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THE PARLIAMENT OF THE COMMONWEALTH OF AUSTRALIA

HOUSE OF REPRESENTATIVES

TREASURY LAWS AMENDMENT (2017 ENTERPRISE INCENTIVES NO. 2
BILL) BILL NO. X, 2017

EXPLANATORY MEMORANDUM

Circulated by authority of the
Minister for Revenue and Financial Services, the Hon Kelly O'Dwyer MP

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General outline and financial impact

Overview

The Government is reforming Australia's insolvency laws. Our current insolvent trading laws put too much focus on stigmatising and penalising failure. As part of the National Innovation and Science Agenda (NISA) these reforms aim to promote a culture of entrepreneurship and innovation which will help drive business growth, local jobs and global success.

The threat of Australia's insolvent trading laws, combined with uncertainty over the precise moment a company becomes insolvent have long been criticised as driving directors to seek voluntary administration even in circumstances where the company may be viable in the longer term. Concerns over inadvertent breaches of insolvent trading laws are frequently cited as a reason that early stage (angel) investors and professional directors are reluctant to become involved in a start-up.

The amendments in Schedule 1, Part 1 of this Bill will create a safe harbour for company directors from personal liability for insolvent trading if the company is undertaking a restructure. This will drive cultural change amongst company directors by encouraging them to keep control of their company, engage early with possible insolvency, and take reasonable risks to facilitate the company's recovery instead of simply placing the company prematurely into voluntary administration or liquidation.

An 'ipso facto' clause is a provision that allows one party to terminate or modify the operation of a contract upon the occurrence of some specific event, regardless of the continued performance of the counterparty. The operation of these clauses can reduce the scope for a successful restructure or prevent the sale of the business as a going concern.

The amendments in Schedule 1, Part 2 of this Bill will make ipso facto clauses which would allow contracts to be terminated solely due to an insolvency event unenforceable if a company is undertaking a restructure.

This reform is aimed at enabling viable businesses to continue to trade in order to recover from an insolvency event instead of these clauses preventing their successful rehabilitation.

Together, these amendments will reduce instances of a company proceeding to a formal insolvency process prematurely and where companies do proceed to voluntary administration, they will have a better

chance of being able to continue trading so that they can restructure and return to normal operations.

This in turn will promote the preservation of enterprise value for companies, their employees and creditors, reduce the stigma of failure associated with insolvency and encourage a culture of entrepreneurship and innovation.

Date of effect: The amendments in Schedule 1, Part 1 of this Bill will take effect from the date of Royal Assent. The amendments in Schedule 1, Part 2 of this Bill will take effect from 1 January 2018.

Proposal announced: The amendments were announced on 7 December 2015. Public consultation on the proposals occurred between 29 April 2016 to 27 May 2016 as part of the National Innovation & Science Agenda ‘Improving bankruptcy and insolvency laws’ proposals paper.

Chapter 1

Schedule 1, Part 1 – Safe harbour for insolvent trading

Outline of chapter

1.1 This Chapter sets out a new safe harbour for company directors from personal liability for insolvent trading in Schedule 1, Part 1 of the Bill.

1.2 Unless otherwise stated, all references are to the *Corporations Act 2001*.

Context of amendments

1.3 Australia's insolvent trading laws currently impose a duty on company directors to prevent a company from trading while insolvent.

1.4 Under section 588G of the Act, a director of a company may be personally liable for debts incurred by the company if at the time the debt is incurred there are reasonable grounds to suspect that the company is insolvent.

1.5 Breaching the insolvent trading provisions may result in civil and criminal penalties against an insolvent company's directors.

1.6 This duty to prevent insolvent trading is framed as a default contravention and the current provisions focus on the timing of when debts are incurred by a company rather than the conduct of the directors in incurring that debt.

1.7 The current focus on the solvency of the company and the time at which debts are incurred leads to perverse outcomes:

- as the relevant threshold is not actual insolvency, but “reasonable grounds for suspecting” insolvency, directors may cease trading prior to the commencement of insolvency proceedings, limiting the ability of a company to trade through financial difficulty
- directors (particularly of larger companies) may have disproportionate concern as to their own personal exposure

during times of financial stress and may potentially move to formal insolvency prematurely or focus on their own liability rather than other potential ways to remedy the situation;

- because of their own existing personal financial commitment to a business, directors in the small and medium enterprise market may not be sufficiently focused on the implications for other stakeholders of continuing to trade and may potentially move to formal insolvency too late, missing the opportunity to engage earlier with creditors to find a solution to the company's problems.

