

EXPOSURE DRAFT

EXPLANATORY STATEMENT

Issued by authority of the Minister for Revenue and Financial Services, Minister for Women and the Minister Assisting the Prime Minister for the Public Service

Corporations Act 2001

Corporations (Stay on Enforcing Certain Rights) Declaration 2018

Paragraphs 415D(7)(b), 434J(6)(b) and 451E(6)(b) of the *Corporations Act 2001* (“**the Act**”) provide that the Minister may, by legislative instrument, declare kinds of rights to which subsections 415D(1), 434J(1) and 451E(1) of the Act respectively do not apply.

Paragraphs 415D(7)(c), 434J(6)(c) and 451E(6)(c) of the Act provide that the Minister may, by legislative instrument, declare the kinds of rights to which subsections 415D(1), 434J(1) and 451E(1) of the Act respectively do not apply in specified circumstances.

The *Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Act 2017* (“**the Amending Act**”) inserted provisions into the Act to stay the enforcement of ipso facto clauses against relevant entities (“**the ipso facto stay**”). The ipso facto stay applies to clauses (including self-executing clauses) which entitle a party to enforce a right under a contract, agreement, or arrangement (collectively, “**arrangements**”) on the occurrence of various insolvency-related trigger events, regardless of the counterparty’s continued performance of its obligations under the contract.

The lack of protection from the operation of ipso facto clauses has been a key criticism of Australia’s insolvency regime in general, particularly in the context of the voluntary administration regime contained in Part 5.3A of the Act and compromises and arrangements under Part 5.1 of the Act.

The amendments made by the Amending Act were one aspect of reforms to Australia’s insolvency law and formed part of the National Innovation and Science Agenda (“**NISA**”). The reforms aim to promote a culture of entrepreneurship and innovation, which will in turn reduce the stigma of failure and help drive business growth, local jobs and global success. The reforms made by the Amending Act promote business recovery and restructuring as a means to drive cultural change. The stay on ipso facto clauses assists businesses to continue to trade in order to recover from an insolvency event instead of preventing their successful rehabilitation.

The ipso facto stay also promotes the objectives of the current voluntary administration regime in the Act by assisting viable but financially distressed companies to continue to operate while they restructure their business.

The operation of ipso facto clauses can reduce the scope for a successful restructure, destroy the enterprise value of a business entering formal administration, or prevent the sale of the business as a going concern. These outcomes can also reduce or eliminate returns in subsequent liquidation by disrupting the businesses’ contractual

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arrangements and destroying goodwill, potentially prejudicing other creditors and defeating the purpose of a voluntary administration.

The ability of a business' suppliers, customers or other creditors to terminate a contract solely due to the financial position of the company, or the commencement of a formal restructure, increases uncertainty for the potential investor and makes the business a less attractive investment opportunity. As a result, the operation of ipso facto clauses may deter such investment, or reduce the price a potential investor is willing to pay for a business.

As a result of the amendments made by the Amending Act, certain rights that amend or terminate an arrangement will not be enforceable and are stayed where a company enters a scheme of arrangement, appoints a managing controller or has come under voluntary administration, except in limited circumstances.

The amendments made by the Amending Act include a provision that allows the Minister to declare kinds of rights that will not be subject to the ipso facto stay. Similarly, the amendments made by the Amending Act allow regulations to prescribe the kinds of arrangements where the rights contained in those arrangements will not be subject to the ipso facto stay. This reflects the fact that there are a variety of situations where staying the operation of ipso facto clauses is either unnecessary or undesirable. For example, the ipso facto stay should not apply to certain kinds of arrangements where:

- arrangements are required or contemplated by Australia's laws or where international obligations would be disturbed;
- markets have evolved to depend on established systems and expectations, and the ipso facto stay would significantly disrupt those markets;
- sophisticated counterparties traditionally negotiate their own arrangements in relation to complex transactions or complex financial products and the ipso facto stay would undermine those arrangements;
- the ipso facto stay would lead to unintended consequences or would severely disadvantage some contracting parties;
- parties have already entered into arrangements to attempt to alleviate a business' financial stress and staying ipso facto clauses would undermine or significantly change the terms of those arrangements; or
- the operation of an ipso facto clause is inherent to the operation of a contract and staying it would lead to a perverse outcome.

Submissions received in a public consultation, which took place during the development of the Amending Act, proposed the kinds of rights which should be excluded from the operation of the ipso facto stay. These submissions were taken into account in developing the *Corporations (Stay on Enforcing Certain Rights) Declaration 2018* ("**the Declaration**"). Further submissions were received in targeted consultations which also took place during the development of the Declaration.

The Declaration will commence on 1 July 2018 and apply from that date.

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Explanation of provisions

Sections 1, 2, 3 and 4—Machinery provisions

Sections 1 to 4 of the *Corporations (Stay on Enforcing Certain Rights) Declaration 2018* (“**the Declaration**”) are machinery provisions setting out:

- the name of the Declaration;
- the day the Declaration commenced;
- the authority for making the Declaration; and
- definitions to assist with interpreting the Declaration.

