Australia

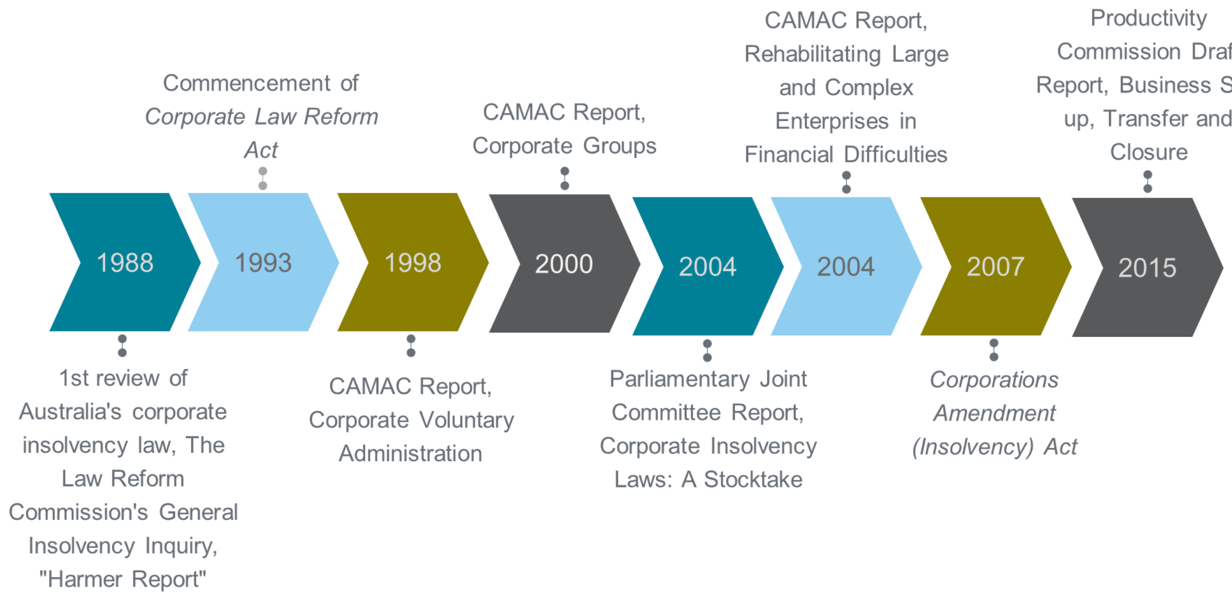
Trending in Restructuring

Ipso facto clauses – Time for reform

22 September2015

The introduction of legislative restrictions on the enforcement of ipso facto clauses has re-emerged as a law reform issue in the Productivity Commission Draft Report *Business Set-up, Transfer and Closure* (May 2015).

Major Australian insolvency law reform developments



Ipso facto clauses bring a contract to an end, or alter its operation, merely because a company has become insolvent or entered into external administration. Such clauses can frustrate attempts to restructure a company that is experiencing financial difficulties. For instance, the company may be refused goods or services that are essential to the continued operation of its business, even though it has no outstanding payments and can continue to make payments. Similarly, a client may refuse to accept further goods or services from the company merely because of the company's financial circumstances.

There has long been a view that these clauses should not be allowed to operate in an insolvency. The Harmer Report, Australia's first major review of insolvency law, recommended that these clauses be void against a liquidator or an administrator. However, this recommendation was not implemented in the subsequent legislative changes. The Corporations Act only contains a very narrow ipso facto type limitation that relates to the provision of essential services (s 600F).

The Corporations and Markets Advisory Committee (CAMAC) considered this matter in 1998 (in its report *Corporate voluntary administration*) and in 2004 (in its report *Rehabilitating large and complex enterprises in financial difficulties*). On both occasions, CAMAC opposed any change to the current law. While CAMAC recognised the advantages of restrictions on ipso facto clauses when a company is in voluntary administration, it gave greater weight to countervailing commercial considerations. For instance, the cost of loan finance for financially healthy companies may increase if further restrictions were placed on secured creditors. Also, ipso facto clauses may be an important way for counterparties to protect their rights in a voluntary administration, for instance where a long term supplier of goods relies on an ipso facto clause to decline to provide additional goods on credit to a company in administration.