1.8 In each case this leads to an absence of focus by directors on their general director's duties and the potentially unnecessary destruction of enterprise value which may occur even where there are clear opportunities to adjust the company's business and continue operating for the overall benefit of the company, its shareholders, employees and creditors.

1.9 The appointment of an administrator to a company is almost always value destructive, making it harder for the company to restructure and increasing the likelihood of its eventual liquidation. Even where a company may actually be solvent or could be turned around, the appointment of an administrator has the potential to result in the company being liquidated because of the loss of confidence amongst its suppliers, credit providers and employees and the general public.

1.10 A cornerstone of a good insolvency regime is the promotion of the efficient allocation (or reallocation) of capital. The current insolvent trading provisions however can result in the unnecessary liquidation of companies that could otherwise be successfully restructured and continue to operate. This is not in the interests of the company's directors, employees, creditors and the economy as a whole.

Summary of new law

1.11 The safe harbour will operate to carve directors out from the civil insolvent trading provisions of section 588G(2).

1.12 The Government is seeking to strike a better balance between the protection of creditors and encouraging honest directors to innovate and take reasonable risks. To this end, the safe harbour amendment focuses on the behaviour of directors in trying to turn their company around, rather than merely on the solvency of the company and the precise timing of debts being incurred as has previously been the case.

1.13 This change is intended to encourage honest company directors to remain in control of a financially distressed company and take reasonable steps to restructure and allow it to trade out of its difficulties.

1.14 The aim of the safe harbour reform is to facilitate more successful company restructures outside of a formal insolvency process where doing so would achieve a better outcome for the company and its creditors as a whole. It encourages directors to engage early with financial distress, and then actively take steps to either restructure the business or, if that is not possible, to quickly move to formal insolvency

1.15 Under the new safe harbour, directors will only be liable for an insolvent company's debts where it can be shown that they were not taking a course of action reasonably likely to lead to a better outcome for the company and its creditors as a whole than proceeding to immediate administration or liquidation.

1.16 Whether a course of action is reasonable will vary on a case-by-case basis depending on the individual company and its circumstances. However, hope is not a strategy. Directors who merely take a passive approach to the business's position or allow a company to continue trading as usual during financial distress, or whose recovery plans are fanciful, will fall outside the bounds of the safe harbour.

1.17 As it is intended as a protection for directors who are acting honestly and diligently, the safe harbour is open only to directors who have been taking appropriate steps so that the company complies with the obligation to maintain books and records, provide for the entitlements (including superannuation) of employees and meets its taxation reporting obligations.

1.18 To fall within the protection of the safe harbour a director will generally only be required to provide evidence about the course of action that was taken. A liquidator (or other person) seeking to make the director personally liable for any debts incurred while the company was insolvent will bear the onus of establishing that the course of action by the director was not reasonable in the circumstances.

1.19 While the change is intended to allow companies to be restructured outside of a formal insolvency process, some companies may not be able to recover and will still proceed to voluntary administration or liquidation despite the directors' best efforts. Provided that the director was pursuing a reasonable course of action then they will still have the benefit of safe harbour in these circumstances.

1.20 Where an administrator or liquidator is appointed, a director who does not provide them with access to the company's books or secondary

evidence following an appropriate request will be prevented from using those materials as evidence of having taken a reasonable course of action for the purposes of the safe harbour. A similar provision applies where a company director does not provide a liquidator or administrator with other information about the company following an appropriate request.

1.21 These restrictions on the use of the safe harbour are in place to ensure that where a company eventually enters administration or is wound up that directors do not withhold books or information about the company in an attempt to prevent a liquidator or administrator from investigating the company's activities and taking appropriate action. Such action may include pursuing recovery against the directors personally for the company's debts if it appears that the directors did not take a course of action reasonably likely to lead to a better outcome than through proceeding to an immediate administration or the liquidation of the company.

1.22 The restriction also ensures that books and information that were not available at the time a liquidator or administrator is appointed are not later prepared in a way to make it retrospectively appear that a director would have fallen within the safe harbour provisions.

1.23 An exemption applies so that these restrictions will not apply in relation to directors who:

- can demonstrate they did not have the books or information and there were no reasonable steps that could have been taken to obtain the materials; or
- were not notified that failing to provide the information requested by the liquidator or administrator would prevent them from using the materials or information to demonstrate they took a course of action that was reasonably likely to lead to a better outcome.

