Retail Industry News: Australia introduces insolvency reforms which limit contract rights to terminate for insolvency

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Introduction

Under reforms commencing in July 2018, Australia will have new insolvency laws which will limit the exercise of contract rights to terminate for insolvency. Partners David McIntosh and Robyn Chatwood, explain how these reforms will impact the retail sector in Australia, including suppliers of goods and services and lenders.

Background

By way of background, Australian insolvency laws in the past have been considered by many commentators to make it harder to restructure or potentially to save businesses which are in financial difficulty. In 2016, acting on this issue, the Australian Government released a paper for public consultation aimed at improving bankruptcy and insolvency laws in order to encourage restructuring and turnaround.

One of the key issues for businesses facing insolvency, is that most contracts entered into by the business contain triggers which either automatically terminate the contract or allow a party to terminate the contract (or threaten to do so) if the other company became insolvent. Termination of material contracts or significant numbers of contracts impacts the enterprise value of the insolvent company, limiting the options for restructuring and/or turnaround. Ultimately, this can mean that creditors and shareholders are worse off.

It is for this reason that the Australian Federal Government decided to reform the Corporations Act 2001 (Cth) (the "Act") in 2017.

What are the reforms?

There are two main changes to the existing laws which should be on the horizon for anyone contracting in the retail sector.

1. Safe harbour:

The first is the introduction of a new "safe harbour" regime - to protect directors of companies who may be at personal risk for trading while insolvent.

Under the safe harbour protections[1], directors, after suspecting their company's insolvency, can develop a "course of action" provided that it is reasonably likely to lead to a "better outcome" for the company than the immediate appointment of an administrator or liquidator. This provides a so-called "safe harbour" where the directors can avoid personal liability for insolvent trading for debts incurred by the company during the period that the directors' course of action is undertaken.

The safe harbour reform is intended to remove the disincentive for directors who had in the past risked personal liability for debts incurred when the company was insolvent. Now the focus can be on turning the company around. There are, however, various tests which will apply to prevent abuse of the safe harbour by directors, and they will need to continually reassess the position.

A key requirement for developing a course of action of the kind that may provide the relevant protection for directors is to ensure that advice is being taken from an "appropriately qualified entity". Whilst this term is not defined, generally, the requirement is likely to be satisfied if the advice as to the course of action is taken from a professional within the accounting or legal professions with enough experience in restructuring, insolvency and turnaround.

The safe harbour laws commenced on **19 September 2017** and apply to any courses of action developed and undertaken below or after that date, but only in respect of debts incurred after that date.

2. Prohibition of the exercise of certain contractual rights to terminate (ipso facto clauses):

The second key change to the laws which will be of concern to the retail sector is the prohibition of certain contractual clauses (called "ipso facto" clauses) that would enable a contract to be terminated solely because a company enters into receivership, schemes or arrangement or voluntary administration. This change will be of interest to anyone who contracts with retailers, such as suppliers, customers or lenders.

The new laws outlaw the ability of a party to a contract from exercising their contractual rights to terminate or modify a contract solely because the other company is insolvent or because it enters into receivership, a scheme of arrangement or voluntary administration. From **1 July 2018**, these types of common contract provisions will be unenforceable.

What is an ipso facto clause?

At present, it is usual for most contracts to include "ipso facto" rights. Ipso facto clauses are those that protect a non-insolvent party to a contract. They usually provide various remedies to the non-insolvent party when the other party becomes insolvent. Commonly remedies in this case include:

- the right to terminate or modify the contract in some way; or
- the right to call upon a guarantee or cash retention; or
- the right to set off claims; or
- the right to suspend works for or supplies to the insolvent company.

Why is an ipso facto clause needed?

Generally, the non-insolvent contract party is motivated to exercise these rights to terminate the contract that they have with the insolvent company - so as to not incur any more debt to the insolvent company or in order to free the non-insolvent company from any further obligations to the insolvent company.

When will the new prohibitions of exercise of ipso facto clauses apply?

