can:

- reduce restructuring options by making any recovery or sale of the business difficult and impractical;
- be harmful to both the goodwill and economic value of the company's business, its relationships and creditworthiness – due to their ability to disrupt business activity during a restructuring process; and
- harm the potential return to creditors in the event of administration or receivership.

Triggering a Stay – Schemes of Company Arrangement (s 415D)

Under subsection 1 of section 415D of the Act, the Insolvency Law Reforms introduce an automatic stay on the enforceability of 'ipso facto' rights against a Part 5.1 body that allow a contract to be terminated or altered for:

- the reason that the body, if it is a disclosing entity, publicly announces that it is or is intending to enter into a scheme of company arrangement;
- the reason that the body is subject to a compromise or scheme of arrangement (proposed for the purpose of avoiding an insolvent winding-up);
- the body's financial position, if the body is the subject of such announcement, application, compromise or arrangement about the body; or
- for a reason that, in substance, is contrary to the above,

if the right arises for that reason by express provision (however described) in a contract, agreement or arrangement (collectively, the "**Arrangements**").

Triggering a Stay – Voluntary Administration (451E)

Under s 451E of the Act a right cannot be enforced against a company for:

- a reason that the company is under administration;
- the company's financial position if the company is under administration; or
- for a reason that, in substance, is contrary to the above,

if the right arises for that reason by express provision (however described) of an Arrangement.

Triggering a Stay – Receiverships and Appointment of Managing Controllers (subsection 1 of section 434J)

Under s 434J of the Act a right cannot be enforced against a corporation for:

- the reason of the appointment or existence of a managing controller of the whole or substantially the whole of the corporation's property; or
- the corporation's financial position, if there is a managing controller of the whole or substantially the whole of the corporation's property; or
- for a reason that, in substance, is contrary to the above,

if the right arises for that reason by express provision (however described) of an Arrangement.

Ipso facto anti-avoidance provisions

Anti-avoidance provisions have been included in the Insolvency Law Reforms to prevent the regime from being frustrated.

The anti-avoidance provisions are broad. They have the effect that regardless of the wording of a contractual clause, if it is in substance contrary to the legislation, it is unlikely to be enforced. Self-executing provisions (that provide for automatic consequences without a party taking a step) are also stayed.

Types of contracts captured

The ipso facto stay will not apply to clauses in Arrangements that were entered into **before** the commencement of the Insolvency

Law Reforms. The stay provisions came into effect on 1 July 2018.

In addition, the stay **does not apply** to clauses in Arrangements:

- made after the commencement of the formal restructure (ss 415D(6)(a), 434J(5)(a) and 451E(5)(a));
- that are contained in a type of contract that is specified in the *Corporations Amendment (Stay on Enforcing Certain Rights) Regulations 2018* (Cth) (the "**Regulations**") or declared by the Minister in the *Corporation (Stay on Enforcing Certain Rights) Declaration 2018* (Cth) (the "**Declaration**" and the Regulations, together the "**Instruments**") (ss 415D(6)(b), 434J(5)(b) and 451E(5)(b));
- which have been declared by the Minister by legislative instrument (ss 415D(6)(c), 434J(5)(c) and 451E(5)(c)-(d)); and
- where there is inconsistency between the stay provisions, the *Payment System and Netting Act 1998* (Cth) and the *International Interests in Mobile Equipment (Cape Town Convention) Act 2013* (Cth) will prevail.

Exceptions to ipso facto stay

On 20 June 2018, the Declaration received royal assent and on 21 June 2018 the Regulations received royal assent. The Instruments provide numerous exclusions to the stay in relation to "ipso facto" clauses. The Instruments took effect on 1 July 2018.