Comparison of key features of new law and current law

<i>New law</i>	<i>Current law</i>
Safe harbour provision to protect directors from liability for debts incurred by an insolvent company if they take a course of action that is reasonably likely to lead to a better outcome for the company and its creditors and the debt was incurred as part of the course of action	No equivalent

Directors will be prevented from using books and information about a company as evidence that they took a reasonable course of action if they have previously not provided these materials to a liquidator or administrator following an appropriate request for the materials	No equivalent
Directors will not be able to rely on the safe harbour in circumstances where the company is not meeting its obligations in relation to employee entitlements (including superannuation) and its taxation reporting obligations	No equivalent

Detailed explanation of new law

1.24 New section 588GA establishes a safe harbour for directors of an insolvent company to protect them against personal liability for contraventions of the insolvent trading provisions under subsection 588G(2) of the Act. *[Schedule 1, Part 1, item 2, subsection 588GA(1)]*

1.25 This safe harbour protection from the insolvent trading provisions in section 588G(2) is aimed at facilitating more successful company restructures outside of formal insolvency processes. It is also aimed at driving a cultural change amongst company directors who encounter uncertainty over a company’s solvency to be more willing to remain in control of the company and take proactive steps to address the situation and restructure a company in way that is likely to deliver a better outcome for the company and its creditors without the fear of being personally liable for any debts incurred as part of the process.

1.26 The safe harbour protection will protect a director in relation to debts that a company incurs associated with a course of action being taken by the director that is reasonably likely to lead to a better outcome for the company and the company’s creditors than proceeding to voluntary administration or winding up. The protection will apply from the time the director starts to take a course of action after beginning to suspect that the company may become insolvent and will apply until either the course of action ends, the course of action stops being reasonably likely to lead to a better outcome for the company and its creditors or the company goes into administration (voluntary or otherwise). *[Schedule 1, Part 1, item 2, paragraphs 588GA(1)(a) – (b)]*

1.27 Whether the course of action is reasonably likely to lead to a better outcome will be assessed on an objective basis. Regarding the time at which a director can be considered to have started to take the course of action, the safe harbour will extend to cover a period in which deliberations and preparations for the course of action are occurring.

1.28 The safe harbour is not intended to be a mechanism for a company to continue trading past the point where it is viable. A key aspect of the protection is that it only applies where a director is taking a course of action that is reasonably likely to lead to a better outcome for the company and its creditors. Once it becomes clear that the company cannot be viable in the long term, the course of action will no longer meet that description and the protection of the safe harbour will cease.

1.29 Determining if a course of action is reasonably likely to lead to a better outcome for the company and its creditors will depend on the circumstances in each case. The safe harbour has a wide application so that it gives directors sufficient latitude to take a course of action that is appropriate in the context of the size, nature and complexity of the relevant company. A course of action that is appropriate for a small company with limited existing debt may not be appropriate for another company that already has a very high level of debt.

1.30 A feature of safe harbour is that it recognises that even in circumstances where a company's solvency is doubtful incurring debts may be part of a reasonable course of action and that it remains in the interests of the company and its creditors that some loss-making trade should be accepted in trying to secure future viability – for example incurring debts associated with the sale of assets which would help the business's overall financial position.

1.31 New subsection 588GA(2) therefore provides an indicative and non-exhaustive list of factors to be considered in determining whether a course of action is reasonably likely to lead to a better outcome for a company and its creditors.

1.32 Factors which may be considered are to see if the director has:

- taken steps to prevent misconduct by officers and employees of the company;
- taken appropriate steps to ensure the company maintains appropriate financial records;
- obtained appropriate advice,

- kept themselves informed about the company’s financial position; and
- been developing or implementing a plan to restructure the company to improve its financial position. [*Schedule 1, Part 1, item 2, subsection 588GA(2)*]

1.33 It is not necessary for all of these factors to apply for directors to have the protection of safe harbour and it may be possible for safe harbour to apply even where none of these factors are present.

1.34 There may also be, in some circumstances, cases where a Court is satisfied that all five factors are satisfied but that the course of action is still not found to be reasonable.

1.35 The factors in subsection 588GA(2) therefore provide only a guide as to the steps a director may consider or take depending on the circumstances. For example, a small business may need only to seek the advice of an accountant, lawyer or other professional, while a large listed entity might retain an entire team of turnaround specialists, insolvency practitioners, and law and accounting firms to advise on a reasonable course of action.

1.36 The safe harbour may apply to a director even where the end result of taking on additional debts as part of a course of action is a worse outcome for the company and its creditors, so long as the course of action was reasonably likely to lead to a better outcome. This recognises that there are many variables that could impact on a company’s rehabilitation, some of which may not be possible to predict.

1.37 However, at the time it becomes reasonably apparent to the director that the changed circumstances will mean that the company is not viable, the director would have to either make adjustments to the course of action to ensure it is still reasonably likely to lead to a better outcome or if that is not possible, place the company into voluntary administration or take steps to wind it up. If a director fails to react appropriately, then the director will no longer have the safe harbour protection for any debts incurred from that point in time.