Under the new laws, the exercise of many of these rights to terminate or modify the contract will be limited. The laws prohibit or stay any exercise or enforcement of this type of contract provisions if:

- a company goes into voluntary administration[2]; or
- a company enters into a scheme of arrangement[3]; or
- a managing controller (that is, a receiver, mortgagee in possession or other controller) is appointed over all or substantially all of the assets of the company[4]

The legislation includes a power for the Australian courts to relieve counterparties from the prohibitions in appropriate circumstances as well as the power to extend the ambit of the restrictions.

Notably also, there are a few categories of contractual rights which are excluded from the new stay provisions caught by the legislation. The reforms do not apply to rights under contracts which are entered into after the date of the order approving the scheme or after the date that the administration begins (as applicable):

- for types of contract specified in any regulations or prescribed by ministerial determination;
- which manage financial risk associated with a financial product which are “commercially necessary” for the provision of that type of product; or
- which are declared as “commercially necessary” for a specific kind of contract by ministerial determination for the function of the contract.

Many types of credit contracts however are still caught by the new legislative stay provisions and so the new laws will apply to many of the usual forms of credit contracts and security agreements in the retail industry. Commercially, there is some relief for credit providers as the new laws expressly provide that lenders or creditors are not required to provide further advances of monies if their rights are rendered unenforceable where a stay applies.

Helpfully, the stay on enforcement of ipso facto clauses applies only to entities entering into receivership, a scheme of arrangement or voluntary administration – and does not apply to many other circumstances which may trigger rights for the non-insolvent contract party (such as non-payment of fees). Of significance is that the restrictions on termination or variation of a contract by the non-insolvent contract party will not apply where the other company is in liquidation (unless it was in voluntary administration before being liquidated) or where it engaged in insolvent trading.

It should be borne in mind that, despite the new restrictions on exercise of certain contractual rights against an insolvent party, other non-ipso facto rights to terminate or amend an agreement for other reasons will remain enforceable. Termination for breach (for example, for non-payment or non-performance by a company) will remain a valid remedy in many circumstances. However, the broad drafting of the legislation introduces uncertainty as to whether the new laws apply to change non-ipso facto clauses.

Why are the laws changing?

The new “ipso facto” law reforms are designed to prevent companies having their major contracts cancelled or varied in a way that the value of the insolvent company’s business is significantly impacted or irretrievably damaged but there may be some hope of restructure or turnaround. They apply to contracts entered into from 1 July 2018.

How does this affect retailers and those contracting in the retail sector?

In summary, we expect that the changes will have a significant impact on how contracts are drafted and enforced across the retail sector.

The safe harbour laws apply to courses of action developed and undertaken before or after **19 September 2017,** but only in respect of debts incurred after that date. The ipso facto provisions will only apply to contracts made after **1 July 2018**.

- Anyone in the retail sector with an existing agreement (especially if it is coming up for renewal) should review it and consider the impact of the new laws on it. In particular, careful thought is needed as to whether existing contracts ought to be extended on renewal rather than replaced by new contracts.
- Clause templates should be restructured to ensure they remain enforceable and it is clear what rights apply in what circumstances if a contract party becomes insolvent - to enable the non-insolvent party to maintain flexibility and be protected in a range of scenarios and circumstances related to the financial distress of the other party.
- Advice should be taken also if intending to enforce or threatening to enforce any other similar or related contractual rights against an insolvent contract party (such as a right to terminate for convenience or for breach) in any circumstances where the contract party has entered into receivership, administration or a scheme of arrangement. This is especially the case given that the Australian courts have been given the ability to restrict the exercise of rights.

Conclusion

Although the new laws will bring Australia closer to international standards of insolvency practice and are designed to encourage restructuring to help viable businesses to survive, they may be nevertheless of concern to many creditors, lenders, customers and suppliers in the retail sector – especially if there is a risk that the other contract party will or may become insolvent.

For further information about the changes to the Australian insolvency laws or for assistance in reviewing or amending your agreements, please contact either Robyn Chatwood and David McIntosh, or your usual contact in our Global Retail practice, our Global Insolvency practice or our Global Corporate practice.

1.Sections 588GA and 588GB of the Act
2. Section 451E of the Act
3. Section 415D of the Act
4. Section 434J of the Act

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