**Dr Nuncio D’Angelo**

24 April 2017

Mr James Mason
Financial System Division
The Treasury
Langton Crescent
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Email: insolvency@treasury.gov.au

Dear Mr Mason

**National Innovation and Science Agenda
Improving Corporate Insolvency Law
Submission: *ipso facto* clauses and financing arrangements**

I make this submission in response to the following materials published by the Minister for Revenue and Financial Services, the Hon Kelly O’Dwyer, on 28 March 2017:

* the Exposure Draft *Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Bill 2017* (the “**Exposure Draft** **Bill**”);
* the *Explanatory Memorandum* for the Exposure Draft Bill (the “**Explanatory Memorandum**”); and
* the document headed *Types of Contractual Rights Excluded from the Stay on Ipso Facto Clauses* (the “**Example List of Excluded Contracts**”).

I disclose that I am a partner practising in banking, finance and insolvency law at the firm Norton Rose Fulbright. However I make this submission in my personal capacity and not on anyone’s behalf or at anyone’s instruction. The views expressed are my own and do not necessarily reflect those of my firm (or any other partner of it) or of any client.

In this submission:

“**Act**” means the *Corporations Act 2001* (Cth).

“**Critical Events**” means the events described in clauses 415D(1) and 451E(1) of the Exposure Draft Bill, which activate the stay on enforceability of *ipso facto* clauses.

“**Financing Agreement**” means any contract, agreement or arrangement under which a person or persons provide financial accommodation to a company. It includes arrangements under which bonds, notes, debentures or other debt securities (including dematerialised securities) are issued by a company.[[1]](#footnote-1)

# Preliminary matters

## This submission is limited to the content of Part 2 of Schedule 1 of the Exposure Draft Bill, headed *Stay on enforcing rights merely because or arrangements or restructures,* ie the part dealing with so-called *ipso facto* clauses.

## As with any law reform in the area of insolvency, the challenge for Parliament is to strike the appropriate balance, based on policy, between the desires of competing stakeholders. In relation specifically to the *ipso facto* clause reforms, it is beyond argument that much of a trading company’s value can be tied up in contracts, as well as essential supply lines, and that the preservation of those contracts and lines in the insolvent administration of the company would be consistent with, for example, the objectives of the voluntary administration regime, as described in section 435A of the Act. Overall, I support the measure.

## However, while the materials published by the Minister traverse many of the issues, they do not, in my view, properly address the position of financiers in relation to contracts for the provision of financial accommodation. This is a material omission in light of the fact that, when a company becomes insolvent, it is not uncommon for the largest creditor or class of creditors, by value, to be financiers.

# Summary of this submission

## I note that some of the examples given in the Example List of Excluded Contracts could be regarded as Financing Agreements or security for Financing Agreements, eg rights of set off, flawed asset arrangements, certain arrangements involving ISDA contracts, aircraft leases, securitisation arrangements, covered bond transactions and debt factoring agreements.[[2]](#footnote-2)

## The Example List of Excluded Contracts states as a guiding principle that exclusions should embrace contracts where “an ipso facto clause is inherent to the type of contract, ie by removing the ipso facto clause it would render the contract unworkable or a nonsense”. An essential characteristic of Financing Agreements is the financier’s right to bring the arrangement to an end upon the happening of certain events, including a Critical Event. I submit that it would be unworkable and a commercial nonsense to require financiers to provide (or continue to provide) accommodation on the basis that they were not permitted to bring the arrangement to an end if the accommodated party suffers a Critical Event.

## A financier’s decision to provide financial accommodation, or to leave a financing arrangement on foot, is always based on an assessment that the accommodated party is of appropriate creditworthiness. Clearly, a company subject to a Critical Event is not or is unlikely to be creditworthy. It appears that the effect of the new provisions is to prevent financiers from bringing their arrangements to an end and, on one view, may even oblige them to keep funding the company in administration, despite the company being of entirely different creditworthiness than when the facility was put in place.

## Because this issue is not discussed in the explanatory materials, there is a question as to whether this is an intended or unintended consequence.

## The objectives of the reforms are clear enough – to prevent the termination of commercial contracts that underpin the company’s business, thus enhancing the scope for a successful restructure or the sale of the business as a going concern. But Financing Agreements are different. Businesses in the ordinary course (ie absent insolvency) are rarely sold with existing financing intact; existing lines are normally paid out and replaced with arrangements provided by the new owner’s financiers. Nor should financiers be obliged to carry on under pre-insolvency financing terms after the company has become insolvent. If an administrator requires funding to be able to conduct the administration, there is an established market practice for financiers to provide new and specific overdraft facilities to the administrator for that purpose.