1.38 A better outcome is one where the company and its creditors as a whole are better off than the company becoming an externally administered body corporate - effectively the company going into administration or being wound up. [*Schedule 1, Part 1, item 2, subsection 588GA(5)*]

1.39 It is likely that in some instances where the safe harbour is utilised a company will take on additional debt as part of a director taking a course of action reasonably likely to lead to a better outcome. This will mean that the

company is taking on ‘new’ creditors after the director first became aware that the company may be insolvent. In considering if the course of action is likely to lead to a better outcome, the director must consider that the company and all of the company’s creditors – its existing creditors before the safe harbour commenced and its new creditors who began engaging with the company after it entered safe harbour will be better served than if the company were to go into administration or liquidation.

1.40 Where a director takes on debt from new creditors and they do not believe they can repay the debt in accordance with its terms this would be ostensibly a breach of the general director’s duties as well as being dishonest. As such, a director would not be protected in relation to incurring debts of this nature.

1.41 A director who relies on the safe harbour will only need to be able to point to evidence which demonstrates that a course of action that was reasonably likely to lead to a better outcome for the company and its creditors was taken. *[Schedule 1, Part 1, item 2, subsections 588GA(3) and 588GA(5)]*

1.42 It is appropriate that the responsibility for providing evidence that the action was taken is with a director who seeks to rely on it as there will often be information which is peculiarly within the director’s knowledge which is not accessible to a liquidator (or other party) bringing insolvent trading proceedings regarding the steps taken as part of the restructuring process. As such it is reasonable to require a director to bring some evidence to satisfy the Court that there is a reasonable possibility that they were taking a reasonable course of action. The mere statement that a course of action was reasonable rather than fanciful is not sufficient. This approach is consistent with the Commonwealth’s guide to framing penalty provisions.

1.43 Once a director provides some evidence to meet this low initial evidential burden, it will be up to a liquidator (or other party) alleging a contravention of section 588G to provide evidence and argue that the safe harbour does not apply because the director did not take a reasonable course of action.

1.44 The safe harbour is intended only to apply to directors acting honestly to pursue a reasonable course of action, and therefore the new provisions contain appropriate safeguards to ensure that the safe harbour is only available to such directors. To this end, there are certain factors which if present in a given case would render the relevant director ineligible to rely on the safe harbour. The first is where a company does not make provisions for its employees’ entitlements (including superannuation). The second is where a company has not complied with its taxation reporting obligations. In both these cases, a director will not be eligible for the safe harbour protection if the company is not meeting its obligations in a manner consistent with a company that is solvent. *[Schedule 1, Part 1, item 2, subsection 588GA(4)]*

1.45 A company that is unable to make provision for its employees' entitlements or is not generally compliant with its taxation reporting obligations is not presumed to be viable. As outlined above, where a company cannot objectively be considered to be viable in the long term the course of action will not be reasonable and therefore its directors should not be protected by the safe harbour.

1.46 In cases where a company has met its employee entitlement obligations and is generally compliant with its taxation reporting obligations, its directors will be protected under the safe harbour unless the company ceases to be compliant. If a company does cease to be compliant then the safe harbour will not apply in relation to any debts incurred beyond that point.

1.47 This is intended to promote early engagement with potential insolvency and reduce the risk of companies not meeting these obligations as they start to experience financial hardship and that any plans to restructure or recover the company must involve ensuring that employee entitlements are fully met and that the company meets its taxation reporting obligations.

1.48 It is acknowledged that while the amendments are designed to allow more companies to restructure and continue operating outside of a formal insolvency process, such efforts will not always be successful. Despite a director's best efforts to follow a reasonable course of action, it is possible that a company may still proceed into administration or liquidation. Where this happens it is important to ensure that administrators are given sufficient information to assess if the company is viable and to check to see that the safe harbour was not misused – that is to say that the directors were actually trying a course of action that was reasonable.

1.49 As such, new section 588GB sets out rules to prevent a director from relying on books or information as evidence to support a safe harbour defence where these materials have been withheld from a liquidator or administrator.

1.50 This will ensure that an administrator or liquidator can quickly make a determination about a company's prospects and take appropriate actions to recover or maintain as much of a company's value as possible. Similarly, the lack of access to books or information about a company could prevent an administrator or liquidator from obtaining information about a director's misfeasance which would have enabled them to appropriately recover funds for the company's creditors.