Regulations

Under the Regulations, the types of Arrangements that will be excluded from the regime can be found in r 5.3A.50 of the *Corporations Regulations 2001* (Cth):

- agreements subject to the meaning of the "Convention", as defined in s 3 of the *International Interests in Mobile Equipment (Cape Town Convention) Act 2013* (Cth);
- an Arrangement that is a license, permit or approval issued by the Federal, State or local government of Australia (the "**Governmental Bodies**");
- Arrangements relating to Australia's national security, border protection or defence capability;
- Arrangements for the supply of goods or services by, or on behalf of, a public hospital or a public health service;
- Arrangements for the supply of essential or critical information technology, or communications technology, products or services to Governmental Bodies, or the public on behalf of Governmental Bodies;
- derivative Arrangements and directly connected Arrangements;
- securities financing transaction Arrangements and directly connected Arrangements;
- Arrangements for the underwriting of an issue, or sale, of securities, financial products, bonds, promissory notes, or syndicated loans;
- Arrangements under which a party is or may be liable to subscribe for, or to procure subscribers for, securities, financial products, bonds, promissory notes or syndicated loans;
- Arrangements that are, or govern, securities, financial products, bonds, promissory notes, or syndicated loans;
- Arrangements under which securities are offered, or may be offered, under a rights issue;
- Arrangements for the sale of all or part of a business, including by way of the sale of securities or financial products;
- Arrangements for the issue of a security or other financial product that belongs to a class of fungible instruments, the first of which was issued before 1 July 2018;
- Arrangements that are margin lending facilities or directly connected Arrangements (within the meaning of Chapter 7 of the Act);
- Arrangements that are covered bonds, or issuing covered bonds, (within the meaning of the *Banking Act 1959* (Cth)) and directly connected Arrangements;
- Arrangements for the management of financial investments;
- Arrangements that involve a special purpose vehicle, and that provides for securitisation, or a public-private partnership;
- Arrangements that involve a special purpose vehicle, and that

provides for a project finance arrangement under which:

- a financial accommodation is to be repaid or otherwise discharged primarily from the project's cash flow; and
- all or substantially all of the project's assets, rights and interests are to be held as security for the financial accommodation;

- Arrangements for the keeping in escrow of source code, or object code, for computer software, and directly related material;
- Arrangements for the commercial charter of a ship if:
  - the ship is not an Australian ship (within the meaning of the *Shipping Registration Act 1981* (Cth) (the "**Shipping Act**")); and
  - the charter is by an Australian national (within the meaning of the Shipping Act) for the purposes of exporting goods from Australia, or from an external Territory, to another country;
- Arrangements under which the priority of security interests in particular property is changed or can change;
- Arrangements that are a flawed asset arrangement;
- Arrangements that are factoring arrangements (within the meaning of the *ASIC Corporations (Factoring Arrangements) Instrument* 2017/794) and directly connected Arrangements;
- Arrangements that are the operating rules (other than the listing rules) of a financial market;
- Arrangements that are the operating rules of a clearing and settlement facility;
- Arrangements that confer rights on the operator of a financial market, or the operator of a clearing and settlement facility, in relation to the operation of the market or facility;
- Arrangements of which the parties include the Reserve Bank of Australia and the operator of a clearing and settlement facility;
- Arrangements under which participants (within the meaning of Chapter 7 of the Act) in a clearing and settlement facility may settle obligations on behalf of other participants (within the meaning of that Chapter) in the facility;
- A legally enforceable arrangement referred to in paragraph 9(1)(b) of the *Payment Systems and Netting Act 1998* (Cth) (the "**Payment and Netting Act**") that supports an approved RTGS system (within the meaning of the Payment and Netting Act) and approved netting arrangement (within the meaning of the Payment and Netting Act) (the "**Main Contracts**") and Arrangements under which the parties to a Main Contract may settle obligations on behalf of the other parties to a Main Contract;
- Arrangements that confer rights on the operator of an approved RTGS system (within the meaning of the Payment and Netting Act) or the coordinator of an approved netting arrangement;
- Arrangements where security is given over financial property, a close-out netting contract, a netting market, a market netting contract (each as defined within the meaning of the Payment and Netting Act);
- Arrangements that are an outsourcing arrangement for the purposes of Prudential Standard CPS 231 Outsourcing or Prudential Standard SPS 231 Outsourcing;
- Arrangements entered into on or after 1 July 2018, but before 1 July 2023, as a result of either of the following (1) the novation of, or the assignment of one or more rights under, an Arrangement entered into before 1 July 2018, or (2) a variation of an Arrangement entered into before 1 July 2018;
- Arrangements entered into on or after 1 July 2018, but before 1 July 2023, for the provision of any of the following kinds of work, goods or services for a particular project (if the total payments under all Arrangements for the project are at least AUD1 billion):
  - building work (within the meaning of the *Building and Construction Industry (Improving Productivity) Act 2016*);
  - work to be carried out anywhere in Australia that, if carried out in New South Wales, would be covered by paragraph 5(1)(d) or (f) of the *Building and Construction Industry Security of Payment Act 1999* (NSW) (the "**Building Act**") and not be excluded by subsection 5(2) of the Building Act;
  - goods or services to be provided anywhere in Australia