## I hasten to add that none of this is to suggest that financiers should be exempted from the current statutory enforcement moratorium in administration – that is a different question and not something that is in play. With the exception discussed below for fully secured creditors, and the other exceptions that currently apply, even if excluded from the operation of the new *ipso facto* reforms financiers would and should remain subject to that moratorium.

## In my submission, however, there is no compelling reason for the *ipso facto* reforms to apply to Financing Agreements such as would justify the detriment they would cause to financiers, as discussed below. It is, therefore, appropriate to consider including all Financing Agreements in the list of exclusions to be promulgated under clause 451E(4)(b). [[3]](#footnote-3)

# The effect on fully secured financiers’ enforcement rights

## Well drafted financing agreements invariably contain a clause which, upon the occurrence of certain events (usually described as “**Events of Default**”), permits the financier unilaterally, among other things:

### to cancel or terminate any commitment to provide further accommodation;

### to accelerate principal, ie extinguish the agreed maturity date and replace it with a demand for immediate repayment of principal (together with all accrued and unpaid interest and fees); and

### to enforce security.

## Among the Events of Default will usually be a series of events (sometimes described collectively as “**Insolvency Events**”) which will include, but not be limited to, the Critical Events described in the Exposure Draft Bill. So framed, an Event of Default provision would be an *ipso facto* clause as contemplated by the Exposure Draft Bill, at least to the extent activated by a Critical Event.[[4]](#footnote-4)

## This has a particular consequence in the case of administration. The commencement of administration would invariably be an Insolvency Event and thus an Event of Default. Currently, upon the happening of that event, the financier would swiftly terminate its commitment and accelerate principal. If it is secured over all or substantially all of the company’s assets, it would commence enforcement (promptly and, in any case, during the 13 business day decision period), usually by appointing a receiver so as to take control of the assets and the company, and place itself outside the statutory enforcement moratorium: see section 441A of the Act.

## The availability of this latter step, which can be regarded as a specific (and valuable) advantage afforded to fully secured creditors, was a policy decision made by Parliament when the voluntary administration provisions were inserted into the predecessor of the Act in 1993.

## Part 2 of Schedule 1 of the Exposure Draft Bill partially deprives fully secured creditors of this advantage and represents a substantial diminution of their rights. Even after the appointment of an administrator, the financier would need to await an Event of Default that was not a Critical Event before taking the steps described above. If that event did not occur before the expiration of the 13 business day decision period the financier would be unable to enforce at all (without the administrator’s consent or the assistance of the Court), thus losing its statutory advantage.

## Because this outcome is not addressed in the explanatory materials, I question whether this is an intended consequence of the proposed reforms.

# The effect on termination of commitments

## As mentioned above, one of the rights financiers invariably have upon the occurrence of an Event of Default is to cancel or terminate their “commitment”, ie their contractual obligation to provide accommodation or further accommodation. This applies to overdraft or working capital facilities, or any other kind of accommodation that is not fully drawn at the relevant date (the difference at any time between the amount drawn and the amount of the total commitment can be described as the “**available commitment**”).

## I note clauses 415D(6) and 451E(6) of the Exposure Draft Bill which suspend any right of the company against a financier for the provision of “additional credit” during the stay period.

## However, this formulation raises the following issues:

### what does “additional credit” mean? Can the available commitment (which is, after all, an extant contractual obligation) be described as “additional credit” so as to allow the financier to resist, under clause 415D(6) or 451E(6) (as applicable), a demand by the company to advance it? Or is it the policy intention that the company should be permitted to continue to draw on contracted available commitments during administration? In other words, does “additional” in clauses 415D(6) and 451E(6) mean additional to the debt outstanding on the date of the Critical Event or additional to any extant legal obligation as at that date?

### some Financing Agreements also contain a condition precedent clause that states that the financier is not obliged to provide any (further) financial accommodation if at the time of the request an Event of Default exists. That Event of Default might be the occurrence of a Critical Event. There is some question as to whether that condition precedent is itself a “right” of a type captured by clauses 415D(1) and 451E(1), thus making it unenforceable (although I acknowledge that the answer may turn on the correct construction of the clause);

### in any case, are clauses 415D(6) and 451E(6) in conflict with clauses 415D(1) and 451E(1) respectively? The right to terminate commitments for an Event of Default that is a Critical Event, being an *ipso facto* provision, is not enforceable due to the latter clauses. That would mean that the financier cannot resist a demand to draw on the available commitment. But that event also activates clauses 415D(6) and 451E(6), which make any right of the company to demand that the financier provide “additional credit” unenforceable.