1.51 Under new subsection 588GB(1), a director will not be able to use a company's books as evidence in relation to a safe harbour defence if:

- a court issues a warrant under subsection 530C(2) because the Court is satisfied that that the director has concealed,

destroyed or removed books of the company or is about to do so; or

- the director has not provided a liquidator with access to the books in accordance with:
 - a notice under section 477 or subsection 530B(4) to inspect the company's books;
 - a court order under section 486; or
 - the requirement under subsection 477(3) or section 530A to provide a liquidator with the company's books as soon as practicable after a court has ordered the company be wound up or the company resolves that it be wound up.

[Schedule 1, Part 1, item 2, subsections 588GB(1) and (6)]

1.52 A similar restriction applies under new subsection 588GB(2) to prevent a director from relying on information about a company as evidence in relation to a safe harbour defence if the director has not provided a liquidator with information in accordance with:

- a notice under section 477;
- a court order under subsection 530A(1); or
- the requirement to provide information under subsection 530A(2).

[Schedule 1, Part 1, item 2, subsections 588GB(2) and (6)]

1.53 The effect of these new restrictions is that director will not be able to deny a liquidator or administrator access to a company's books or information about a company and later use these books or the information as a part of a safe harbour defence.

1.54 These restrictions will limit potential dishonest activity where books and information are fabricated retrospectively to make use of the safe harbour defence.

1.55 These new restrictions will not however apply to directors who prove that they did not possess the relevant books or information and there were no reasonable steps that could have been take to obtain the materials. This will protect directors who genuinely do not have access to the material at the time it is sought by a liquidator or administrator. *[Schedule 1, Part 1, item 2, paragraph 588GB(3)(a)]*

1.56 The restrictions will also not apply to directors in certain cases where a liquidator seeking the books or information does not notify them that a failure to provide the books or information will prevent them from being later used by the directors as evidence in relation to the safe harbour.

[Schedule 1, Part 1, item 2, paragraph 588GB(3)(b)]

1.57 In order to appropriately notify a director that a failure to provide books or information about the company will prevent the director from using them as evidence as part of a safe harbour defence, a liquidator must either:

- include this notification as part of their notice seeking access to books or information about the company that is issued under section 477 or subsection 530B(4);
- provide this notification as part of a written notice given to the director that they are relying on a court order made under section 486, subsection 477(3) or subsection 530A(2) to access the books or information about the company; or
- provide this notification as part of a written notice to the director that they are seeking the company's books or information pursuant to a warrant issued under subsection 530C(2).

[Schedule 1, Part 1, item 2, subsection 588GB(4)]

1.58 Liquidators seeking information on the basis of a court order under subsection 530A(1) will not be required to notify a director that their failure to provide books or information about the company would prevent them from later using those books as part of a safe harbour defence.

[Schedule 1, Part 1, item 2, subsection 588GB(4)]

1.59 A failure by a liquidator to notify a director about the consequences of not providing books or information about a company will not otherwise impact the validity of any notice, order or warrant that is issued. *[Schedule 1, Part 1, item 2, subsection 588GB(5)]*

Consequential amendments

1.60 As the safe harbour for insolvent trading is being introduced, the title of section 588H which provides for the existing defences to insolvent trading is being renamed to 'other defences'. *[Schedule 1, Part 1, item 3]*

1.61 Paragraph 588E(8)(d) is amended so that where a matter relating to the safe harbour in section 588GA is proved in relation to a proceeding, it is

also taken to be proved in relation to other proceedings relating to the same matter. *[Schedule 1, Part 1, item 1]*

Application and transitional provisions

1.62 These amendments apply to actions taken and debts incurred on or after commencement of this part of the bill. *[Schedule 1, Part 1, item 4]*

Chapter 2

Schedule 1, Part 2 – Stay on enforcing rights merely because of arrangements or restructures

Outline of chapter

2.1 This Chapter sets out new provisions to stay the enforcement of ipso facto clauses that are triggered when a company enters formal insolvency proceedings.

2.2 Unless otherwise stated, all references are to the *Corporations Act 2001*.

Context of amendments

Context of amendments

2.3 An ipso facto clause allows one party to terminate or modify the operation of a contract upon the occurrence of some specific event. In the current insolvency context, such clauses allow one party to terminate or modify the contract solely due to the commencement of formal insolvency proceedings, such as on the appointment of a voluntary administrator. This type of termination can occur regardless of the continued performance of the counterparty of its obligations under the contract.

2.4 The operation of ipso facto provisions can thus 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.

2.5 These outcomes can reduce or eliminate returns in liquidation because they disrupt the businesses' contractual arrangements and destroy goodwill, potentially prejudicing other creditors and defeating the purpose of a voluntary administration.