Section 5—Declaration of the kinds of rights

Section 5 contains the operative provisions that declare the kinds of rights to which the stay on the enforcement of ipso facto clauses against relevant entities (“**the ipso facto stay**”) is not to apply.

- Subsection 5(1) declares the kinds of rights to which subsection 415D(1) of the *Corporations Act 2001* (“**the Act**”) does not apply.
- Subsection 5(2) declares the kinds of rights to which subsection 434J(1) of the Act does not apply.
- Subsection 5(3) declares the kinds of rights to which subsection 451E(1) of the Act does not apply.

Subsection 5(4)—list of the kinds of rights

Subsection 5(4) lists the kinds of rights that are declared in subsections 5(1) to (3), and declared for the purposes of paragraphs 415(7)(b), 434(6)(j) and 451(6)(b) of the Act.

Paragraphs (a) and (b)—uplift clauses and indemnification

Paragraphs (a) and (b) prescribe that the ipso facto stay does not apply to financing arrangements, insofar as they entitle the lender to charge a higher rate of interest following a relevant insolvency event or to enforce an indemnity for costs, expenses, losses and liabilities incurred as a result of the other party experiencing a relevant insolvency event.

A financing arrangement, which is defined in section 4 of the Declaration, refers to any contract, agreement or arrangement under which a person provides financial accommodation to a company. The concept of ‘financial accommodation’ is broader than a loan and includes arrangements under which bonds, notes, debentures and other debt securities are issued by a company.

Financing arrangements may provide that on an insolvency event, a lender may begin to charge a higher rate of interest to reflect the increased credit risk faced by a borrower entering into formal insolvency. Such provisions typically begin to apply automatically on the occurrence of a formal insolvency.

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These arrangements may also include indemnities for various costs which the lender incurs as a result of the borrower experiencing an insolvency event. For instance, they may require the borrower to cover the cost of any legal advice the lender obtains on its enforcement options when the borrower becomes insolvent.

The ipso facto stay is aimed at assisting viable but financially distressed companies to continue to operate while they restructure their business, but it is not intended to prevent adjustments in the cost of credit to reflect changed risk. As such, the ipso facto stay does not apply to a lender's right to charge a higher interest rate to reflect the increased credit risk when the borrower experiences an insolvency event.

The ipso facto stay does not apply to the right of indemnity (covering, for instance, the cost of any legal advice a lender may obtain on its enforcement options when the borrower becomes insolvent) for similar reasons.

Paragraph (c)—termination rights in a standstill or forbearance arrangement

Paragraph (c) prescribes that the ipso facto stay does not apply to rights to act on earlier defaults suspended or reserved under standstill or forbearance type arrangements that are triggered on the occurrence of a relevant insolvency event.

Forbearance arrangements are an agreement under which a lender agrees to refrain from exercising their enforcement rights on a default event. These are an important restructuring tool and give the debtor breathing space to assess their financial position and to arrange a workout or restructure.

It is common for financiers to agree to enter into forbearance agreements on terms where the forbearance is designed to terminate if the company enters into formal insolvency. In such cases, a party will usually already be in default of its obligations in a contract and it is only the goodwill of the financier which has avoided enforcement action.

The ipso facto stay is only intended to operate to provide breathing space in formal insolvency when the insolvent party is continuing to meet their contractual obligations. In cases where a forbearance agreement is in place, the insolvent company has already failed to perform its obligations and it would be a perverse outcome to prevent a financier from enforcing rights they would earlier have been able to enforce merely because the company has entered formal insolvency.

Additionally, not excluding standstill and forbearance agreements from the operation of the ipso facto stay would be a disincentive to entering into such agreements which would potentially result in earlier enforcement activity.

Paragraph (d)—right to change the priority in which amounts are to be paid

Paragraph (d) prescribes that the ipso facto stay does not apply to a contract insofar as it contains a 'flip clause' (to the extent that these are not already excluded by paragraphs 5.3A50(2)(c) and (o) of the *Corporations Regulations 2001*).

Flip clauses are a feature of many structured finance arrangements and operate to change the priority or payment obligations between parties. For example, they may

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operate to ‘flip’ the priority of obligations between swap providers and noteholders on a default event such as a formal insolvency event.

It is not the purpose of the ipso facto stay to affect either the statutory waterfall of agreed priorities in insolvency, or any contractual arrangement between a company’s creditors which may change their respective priorities. For this reason it is appropriate to exclude such arrangements from the scope of the ipso facto stay.

Paragraphs (e) to (g)—rights of set-off and acceleration of such rights

Paragraphs (e) to (g) prescribe that the ipso facto stay does not apply to a contract insofar as it contains a right of set-off, a right to net balances (or other amounts) or a right to take an action to enforce such rights.

