

# Do you still have the right to terminate for insolvency?

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It is common for commercial contracts to contain 'ipso facto' clauses. These types of clauses allow one party to terminate or vary the terms of a contract on the occurrence of certain events. Such clauses are often triggered by insolvency events such as the appointment of voluntary administrators, entry into a scheme of arrangement or receivership - regardless of the fact that the affected party is still ready, willing and able to perform the contract.

If a company has entered into a contract and is undergoing financial distress, the other party to the contract may have a right to terminate the contract due to the company's solvency status. Termination of a valuable contract can have implications for the affected company's value, any chances of survival and undermine any insolvency proceedings. To assist those companies, the *Corporations Act 2001* (Cth) (**Act**) will be amended to prevent a party from terminating a contract due to certain insolvency events.

## 1 The New Regime

On 12 September 2017 the Act was amended to include statutory restrictions which prevent a party to an agreement from exercising certain rights (such as termination) on the basis that the other party has suffered certain types of "insolvency events" (**Insolvency Amendment**). The Insolvency Amendment will apply to **all contracts entered into after 1 July 2018**. It will not apply to any contracts made or amended before that date.

The Insolvency Amendment operates to make certain contractual rights temporarily unenforceable (ie there is a 'stay' on enforcement) if one of the following insolvency events occurs:

- A company is undertaking (or announces) a compromise or arrangement (under section 411 of the Act) to avoid being wound up;
- A company has a managing controller appointed over the whole or substantially the whole of the company's property; or
- A company enters into voluntary administration.

The length of the stay period will depend on the particular insolvency event (and relevant court orders) but as general examples:

- If a company enters into a compromise or arrangement with its members or creditors there will be a stay from the announcement of or entry into the scheme- until such time that the scheme application is either not made, withdrawn or rejected by the Court, or is completed (except by winding up);
- If a receiver or other managing controller of a corporations property is appointed – there will be a stay until that receiver's or managing controller's appointment ends; and

- If a company enters into voluntary administration – there will be a stay until the administration ends or the company's affairs have been fully wound up (whichever occurs last).

## **2 Effect of new provisions**

From 1 July 2018:

- (a) A party considering terminating a contract (on the basis that the other party has suffered a relevant insolvency event):
  - will not be able to do so (for the stay period); and
  - may be able to lawfully terminate if there are other provisions giving clear contractual rights to terminate eg for matters such as non-performance of the contract; failure to meet payment obligations or by mutual agreement (eg on notice for no cause).
- (b) If a party to a contract seeks to exercise a right to terminate that is unenforceable under the Act, the contractor (or the receiver or administrator as agent for the contractor) could potentially bring an action for damages on the basis the other party:
  - wrongly repudiated the contract; and
  - had no right to stop performing its obligations under the contract (given the contract was still on foot).

## **3 What measures can you take?**

Contracts entered into after 1 July 2018 should contain clear clauses regarding the following:

- termination for non-performance and non-payment;
- performance requirements and clarity as to events of default; and
- if applicable, clauses to apply during any stay period such as holding off milestone payments and reinforcing unaffected rights (eg the right to inspect financial statements and obtain parent company guarantees).

Parties to contracts should consider seeking legal advice regarding the impact of the Insolvency Amendment on their contracts and business, including issues such as:

- application of the Insolvency Amendment to standard contracts and terms of trade provisions and what (if any) amendments are required;
- how the risk of counterparty insolvency occurring in the first place can be reduced as part of a thorough due diligence process before a contract is signed eg by conducting thorough reference checks, PPSR checks, examining financial reports, scrutiny of financial position etc;
- ways of identifying a company that is heading to financial distress before the 'stay' takes effect (so that the ipso facto clauses can still be used) and possible inclusion of a termination for convenience right; and
- whether it is possible to vary the term of a pre 1 July 2018 contract so that it remains unaffected by the Insolvency Amendment.

At IRDI Legal, our team of experienced commercial lawyers can assist you with all of the above issues relating to the Insolvency Amendment. Please contact us to find out more.