2.6 For example, if a company is viable in the long term but has a short term lack of liquidity which leads the directors to appoint a voluntary administrator, an ipso facto clause might allow a major supplier to cancel their contract. This may in turn deprive the business of the chance to continue to trade while they restructure even though there has not otherwise been a

breach of the contract, with a negative impact on the business, its employees and other creditors.

2.7 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 schemes of arrangement under Part 5.1 of the Act. Making ipso facto clauses unenforceable during a company restructure will ensure that the objectives of the existing voluntary administration regime in the Act work more effectively by assisting viable but financially distressed companies to continue to operate while they restructure their business.

2.8 Under this amendment, ipso facto clauses which allow a contract to be terminated or varied solely due to the fact that an 'insolvency event' has occurred, regardless of continued payment or performance, would be stayed during a formal restructure. This will be subject to exceptions where ipso facto clauses are inherently necessary to the operation of a contract.

2.9 The aim is to allow breathing space for a company to continue to trade while in external administration or while conducting a scheme of arrangement aimed at avoiding insolvent liquidation. It also provides more options for directors of companies facing severe financial hardship when entering into early negotiation with their creditors about pursuing a restructure (including under the safe harbour provisions) knowing that future entry into formal insolvency will not necessarily trigger an ipso facto clause. This will assist in protecting asset values for the benefit of the company, its employees and its creditors which in turn will assist to promote a culture of entrepreneurship and reduce the stigma of failure.

2.10 Notwithstanding the operation of the stay, a counterparty maintains the right to terminate or amend an agreement with the debtor company for any other reason, including for a breach involving non-payment or non-performance.

2.11 Nothing in the operation of the stay would require any creditor to provide a new advance of money or credit or to provide additional security for further credit to a debtor company.

Summary of new law

2.12 The amendments in Part 2 of Schedule 1 of the bill provide that ipso facto clauses that amend or terminate an agreement because of an insolvency event are not enforceable except in certain circumstances.

2.13 The provisions apply to stay the enforcement of these rights in relation to a Part 5.1 body that applies for a scheme of compromise or arrangement and to companies that enter into administration. The stay applies regardless of whether the right is self-executing or triggered by one of the parties to an agreement.

2.14 This stay on the enforcement of rights does not apply in relation to rights:

- in a type of contract specified in regulations a ministerial determination;
- of a kind prescribed in the ministerial determination;
- in agreements made after the commencement of a scheme of compromise for a Part 5.1 body or administration of a company;
- that manage financial risk associated with a financial product that is commercially necessary for that type of financial product.

2.15 The courts will have discretion to allow a right to be enforced if doing so would be appropriate in the interests of justice.

2.16 The courts will also have the discretion to restrict the enforcement of other rights in an agreement if it appears likely that those rights will be exercised merely because of an insolvency event.

Comparison of key features of new law and current law

<i>New law</i>	<i>Current law</i>
Stay on the enforcement of rights that amend or terminate a contract merely because a Part 5.1 body enters into a scheme of compromise	No equivalent
Courts will have a discretion to allow or prevent the enforcement of rights that are triggered or may be used merely because a Part 5.1 body enters into a scheme of compromise	No equivalent
Stay on the enforcement of rights that amend or terminate a contract merely because a company enters administration	No equivalent

Courts will have a discretion to allow or prevent the enforcement of rights that are triggered or may be used merely because a company enters administration	No equivalent
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Detailed explanation of new law

2.17 The amendments in Part 2 of Schedule 1 of the bill provide for a stay against the enforcement of terms that amend or terminate an agreement merely because of a formal insolvency event. The amendments apply in relation to entities entering into a Part 5.1 scheme of compromise or arrangement, and also companies that are placed into administration.

Stay on enforcement of rights triggered as a result of a compromise or arrangement under Part 5.1

2.18 New subsection 415D in Part 5.1 of the Act provides a stay against the enforcement of rights which would allow a contract to be terminated or amended if a Part 5.1 body makes an application to enter into a compromise or arrangement or has such an application approved. *[Schedule 1, Part 2, item 5, subsection 415D(1)]*

2.19 The rights will however only be unenforceable where the Part 5.1 body's application under section 411 states that it is being made so that the party can avoid being wound up in insolvency. *[Schedule 1, Part 2, item 5, subsection 415D(3)]*

2.20 The effect of this provision is that a clause that provides for a contract to be terminated or amended only because one of the parties has entered into or is seeking to enter into a scheme of arrangement is not enforceable. A term in contract that purports to operate in this way will not be enforceable regardless of whether it is self-executing or takes effect at the election of one of the parties.

2.21 The provision applies in relation to Part 5.1 bodies which are defined under section 9 to include companies under the Act and an entity registered under Division 1 or 2 of Part 5B.2 of the Act.