The Parliamentary Joint Committee on Corporations and Financial Services in its 2004 report *Corporate Insolvency Laws: a Stocktake* was more responsive to concerns about ipso facto clauses. It recommended that administrators should be permitted to apply to a court for an order that a party to a contract may not terminate the contract by virtue of entry by a company into voluntary administration. The court would be required to be satisfied that the contracting party's interests will be adequately protected. CAMAC noted that this proposal 'may require the court to make commercial decisions about what clauses should be unenforceable, and for what reasons'.

The Productivity Commission did not find the commercial concerns raised by CAMAC convincing. It considered that ipso facto clauses can severely constrain the ability of a business to continue trading during a restructuring, prevent the sale of corporate businesses as going concerns and reduce or even eliminate returns to creditors in an ensuing liquidation. It recommended that ipso facto clauses that allow termination of contracts solely due to an insolvency event should be unenforceable if a business comes under the control of an administrator or receiver. The Commission favoured a similar restriction on enforceability if a company availed itself of the proposed safe harbour arrangements that the Commission also recommended in its Draft Report (see the 3 June 2015 Ashurst Alert *Easing the path to a turnaround - director safe harbour*).

The Australian Restructuring Insolvency & Turnaround Association (ARITA) has also supported the suspension of ipso facto clauses when a company goes into voluntary administration.

Ashurst supports a change along the lines suggested by the Productivity Commission, but with three important provisos.

First, the suspension of ipso facto clauses should not apply to contracts to extend new debt financing or financial accommodation. A creditor should not be obliged to provide fresh funds to a company that is in financial difficulty. This is the approach taken by the United States insolvency regime, which otherwise suspends the operation of ipso facto clauses in an insolvency.

Secondly, the US financial accommodation carve-out does not cover ordinary credit sales contracts (under which goods and/or services are supplied, with payment to be made later). This type of contract is therefore subject to the restriction on ipso facto clauses, even though such contracts technically involve a credit element. If an Australian financial accommodation carve-out were based on the US model, a supplier under a credit sales contract would be protected by personal liability of the administrator or receiver under the Corporations Act if the relevant external administrator had taken some action to require supply. However, an external administrator has no personal liability if that person took no such action. It may be necessary to extend the current personal liability to ensure that all suppliers under credit sales contracts are adequately protected, whether or not an external administrator has taken any further action to require supply.

Thirdly, any reform relating to ipso facto clauses should not interfere with the current right of a creditor with a security interest over the whole, or substantially the whole, of the property of a company under administration to take enforcement action. The ability of that type of creditor to stand outside the voluntary administration procedure is an important feature of that regime. It is aimed at ensuring the continued availability of reasonably priced secured credit, particularly from banks, by preserving their ability to move quickly to take control of secured property and minimise the risk of an erosion in the value of their security.

Contacts

Emanuel Poulos	Sydney	T: +61 2 9258 6715	emanuel.poulos@ashurst.com
Tony Ryan	Sydney	T: +61 2 9258 6602	tony.ryan@ashurst.com
James Marshall	Sydney	T: +61 2 9258 6508	james.marshall@ashurst.com
Joseph Scarcella	Sydney	T: +61 2 9258 6843	joseph.scarcella@ashurst.com
Timothy Sackar	Sydney	T: +61 2 9258 6432	timothy.sackar@ashurst.com
Ross McClymont	Melbourne	T: +61 3 9679 3025	ross.mcclymont@ashurst.com
Michael Sloan	Melbourne	T: +61 3 9679 3027	michael.sloan@ashurst.com
Lionel Meehan	Melbourne	T: +61 3 9679 3242	lionel.meehan@ashurst.com

Follow Ashurst Finance updates on Twitter – **@Ashurst_Finance**

To view more articles on the latest in Finance visit the **Ashurst FinanceHub**