

## EXPLANATORY STATEMENT

### **Issued by authority of the Minister for Revenue and Financial Services, Minister for Women and 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 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 arrangement.

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 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 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.

The reforms 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. 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 also promote business recovery and restructuring as a means to drive cultural change.

As a result of the reforms, 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 ipso facto stay assists businesses to continue to trade in order to recover from an insolvency event. The stay also promotes the objectives of the current restructuring regime in the Act by assisting viable but financially distressed or insolvent companies to continue to operate while they restructure their businesses.

The ipso facto stay will only apply to the enforcement of rights in contracts, agreements and arrangements. The stay is not intended to interfere with any statutory rights of contractual parties.

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 allow regulations to prescribe 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 an arrangement, and staying it would lead to a perverse outcome.

The *Corporations (Stay on Enforcing Certain Rights) Declaration 2018* (“**the Declaration**”) declares kinds of rights under paragraphs 415D(7)(b), 434J(6)(b) and 451E(6)(b) of the Act, and declares kinds of rights in specified circumstances under paragraphs 415D(7)(c), 434J(6)(c) and 451E(6)(c) of the Act. This will ensure that if an arrangement contains these kinds of rights, or contains these kinds of rights and certain circumstances are met, they remain available to parties to those arrangements should the events in subsections 415D(1), 434J(1) and 451E(1) respectively occur.

By virtue of sections 415FA, 434LA and 451GA of the Act, the declaration of the kinds of rights to which the ipso facto stay does not apply also extends to a

self-executing provision in a corresponding way. This means that if a right is declared under paragraph 415D(7)(b), 434J(6)(b) or 451E(6)(b), the declaration of those kinds of rights also extends to a self-executing provision that, when executed, provides those rights.

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 Declaration.

Further submissions were received in targeted consultations which also took place during the development of the Declaration. Exposure drafts of the Declaration and accompanying explanatory materials were released for public consultation from 16 April 2018 to 11 May 2018. Submissions received during these consultations were also taken into account in the development of the Declaration.

The Declaration is a Legislative Instrument for the purposes of the *Legislation Act 2003*.

The Declaration commenced on 1 July 2018.

## **Statement of Compatibility with Human Rights**

*Prepared in accordance with Part 3 of the Human Rights (Parliamentary Scrutiny) Act 2011*

*Corporations (Stay on Enforcing Certain Rights) Declaration 2018*

This Legislative Instrument is compatible with the human rights and freedoms recognised or declared in the international instruments listed in section 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*.

## **Overview of the Legislative Instrument**

The Declaration declares that the stay on ipso facto clauses will not apply to the rights set out in Attachment. This ensures that the parties will remain able to exercise these rights in the event the stays in subsections 415D(1), 434J(1) and 451E(1) respectively are triggered by a relevant insolvency event.

## **Human rights implications**

This Legislative Instrument does not engage any of the applicable rights or freedoms.

## **Conclusion**

This Legislative Instrument is compatible with human rights as it does not raise any human rights issues.

## 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 kinds of rights**

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

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

#### *Subsection 5(4)—list of kinds of rights*

Subsection 5(4) lists the kinds of rights declared in subsections 5(1) to (3), and under paragraphs 415D(7)(b), 434J(6)(b) and 451E(6)(b) of the Act.

### Paragraphs (a) and (b)—right to change the basis on which an amount is calculated and the right to indemnification

Paragraph (a) declares 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. Such clauses are commonly known as uplift clauses.

A financing arrangement, which is defined in section 4 of the Declaration, includes 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, for certainty, it is intended to capture 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 posed by a borrower entering into formal insolvency. Such provisions typically begin to apply automatically on the occurrence of a formal insolvency.

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.

Paragraph (b) excludes the right to enforce an indemnity for costs, expenses, losses and liabilities incurred by a person as a result of the other party experiencing a relevant insolvency event.

Certain 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 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 to uplift clauses referred to in paragraph (a).

### Paragraph (c)—right to terminate a standstill or forbearance arrangement

Paragraph (c) prescribes that the ipso facto stay does not apply to rights to act on earlier defaults that have been suspended or reserved under standstill or forbearance type arrangements. This is achieved by allowing a party to terminate a standstill or forbearance type arrangement so they can enforce their rights in relation to the earlier default of the counterparty.

Standstill and forbearance arrangements are defined in section 4 of the Declaration as a contract, agreement or arrangement which suspends or restricts the enforcement of rights under another contract, agreement or arrangement. They can take the form of an agreement under which a party agrees to refrain from exercising their enforcement rights on a default event. These are an important restructuring tool and give debtors 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.

When a right to terminate a standstill or forbearance agreement is exercised, the parties go back to the position they were in before they entered the standstill or forbearance agreement. This means that the counterparty to a defaulting party will have all the rights they originally had, and that had been suspended or reserved by the standstill or forbearance agreement.

Additionally, staying the right to terminate standstill and forbearance agreements would be a disincentive to entering into such agreements, which would potentially result in earlier enforcement activity.

### Paragraph (d)—right to change the priority or order in which amounts are to be paid, distributed or received

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 in subregulation 5.3A.50(2) 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 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.

The provision also extends to allow those who ultimately benefit from amounts to be paid or received to change the order of the distribution of those amounts between those beneficiaries.