2.22 Where this type of a right exists in a contract, it will not be enforceable against a Part 5.1 body from the time the Part 5.1 body makes an application under section 411 to enter into a scheme of arrangement until either:

- the application is withdrawn or is rejected by the court; or

- once the compromise or arrangement finishes, unless this occurs because the party is to be wound up, in which case the stay will operate until the party is wound up.

[Schedule 1, Part 2, item 5, subsection 415D(2)]

2.23 In some circumstances, it will not be appropriate to stay the enforcement of an ipso facto clause that is triggered by a formal insolvency event. As such, subsection 415D(4) provides an exemption to allow certain types of rights that would otherwise be unenforceable under subsection 415D(1) to continue to operate. These rights include rights:

- in agreements entered into after the day a compromise or arrangement is approved;
- of a kind prescribed a ministerial declaration;
- that are found in the kinds of contracts or agreements prescribed in regulations a ministerial declaration;
- that manage financial risk that are associated with a financial product that would be commercially necessary for the provision of that type of financial product.

[Schedule 1, Part 2, item 5, subsections 415D(4) and (5)]

2.24 The regulations will prescribe the types of contracts in which rights may still be enforced even if they are triggered by an insolvency event. It is appropriate to do this in the regulations so that the list can be updated regularly in response to the development of new and innovative financial products. As more new and complex financial products become available, the types of rights that may still be enforceable will need to be adjusted and the changes will have to be made in a timely way.

2.25 Similarly, the power to allow certain rights that trigger on an insolvency event to still be enforceable through a ministerial determination is required to ensure that where there are any unintended consequences, they can be remedied very quickly.

2.26 There are types of financial products the primary purpose of which is to manage risk. For these types of financial products an ipso facto provision may be essential for the function of the relevant contract and to stay the operation of the ipso facto provision would defeat the purpose for which the parties entered the contract. Therefore the ipso facto provisions are 'commercially necessary'. For examples, swaps, where the party is entitled to close out their position in order to manage counterparty risk.

2.27 Where applicable rights are not enforceable against a Part 5.1 body because of subsection 415D(1), any rights the Part 5.1 body has to obtain additional credit from the other party are also not enforceable. This provision ensures that while a right to amend or terminate the contract is not enforceable, there is also no requirement for additional credit to be provided under the contract. *[Schedule 1, Part 2, item 5, subsection 415D(6)]*

2.28 Courts will have a discretion to rule that the stay of an enforcement of a right under subsection 415D(1) does not apply where the court is satisfied that the compromise or arrangement was not sought for the purpose of a Part 5.1 body avoiding being wound up. *[Schedule 1, Part 2, item 5, paragraph 415E(1)(a)]*

2.29 A Court may also order that a stay on the enforcement of a right under subsection 415D(1) does not apply because it is satisfied that doing so would be in the interests of justice. *[Schedule 1, Part 2, item 5, paragraph 415E(1)(b)]*

2.30 A Court may make such an order on application by the holder of a relevant right to allow that right to be enforceable from the time the Part 5.1 body made the application for the compromise or arrangement under section 411. *[Schedule 1, Part 2, item 5, subsections 415E(2) and (3)]*

2.31 The flexibility provided to the Courts means that they can intervene to allow a right to be enforceable if that would be appropriate in the circumstances.

2.32 Subsection 415F provides that a Court can make an order that any rights under a contract, agreement or arrangement are only enforceable against a Part 5.1 body with the leave of the Court and subject to terms imposed by the Court. The power to make such an order arises where a Part 5.1 body has made an application under section 411 for a compromise or arrangement or is subject to a compromise or arrangement following an application under section 411. *[Schedule 1, Part 2, item 5, subsections 415F(1) and (2)]*

2.33 The Court has the power to make an order to stay a right if it is satisfied that:

- The rights are being exercised, likely to be exercised or there is threat that the right will be exercised only because an application for a compromise or arrangement is made or has been approved;
- The application for the stay is included as part of the section 411 application or is made by a person appointed to administer a compromise or arrangement for a Part 5.1 body following an application under section 411; and

- the section 411 application states that the purpose of the application was to avoid the Part 5.1 body being wound up in insolvency.