that, if provided in New South Wales, would be related goods and services (within the meaning of the Building Act); and

- Arrangements that are entered into to enable the satisfactory completion of Arrangements covered by the above paragraphs and are for the provision of a kind of work, goods or services covered by that paragraph.

Declaration

Under the Declaration, the type of rights excluded from the ipso facto stay include:

- a right to change the basis, including by the application of a different rate, on which an amount is calculated under a financing arrangement or a guarantee, an indemnity or security related to a financing arrangement (whether or not the guarantee, indemnity or security is limited in any way);
- a right to payment by way of indemnity (whether limited or not) in respect of any liability or loss arising as a result of a person preserving or enforcing rights or any charges and expenses incurred by a person in preserving or enforcing rights;
- a termination right under a standstill or forbearance arrangement, whether or not the standstill or forbearance arrangement suspends, preserves or modifies the right under the other contract, agreement or arrangement to which it applies;
- a right to change the priority or order in which amounts are to be paid, distributed or received under a contract, agreement or arrangement;
- a right of set-off or a right of combination of accounts (and related acceleration, conversion of currency rights and a right to crystallise a security interest);
- a right to net balances or other amounts (and related acceleration, and conversion of currency rights, and a right to crystallise a security interest);
- a right to assign or otherwise transfer rights or obligations or novate rights or obligations;
- a right for property that is subject to a circulating security interest to become subject to a non-circulating security interest, for a floating charge over property to operate as a fixed charge, or for property consisting of accounts or chattel paper to be transferred to a secured party by way of security, or that restricts the grantor of a security interest in property from dealing with the property);
- a right to perform obligations, to engage another person to perform obligations, to enforce rights, or to engage another person to enforce rights, of the specified person under a contract, agreement or arrangement; and
- a right to enforce a possessory security interest in circumstances where paragraphs 440JA(b), (c) and (d) of the Act are satisfied, where the reference to the company in paragraph 440JA(b) of the Act is taken to be a reference to the specified person.

Period of the stay

Scheme – A stay for a Part 5.1 body under a scheme begins when a public announcement is made or when the scheme application is made, and **ends**: (1) if the body fails to make the announced application, at the end of three months or a longer period ordered by the Court, (2) when the application is withdrawn or dismissed by the Court, or (3) when the company is wound up.

Receivership or controller – The stay **begins** when the managing controller is appointed and **ends** when: (1) the managing controller's control of the company's property ends; or (2) the last day any Court orders extending the stay cease.

Administration – The stay **begins** when the company comes under administration and **ends** when: (1) the administration ends; (2) the last day any Court orders extending the stay cease; or (3) if the administration ends because the company is being wound up.

Court ordered extensions – The rights holder of the ipso facto rights (i.e. a counterparty to a company under a scheme, managing controller or administration) may apply to the Court seeking an order that the stay be lifted, provided that it is in the interests of justice (ss 415E, 434K and 451F).

The Court also retains the power to allow one or more ipso facto rights under a contract, agreement or arrangement to be enforceable (ss 415F(1), 434L(1) and 451G(1)).