## These uncertainties should be clarified to ensure that the policy intention evident in clauses 415D(6) and 451E(6) of the Exposure Draft Bill is properly effectuated.

## It also follows that, if (as I suspect must be the case) it is the policy to allow financiers to cease providing further accommodation upon the happening of a Critical Event, there is no reason why they should not also be permitted to accelerate principal outstanding and accrue other amounts due or owing – after all, at least in administration, they would still be subject to the enforcement moratorium (subject to the existing exceptions).

# The effect on default interest clauses

## Some Financing Agreements provide for an uplift in the applicable rate of interest if the accommodated party is in default, to compensate for the poorer creditworthiness of the accommodated party, the concomitantly higher risk to the financer and the additional management time required to administer the facility (although some default interest clauses only apply the higher rate to overdue amounts so that a default that does not involve late payment does not trigger them).

## Where a Financing Agreement applies the default rate upon the occurrence of an Event of Default, the provision would be an *ipso facto* clause as contemplated by the Exposure Draft Bill, at least to the extent that the default is a Critical Event. That means that the financier would not be able to charge the higher default rate against a company in administration or, therefore, be compensated for the higher risk it has suffered, unless and until another Event of Default, not being a Critical Event, occurred (if at all).

## Is this economic cost an intended consequence of the reforms? Again, note that unless one of the existing exceptions apply, the financier would still not be able to enforce its claim during administration.

# The effect on indemnities for defaults

## Many Financing Agreements contain an indemnity from the accommodated party in favour of the financier for any cost, expense, loss or liability (including legal fees) incurred by that financier as a result of the occurrence of an Event of Default.

## It would seem that those indemnities would be unenforceable as *ipso facto* clauses, at least to the extent of Events of Default that are Critical Events. Thus, the additional costs incurred by the financier in dealing with the accommodated party while it is in administration (for example, the cost of investigating the default and obtaining detailed legal advice on its rights and enforcement options) could not be claimed or added to the amount owing to the financier under this indemnity, unless and until another Event of Default, not being a Critical Event, occurred (if at all).

## Is this economic cost an intended consequence of the reforms? Again, note that unless one of the existing exceptions apply, the financier would still not be able to enforce its claim during administration.

# Conclusion

## Because the issues described above are not discussed in the explanatory materials accompanying the Exposure Draft Bill, there is a question as to whether they have been contemplated and whether the consequences described are intended or unintended.

## This should be clarified in the proposed legislation and accompanying regulations.

## In my submission, it is appropriate to consider whether the list of exclusions promulgated under clause 451E(4)(b) of the Exposure Draft Bill should include (ie exempt) all Financing Agreements.

I would be happy to discuss further any of the above. I may be contacted using the details shown below.

Yours sincerely

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1. I use the term *financial accommodation* deliberately to encompass more than simply loans, since a company can, of course, be accommodated in a wide variety of ways that do not involve loans. The expression is defined in various legislation for particular purposes but I do not here seek to give it a definitive meaning. It may be that, if these submissions are accepted, a definition might need to be included in the legislation. [↑](#footnote-ref-1)
2. Incidentally, and not relevant to the rest of this submission, the list also includes “Replacement of trustees”. I assume this means a clause in a trust instrument that operates to automatically replace, or allow the beneficiaries to replace, a trustee upon the happening of a Critical Event. If that is so, then this should more correctly say “Removal of trustees” since not all such clauses address replacement – most simply state that the trustee is automatically ejected (or give the beneficiaries the right to eject it) from office on the happening of the relevant event. [↑](#footnote-ref-2)
3. Although one must always exercise caution when comparing the United States Chapter 11 regime to our voluntary administration regime due to various fundamental differences in policy and approach, it is interesting to note that the US regime does exempt from the prohibition against enforcing *ipso facto* clauses “a contract to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor, or to issue a security of the debtor”: see 11 U.S.C. §365(e)(2)(B).  [↑](#footnote-ref-3)
4. Indeed, the *Example* given under clause 451E(1) of the Exposure Draft expressly states that “a right to accelerate payments by the company, will not be enforceable to the extent that those rights are triggered by the company coming under administration”. [↑](#footnote-ref-4)