[Schedule 1, Part 2, item 5, subsection 415F(2)]

2.34 Where a Court imposes an order to stay a right, the order must specify the period for which it applies, which cannot exceed the period under subsection 415D(2) (see paragraph 2.22). *[Schedule 1, Part 2, item 5, subsection 415F(3)]*

2.35 However, a Court cannot make an order to stay rights that are provided for under subsection 415D(4) (see paragraph 2.23). *[Schedule 1, Part 2, item 5, subsection 415F(4)]*

2.36 A Court will be able to give an interim order before deciding on an application for a stay on the enforcement of a right but cannot require an undertaking as to damages as a condition for granting the interim order. *[Schedule 1, Part 2, item 5, subsections 415F(5) and (6)]*

Stay on the enforcement of rights because a company is under administration

2.37 Subsection 451E(1) provides that a right in a contract, agreement or arrangement is not enforceable against a company only because the company enters into external administration. *[Schedule 1, Part 2, item 6, subsection 451E(1)]*

2.38 These types of rights will not be enforceable against a company from the time the company enters into administration until the administration ends unless:

- the administration ends because the company is being wound up, in which case the rights will not be enforceable until the time the company is wound up; or
- within 7 days of the administration ending, the company makes an application to the Court to extend the period for which the rights will not be enforceable, in which case the rights will not be enforceable until:
 - either the application is withdrawn or the Court rejects the application; or
 - the order of the Court extending the period ceases to apply.

[Schedule 1, Part 2, item 6, subsection 451E(2)]

2.39 A Court may extend the period for which a right is not enforceable against a company if:

- a section 444F order limiting the rights of secured creditors is in force for the benefit of the company; and
- the court is satisfied that doing so would be in the interests of justice; and
- the applicant for the extension is the same as the applicant for the section 444F order.

[Schedule 1, Part 2, item 6, subsection 451E(3)]

2.40 An extension order issued by a Court under subsection 451E(3) applies until the time the relevant section 444F order limiting the rights of the company's creditors applies.

2.41 The stay on the enforcement of rights under subsection 451E(1) does not apply:

- if the rights relate to a contract, agreement or arrangement entered into after the day the company goes into administration;
- to rights that are of part of a type of contract, agreement or arrangement that are specified in the regulations or ministerial determination;
- is a right of a kind specified in a ministerial declaration; or
- is a right that manages financial risk associated with a financial product that is commercially necessary for the provision of that type of financial product.

[Schedule 1, Part 2, item 6, subsections 451E(4) and (5)]

2.42 The regulations will prescribe the types of contracts in which rights may still be enforced even if they are triggered by an insolvency event. It is appropriate to do this in the regulations so that list can be updated regularly in response to the development of new and innovative financial products. As more new and complex financial products become available, the types of rights that may still be enforceable will need to be adjusted and the changes will have to be made in a timely way.

2.43 The power to allow certain rights that trigger on an insolvency event to still be enforceable through a ministerial determination is required to

ensure that where there are any unintended consequences, they can be remedied very quickly.

2.44 In addition, there are some types of financial products where the product would only ever be available or appropriate if an ipso facto right that is triggered on an insolvency event is enforceable. For example swaps, where the party is entitled to close out their position in order to manage counterparty risk. These rights will continue to be enforceable but only where they are commercially necessary for that type of contract.

2.45 While rights against a company are not enforceable because of subsection 451E(1), any rights the company has against the other party for the provision of additional credit are also not enforceable. *[Schedule 1, Part 2, item 6, subsection 451E(6)]*

2.46 On application by the holder of a right that is unenforceable, the Court has a general discretion to order that the right can in fact be enforced in the interests of justice. *[Schedule 1, Part 2, item 6, section 451F]*

2.47 New subsection 451G(1) provides the Court with the discretion to make an order that a right in a contract is not enforceable against a company without the leave of the court and subject to the terms imposed by the Court. *[Schedule 1, Part 2, item 6, subsection 451G(1)]*

2.48 A Court is able to do this on application by a company's administrator in relation to a company that is in administration where the court is satisfied that the rights are exercised, are likely to be exercised, or there is a threat that they will be exercised merely because the company is in administration. *[Schedule 1, Part 2, item 6, subsection 451G(2)]*

2.49 However, a Court cannot make such an order in relation to rights under subsection 451E(4) (see paragraphs 2.41). *[Schedule 1, Part 2, item 6, subsection 451G(4)]*

2.50 Where a Court does make an order, the order must specify the period for which the rights will not be enforceable and this period must not exceed the period referred to in subsection 451E(2) (See paragraph 2.38). *[Schedule 1, Part 2, item 6, subsection 451G(3)]*

2.51 A Court is able to make an interim order before deciding to make an order that a right is not enforceable against a company but must not make the order subject to an undertakings as to damages. *[Schedule 1, Part 2, item 6, subsections 451G(5) and (6)]*

Application and transitional provisions

2.52 The amendments in this part of the bill apply to rights arising under contracts, agreements or arrangements entered into on or after 1 January 2018. [*Schedule 1, Part 2, item 7*]