Paragraphs (e) and (f) operate in relation to rights which allow the parties to set off their financial obligations against each other. There would be no benefit in applying the ipso facto stay to such rights as these arrangements have the effect of simplifying a transaction and reducing the amounts that need to be exchanged to settle it.

Paragraph (g) prescribes that the ipso facto stay does not apply to a contract insofar as it contains acceleration rights that are necessary to take the full benefit of the protected rights of set-off or net balancing.

Acceleration rights override the previously agreed maturity date of a loan (or similar agreement) where the borrower defaults and allows the lender to demand immediate repayment of all amounts owing. This exclusion preserves rights to accelerate or crystallise a debt upon a relevant insolvency event, but only to the extent that this is necessary to fully exercise a right of set-off protected by this declaration.

This exclusion will allow a party to take full advantage of its rights of set-off where not all of the debt sought to be set-off is due at the relevant time.

Paragraph (h)—rights of assignment and novation

Paragraph (h) prescribes that rights of assignment and novation are excluded from the ipso facto stay.

Prohibiting the enforcement of rights of assignment and novation would not achieve the policy aims of the amendments made by the Amending Act, but would rather significantly disrupt debt trading markets and inhibit the operation of rollover contracts.

Paragraph (i)—self-executing provisions

Paragraph (i) prescribes that certain self-executing provisions are excluded from the ipso facto stay in order to provide certainty around the treatment of circulating assets in insolvency and ensure that there is no conflict between the operation of the Act and the *Personal Property Securities Act 2009*.

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Paragraph (j)—step-in rights

Paragraph (j) provides that a right to perform obligations of an entity (being the body, corporation or company which would have the benefit of the ipso facto stay) under a contract, agreement or arrangement or a right to enforce a right under a contract, agreement or arrangement that would be enforceable by that entity (commonly known as step-in rights) are excluded from the ipso facto stay.

The provision refers to the entity which would have the benefit of the ipso facto stay as a 'specified person'. A 'specified person' is defined in section 4 of the Declaration and means the body, corporation or company the subject of subsection 415D(1), 434J(1) or 451E(1) of the Act (as applicable).

Certain contracts, for example construction contracts and long-term services contracts, will generally include provisions which allow, on the occurrence of any insolvency event in relation to one party, for another entity to 'step-in' to the shoes of that party and enforce certain rights or perform obligations of that party.

The contracting parties have negotiated these arrangements which are designed to keep the contract on foot where it might otherwise be terminated. These negotiated agreements as to the rights in insolvency should not be disturbed, as they support the overarching policy objectives of allowing the business to continue and/or maintaining value for the insolvent or restructuring entity.

Section 6—Declaration of the kinds of rights in specified circumstances

Section 6 contains the operative provisions that declare the kinds of rights to which the ipso facto stay is not to apply in specified circumstances.

Subsections 6(1) to (3) provide that, for the purposes of paragraphs 415D(7)(c), 434J(6)(c), and 451E(6)(c), a right to appoint a controller is a kind of right to which subsections 415D(1), 434J(1) and 451E(1) of the Act respectively do not apply in specified circumstances.

The specified circumstances are listed in subsection 6(4) and are required to be satisfied before the right to appoint a controller is excluded from the ipso facto stay.

First, for a right to appoint a controller to be excluded from the ipso facto stay, the person who enforces the right must have a security interest in the property of the specified person. For example, a creditor must have a security interest in the property of the company the creditor is looking to enforce the right to appoint a controller against (paragraph 6(4)(a)).

Second, a controller must have been appointed in relation to property of the specified person, or the right to appoint a controller to the property of the specified person has been enforced (paragraph 6(4)(b)).

A specified person is defined in section 4 of the Declaration and means the body, corporation or company the subject of subsection 415D(1), 434J(1) or 451E(1) of the Act (as applicable).

A controller is defined in section 9 of the Act and means, in relation to property of a corporation, a receiver, or receiver and manager, of that property, or anyone else who

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is in possession, or has control, of that property for the purpose of enforcing a security interest.

It is often the case that a company will have several secured creditors with the right to appoint a controller over the same property. The ability of the first of these creditors to appoint a controller is not prevented by the operation of the stay, however the remaining secured creditors' rights to appoint a controller on the basis of the first appointment would be stayed. This would frustrate, for example, a commonly existing ipso facto right of a priority secured creditor to appoint a different controller following the appointment of a controller by a lower ranking secured creditor. This would be a perverse outcome that could lead to a race between creditors to appoint a controller.

The contractual arrangements between parties as to the priority of secured creditors in insolvency events should not be disturbed.

By excluding the right to appoint a controller from the operation of the ipso facto stay, creditors will have time to consider the situation and circumstances and make an informed decision whether to enforce their rights to appoint a controller, rather than race to ensure their security interests are protected.

The ability to enforce the right to appoint a controller is only excluded when a controller has already been appointed by another creditor, or when that other creditor has elected to appoint a controller and the controller is in the process of being appointed.