### Paragraphs (e) and (f)—rights of set-off

Paragraphs (e) and (f) prescribe that the ipso facto stay does not apply to a contract insofar as it contains a right of set-off or a right to net balances (or other amounts).

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.

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 (g)—right to take action to enforce certain rights

Paragraph (g) prescribes that the ipso facto stay does not apply to rights to take action to enforce certain rights protected by the Declaration. This will ensure a party will be able to take the full benefit of the protected right. A right to take action to enforce can include, for example, acceleration, the right to convert or exchange amounts in different currencies, or the right to crystallise a security interest.

Acceleration rights allow an amount that might be due in the future, to become due and payable immediately. Acceleration rights can, for example, 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. The provision also preserves the ability to crystallise a security interest so that the holder of a security interest can exercise the right to appoint a controller specified in section 6 of the Declaration. This will ensure that holders of security interests are placed on an equal playing field, regardless of the term for which credit has been extended.

### 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 reforms made by the Amending Act, but would rather significantly disrupt debt trading markets and inhibit the operation of rollover contracts.

### Paragraph (i)—certain rights regarding the treatment of circulating assets

Paragraph (i) prescribes that certain rights, regarding the treatment of circulating assets in insolvency, are excluded from the ipso facto stay.

These rights have been excluded to ensure there is no conflict between the operation of the Act and the *Personal Property Securities Act 2009*.

### 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, are excluded from the ipso facto stay. These are commonly known as ‘step-in’ rights.

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 of a party, for another entity to ‘step-in’ to the shoes of that party and enforce certain rights or perform the obligations of that party. The provision is not intended to be limited to performing the obligations or enforcing rights in the contract, agreement or arrangement between the parties that contains the step-in right, but also includes performing obligations or enforcing rights contained in other contracts, agreements or arrangements that are contemplated by and are within the ambit of the primary step-in right.

To provide certainty that a party can engage another person to perform the obligations or enforce rights, the provision expressly states that the right to engage another person to perform the obligations or enforce rights is also excluded from the ipso facto stay.

These arrangements are usually negotiated by the contracting parties and are designed to keep the contract on foot where it might otherwise be terminated. These rights 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.

### Paragraph (k)—right to enforce a possessory security interest referred to in section 440JA of the Act

Paragraph (k) provides that a right to enforce a possessory security interest referred to in section 440JA of the Act is excluded from the ipso facto stay.

Section 440JA of the Act exempts possessory security interests held by authorised deposit-taking institutions ('ADIs', within the meaning of the *Banking Act 1959*) and operators of clearing and settlement facilities (within the meaning of section 768A of the Act) from the moratorium in Division 6 of Part 5.3A of the Act. Division 6 provides for the protection of the company's property during administration. Section 440JA also only applies to certain property which is subject to a possessory security interest, such as cash, negotiable instruments, securities and derivatives.

The exemption from the moratorium reflected that possessory security interests over, among other things, unpresented cheques and bills of exchange, would be unworkable if the ADI or operator of a clearing and settlement facility needed to obtain the consent of an administrator or prior leave of the court under section 440B of the Act in order to dispose of such property.

Before the commencement of the ipso facto stay provisions, the enforcement of such possessory security interests covered by 440JA outside of voluntary administration was usually provided for in the contractual arrangements between the parties, and was not limited by any provisions in the Act. From the commencement of the ipso facto stay, these types of contractual rights, to the extent they are stayed by the ipso facto stay provisions, will no longer be able to be enforced.

To ensure these types of contractual rights remain enforceable, they have been excluded from the operation of the ipso facto stay. This provision operates by drawing on section 440JA of the Act, and applying it to the specified person. Subsection 5(6) clarifies that the reference to the term "the company" in paragraph 440JA(b) of the Act, is take to be a reference to the "specified person" for the purposes of this provision.

### *Subsection 5(5)—expressions from the Personal Property Securities Act 2009*

Subsection 5(5) clarifies that expressions contained in paragraph 5(4)(i), and that are defined in the *Personal Property Securities Act 2009* ("the PPSA"), take the meaning in the PPSA.

### **Section 6—Declaration of the right to appoint a controller in specified circumstances**

Section 6 contains the operative provisions that declare when the right to appoint a controller is not stayed by the ipso facto stay.



Subsections 6(1) to (3) provide that, under paragraphs 415D(7)(c), 434J(6)(c), and 451E(6)(c) of the Act, a right to appoint a controller is declared as 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 subsections 6(4) and (5), and are required to be satisfied before the right to appoint a controller is excluded from the ipso facto stay.

For the specified circumstance in subsection 6(4), 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.

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.

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 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.

Subsection 6(5) provides a separate circumstance that is only applicable to the right to appoint a controller declared in subsection 6(1). The circumstances in subsection 6(5) are that the whole, or substantially the whole, of the property of the specified person is subject to a security interest, and the right is to be enforced by the person who has that security interest.

## ATTACHMENT

Subsection 6(5) aims to address the situation where a specified person might announce a scheme of arrangement simply to frustrate the ability of an all asset secured creditor from appointing a controller over the property of the specified person that is subject to the security interest. Subsection 6(5) opens the circumstances up so that an all asset secured creditor can appoint a controller regardless of whether a controller has already been appointed, or a right to appoint a controller has been enforced. This will prevent entities announcing a spurious scheme of arrangement in order to frustrate secured creditors.