Effects and observations

We note some of the key effects:

- The reforms enhance an entity's ability to trade through these insolvency processes, maintain enterprise value and goodwill and avoid value destruction caused by ipso facto clauses.
- Blanket contractual termination triggers are stayed in most cases.
- Secured creditors are still protected – under ss 441A(3) and 441B(2) the stay due to company administration cannot prevent the secured party or receiver from enforcing their interest before or during the decision period if they hold security over all or substantially all of the assets of the company.
- Going forward, companies need to reconsider their standing contracts in the context of the ipso facto reforms, as do financiers in relation to their loan documents.
- Whilst ipso facto clauses cannot be enforced during a stay, a counterparty still retains its contractual rights to terminate an agreement by reason of a breach of contract (i.e. non-payment or non-performance) or for convenience, and these provisions will therefore become more critical.
- The anti-avoidance provisions are broad and regardless of the wording of a contractual clause, if it is in substance contrary to the legislation, it is unlikely to be enforceable under the stay.
- In practice we have seen parties structure documents to bring enforcement rights within the carve-out under the new Declaration; for example, by allowing acceleration to the extent required to allow an exercise of set-off rights. Additionally, parties are considering which group entities within a counterparty should be tested under financial covenants in light of the stays on exercising rights on the basis of "financial position".
- The ipso facto provisions **do not apply retrospectively** to Arrangements entered into prior to 1 July 2018.
- Arrangements resulting from a novation, assignment or variation on or after 1 July 2018, but before 1 July 2023, of an Arrangement entered into prior to that time are excluded from the operation of the stay.

CONTACTS

Richard Gordon
Managing Partner
Australia

T +61 2 8922 8077
E richard.gordon
@cliffordchance.com

Mark Currell
Partner

T +61 2 8922 8035
E mark.currell
@cliffordchance.com

Angela Pearsall
Partner

T +61 2 8922 8007
E angela.pearsall
@cliffordchance.com

Jenni Hill
Partner

T +61 8 9262 5582
E jenni.hill
@cliffordchance.com

Paul Lingard
Managing Partner
Perth

T +61 8 9262 5575
E paul.lingard
@cliffordchance.com

Mark Gillgren
Counsel

T +61 8 9262 5543
E mark.gillgren
@cliffordchance.com

Chad Bochan
Counsel

T +61 2 8922 8501
E chad.bochan
@cliffordchance.com

Nadia Kalic
Counsel

T +61 2 8922 8095
E nadia.kalic
@cliffordchance.com

Alastair Gourlay
Counsel

T +612 8922 8043
E alastair.gourlay
@cliffordchance.com

Nish Shetty
Partner

T +65 6410 2285
E nish.shetty
@cliffordchance.com

Andrew Brereton
Partner

T +65 6410 2279
E andrew.brereton
@cliffordchance.com

Scott Bache
Partner

T +852 2826 3493
E scott.bache
@cliffordchance.com

This publication does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

www.cliffordchance.com

Clifford Chance, Level 7, 190 St Georges Terrace, Perth, WA 6000, Australia

© Clifford Chance 2018

Liability limited by a scheme approved under professional standards legislation

We use the word 'partner' to refer to a member of Clifford Chance LLP, or an employee or consultant with equivalent standing and qualifications

Abu Dhabi • Amsterdam • Barcelona • Beijing • Brussels • Bucharest • Casablanca • Dubai • Düsseldorf • Frankfurt • Hong Kong • Istanbul • London • Luxembourg • Madrid • Milan • Moscow • Munich • Newcastle • New York • Paris • Perth • Prague • Rome • São Paulo • Seoul • Shanghai • Singapore • Sydney • Tokyo • Warsaw • Washington, D.C.

Clifford Chance has a co-operation agreement with Abuhimed Alsheikh Alhagbani Law Firm in Riyadh.

Clifford Chance has a best friends relationship with Redcliffe Partners in Ukraine.

CLIFFORD
CHANCE