Terminating Contracts due to Insolvency | Review Your Contracts with Companies

The *Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Act 2017 has introduced some changes concerning insolvent companies and their directors, which suggest the need for additional caution when contracting with companies and the need to review existing contracts.*

The changes involve:

- Creation of a "safe harbour" for company directors, in terms of potential personal liability for insolvent trading, if undertaking a legitimate restructure of a distressed company outside formal insolvency.

- To an extent, staying the operation of clauses which grant termination or other rights against a company should an insolvency event occur, commonly known as "ipso facto" clauses.

*This article will focus on the second of these, known as the "ipso facto regime" ("Regime"), which commenced on 1 July 2018. The Regime is of great importance to a wide range of transactions, including construction contracts and deeds recording terms of s*ettlement in building defect and other construction disputes.

Broadly:

- The Regime applies to a broad range of contracts, but there are exceptions. In particular, the Regime:

    - does not apply to contracts entered into prior to 1 July 2018.
    - does not extend to contracts entered into prior to 1 July 2018, by reason only of a novation, renewal or variation during the period from 1 July 2018 to 1 July 2023.
    - does not apply to business sale agreements and share sale agreements.
    - does not extend to a wide range of other transactions, e.g. specified financing transactions.

- Where the Regime applies:

    - Generally, it imposes a stay on enforcement of contractual provisions that allow one party to terminate or modify the operation of the contract (or provides for this to occur automatically) for prohibited reasons, generally because of the company's financial position or because of the occurrence of a specified insolvency event, generally appointment of an administrator, appointment of a receiver to substantially all of the company's assets or entry into a scheme of arrangement.

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- A stay is also imposed on any obligation to provide any further advance of money or credit, as a protection of lenders whose enforcement rights have been stayed.

- An insolvency administrator can apply for an order extending the stay to the exercise of other rights, even where the right is not dependent on a prohibited reason, if the court is satisfied that a party is likely to exercise those rights for a prohibited reason, e.g. a termination for convenience right.

The Regime does not have the converse effect, i.e. occurrence of an insolvency event does not prevent exercise of rights otherwise available, e.g. as a consequence of default under the relevant contract.

- The Regime does not stay a wide range of rights other than termination, e.g.:

  - changing the basis on which an amount is calculated under financing arrangement, e.g. default interest).
  - indemnity for default or recovery costs.
  - Set off or combination of accounts.
  - assignment and novation.
  - step-in rights.

Recommended Action

Businesses and parties dealing with them need to review:

- Current contracts with companies, e.g. they may need to make greater provision for termination or mitigation of risk in the event of defined event not constituting prohibited reasons under the Regime

- Procedures, especially management of risk, in the case of insolvency of companies with which the business deals, e.g. they may need to promptly action defaults in advance of occurrence of an insolvency event.

Key takeaways

- The ipso facto regime imposes a stay on enforcement of contractual provisions allowing termination due to insolvency events.
- The regime does not apply to contracts entered into before 1 July 2018.
- Businesses should review current contracts to mitigate risks associated with insolvency.
- An insolvency administrator can seek to extend the stay on rights even if not dependent on prohibited reasons.
- The regime does not prevent the exercise of rights available due to default under the contract.

****The information contained in this article is general information only and not legal advice. The currency, accuracy and completeness of this article (and its contents) should be checked by obtaining independent legal advice before you take any action or otherwise rely upon its contents in any way.*

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Prepared by Bannermans Lawyers
19 December 2018

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