The importance of the stay on *ipso facto* clauses during COVID-19

Legislative changes that came into effect in 2018 will be particularly helpful to businesses that are facing potential insolvency issues due to the financial impacts of the COVID-19 pandemic.

The *Corporations Act 2001* (Cth) (the **Act**) was amended in 2018 to provide a temporary hold on the enforcement of certain *ipso facto*, or termination, clauses in contracts. Parties to contracts that came into effect on or after 1 July 2018, are no longer able to terminate or amend the contract in accordance with an *ipso facto* clause because a contracting party enters into voluntary administration, receivership or a scheme of arrangement with creditors.

What is an ipso facto clause?

Ipso facto clauses – also known as termination provisions – are found in a wide range of commercial contracts. They create a contractual right that allows one party to elect to terminate or modify the operation of a contract, or for the contract to terminate automatically, upon the occurrence of a specific trigger event.

In the insolvency context, an *ipso facto* clause is triggered on the occurrence of an 'insolvency event', which generally occurs in circumstances where an administrator, liquidator, receiver or controller is appointed. An *ipso facto* clause will ordinarily be triggered irrespective of whether the party that has suffered the insolvency event is otherwise performing its obligations under the contract.

Ipso facto clauses have long been the subject of debate in Australia. On the one hand, these clauses are said to be beneficial as they provide contracting parties with a right to terminate a contract if another party is at risk of becoming insolvent. On the other hand, *ipso facto* clauses are also often criticised for reducing the prospects of a successful turnaround of an insolvent (or potentially insolvent) party, and otherwise of negatively impacting the enterprise value of a business that may be entering formal administration.

What are the relevant laws?

The 2018 amendments to the Act seek to stay the enforcement of *ipso facto* clauses by mandating an automatic 'stay' on a party's right to enforce a provision to terminate or amend a contract (such as through the operation of acceleration clauses) because the counterparty enters into voluntary administration, receivership or a scheme of arrangement.

More specifically, the Act operates to stay a contractual right to suspend or terminate the contract arising because:

- a company enters into a scheme or arrangement (or announcing it will enter into a scheme or arrangement) to avoid being wound up in insolvency;
- a managing controller or receiver is appointed to a company; or
- a company goes into voluntary administration.

However, this stay will not prevent parties from terminating in other circumstances, such as a breach of contract arising from non-payment or non-performance.

The Act also allows courts to override the stay if it is satisfied that it is appropriate to do so in the interests of justice.

Importantly, these provisions only apply to contracts entered after 1 July 2018.

How long is the stay effective?

The length of the stay will depend on the type of insolvency event that occurs. The following table sets out the various timelines.

Insolvency Event	When the Stay Begins	When the Stay Ends	Purpose of Stay
Compromise or Scheme of Arrangement	When the company makes a public announcement or when a scheme application is made under s 411 of the Act.	Three months after the public announcement, when the application is unsuccessful or dismissed, or when the company is wound up.	Allows the company to restructure without the negative effects of placing the company into formal insolvency proceedings.
Receivership or Appointment of a Managing Controller	When the managing controller or receiver is appointed over the company's property.	When the receiver or controller's control over the company property ends.	Allows the company to restructure.
Voluntary Administration	When the company elects to enter administration and appoints an administrator to investigate its financial affairs and assess its viability.	When the administration ends because the company is being wound up.	Facilitates the rehabilitation of distressed companies and enables them to continue trading.

The period of a stay can be extended in relation to any of the above three insolvency events if the Court is satisfied that an extension is appropriate having regard to the interests of justice. In exercising its discretion, the Court is required to have regard to the interests of justice.

The Court may look favourably upon the extension of the length of a stay where the main cause of the company's financial difficulties is COVID-19. This will particularly be the case where there:

- are reasonable prospects of the company recapitalising, or its business being sold as a going concern, once the disruption has stabilised; and

- is sufficient funding available to the administrator or managing controller to enable the company to continue to trade in the meantime.

Exclusions from the stay on ipso facto clauses

There are certain agreements and arrangements that are excluded from the stay on *ipso facto* clauses, which include:

- business and share sale agreements;
- contracts resulting from a novation, assignment or variation on or after 1 July 2018 of a contract entered into prior to that time;
- subscription agreements for securities or financial products;
- arrangements for underwriting the issuance or sale of securities or financial products;
- government licences or permits;
- arrangements for the keeping of source code in escrow; and
- financial market operating rules and certain arrangements relating to clearing and settlement facilities.

There are many other forms of agreements and arrangements that are excluded from the stay on *ipso facto* clauses, beyond those listed above.

Similarly, a Ministerial declaration may exclude the enforcement of certain rights within an arrangement from the operation of the stay even when the arrangement as a whole is not excluded. This reflects the fact that there are a variety of situations where staying the operation of *ipso facto* clauses is either unnecessary or undesirable.

What this means for you

- **Parties to existing contracts** - should review their rights under contracts prior to seeking to terminate those contracts due to an insolvency event of a contract counterparty as the laws relating to *ipso facto* clauses may prevent you from being able to do this. This is a complex area of law and you should obtain specific advice, particularly to determine whether there are any exclusions from the stay on *ipso facto* clauses that may apply to you.

- **Parties entering new contracts** - should consider whether it is appropriate to include a clause that provides an express right to terminate a contract following non-performance or non-payment, as the Act does not prevent termination in these circumstances.

- **Parties facing an insolvency event due to COVID-19** - should seek to rely on the stay on *ipso facto* clauses to the extent possible, to ensure they do not lose valuable contracts during this unstable time. Parties who are already experiencing an insolvency event should consider seeking advice on whether to apply to the Court for an extension of the stay period to provide further relief during these unprecedented times.

Further Information

If you would like further information about the effect of the stay on *ipso facto* clauses on you or your business, please contact Tom Morgan or Mark Faraday from Henry William Lawyers. This article is not legal advice. It is intended to provide commentary and general information only. Access to this article does not entitle you to rely on it as legal advice. You should obtain formal legal advice specific to your own situation. Please contact us if you require advice on matters covered by this article.