Ipso facto protection: As dead as the language and rightfully so?

Abstract: *Singapore's new omnibus insolvency legislation introduces a restriction on the enforcement of* ipso facto *clauses against a company on the basis that it has commenced certain restructuring proceedings or become insolvent. This article compares Singapore's approach to those of other jurisdictions, analyses how the new legislation is likely to operate in the context of loan documentation, and argues that the abolition of* ipso facto *protection is a welcome development.*

Key takeaways for lenders

- Ensure that contractual rights, especially the right to terminate or modify the contract, are premised on events distinctly unrelated to the commencement of restructuring proceedings or the company's solvency status.
- Creativity and a fair assessment of the bank's risk appetite for customers, who while not yet non-performing should be more closely-monitored, will help determine the types of clauses to include, e.g., increased reporting requirements or greater information access upon certain trigger events that are just shy of insolvency.
- That said, continue to include *ipso facto* clauses because the court may grant relief, and also because such clauses will become fully enforceable again when restructuring proceedings end.

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1 On 1 October 2018, the Singapore Parliament passed the Insolvency, Restructuring and Dissolution Act 2018 ("**Insolvency Act**"), which consolidates Singapore's laws on bankruptcy, corporate insolvency and restructuring into an omnibus legislation. One feature introduced by the Insolvency Act is the restriction on the operation of *ipso facto* clauses in the restructuring and insolvency context.

2 "*Ipso facto*" is a Latin phrase meaning "by the very fact of". An *ipso facto* clause allows a counterparty to unilaterally terminate the contract or pursue certain remedies merely upon the occurrence of specific trigger events. In the context of restructuring and insolvency, trigger events typically include the company's application for a scheme of arrangement or judicial management. The occurrence of such events generally signals that the company is in financial distress—if so, a counterparty might want to invoke its *ipso facto* clauses to cut its losses by accelerating any payments owed to it, modifying the terms of the relationship or even terminating the contract altogether, instead of continuing to engage with a distressed company that may eventually be unable to perform its obligations. Accordingly, for counterparties, the value of *ipso facto* clauses is self-evident.

3 Yet, there are good reasons why *ipso facto* clauses should not operate without restriction in the restructuring and insolvency context. The main thrust is that such clauses can severely undermine the prospects of a successful restructuring even though the counterparty is not prejudiced by the same. For instance, if key creditors and suppliers invoke their *ipso facto* clauses to disrupt or cancel material contracts with the company even though it is still performing its obligations thereunder, this would effectively put an end to the company's operations and any attendant possibility of a successful restructuring. The general body of creditors would receive less than they would have, had the company had been successfully rehabilitated. Thus, restrictions on *ipso facto* protection are crucial to preserve a distressed company's ability to trade its way out of trouble and ensure the business remains protected while the balance sheet is deleveraged through a debt restructuring exercise.

A changing tide

4 Not so long ago, restrictions on the operation of *ipso facto* clauses were the exception rather than the norm. As noted by the Insolvency Law Review Committee of Singapore in 2013, only a handful of countries imposed such restrictions—e.g., the US, Canada and France. Jurisdictions which did not impose limits—e.g., the UK, Japan, China, Australia, Germany and Hong Kong—formed the majority.

5 Several years later, the tide has changed. In September 2017, Australia enacted a new regime imposing an automatic stay on the enforcement of *ipso facto* clauses when a company enters into any of the stipulated insolvency processes. More recently, in August 2018, the UK announced its intention to legislate against the enforcement of *ipso facto* clauses by suppliers of goods and services on the mere ground that a company has entered formal insolvency. It therefore comes as no surprise that in her latest round of reforms by way of the Insolvency Act (which has yet to come into force), Singapore joined the growing list of jurisdictions set to limit *ipso facto* protection.

Singapore

6 Under Section 440(1) of the Insolvency Act, upon the commencement of certain insolvency and/or restructuring proceedings (including applications for judicial management or a scheme of arrangement), counterparties are prohibited from terminating or amending any agreement (or any rights thereunder) or claiming an accelerated payment or forfeiture of the term under any agreement, by reason only that such proceedings have been commenced, or that the company is insolvent. However, counterparties are **not** prevented from exercising those rights in reliance of *other* contractual grounds, such as the company's non-payment or non-performance of its obligations. Further, the restriction is only suspensory, operating from commencement to conclusion of the proceedings (irrespective of their success), without terminating or extinguishing the counterparty's rights.

7 There are three other key features. First, nothing in Section 440 is to be construed as: (a) prohibiting a counterparty from requiring payments to be made in cash for goods, services, use of leased property or other valuable consideration provided after the commencement of the restructuring proceedings; or (b) requiring the further advance of money or credit (Section 440(2)).

8 Secondly, contracting out of the regime is prohibited. Contractual provisions that have the effect of providing for or permitting anything that is in substance contrary to Section 440 are "of no force or effect" (Section 440(3)).

9 Finally, to protect counterparties' interests, there are two in-built safeguards.

- First, under Section 440(5), six categories of contracts are exempted from the restriction. These include contracts relating to Singapore's national or economic interest, government licenses, permits or approvals, and any eligible financial contract as may be prescribed. At present, the legislation defining the "eligible financial contracts" has not been promulgated. However, Parliament has suggested that, similar to the position in the US, this exemption will likely cover repurchase agreements, swap agreements and forward contracts.
- Secondly, under Section 440(4), a counterparty may apply to the court for a declaration that the restriction does not apply, or only to a limited extent. Relief will be granted if the court is satisfied that the operation of the restriction would likely cause the applicant "significant financial hardship".

Canada

10 Singapore's approach is modelled on Canada's Companies' Creditors Arrangement Act ("**CCAA**") and hence, unsurprisingly, they share similar features. It is, however, worth noting some differences in the prescribed safeguards. First, on the exemptions, Section 34(7) of the CCAA only sets out two categories as compared to the Insolvency Act's six. The first is any "eligible financial contract", which the Eligible Financial Contract Regulations (Companies' Creditors Arrangement Act) defines as, among others, derivatives agreements; agreements to borrow or lend securities or commodities; repurchase, reverse repurchase or buy-sellback agreements relating to securities or commodities; and master agreements regarding the foregoing. This definition provides another indication of how Singapore may define the same term in her domestic legislation. The second exemption in Section 34(7)(b) provides that the restriction does not prevent a member of the Canadian Payments Association from ceasing to act as a clearing agent or group clearer. The Insolvency Act appears to contain no equivalent provision.

11 As to the second safeguard (i.e., the counterparty's ability to apply for relief), there appears to be no substantive difference between Section 440(4) of the Insolvency Act and Section 34(6) of the CCAA. Thus, any Canadian jurisprudence on what amounts to "significant financial hardship" should be of persuasive value in the Singapore courts.

US

12 In the US, the legislation imposing restrictions on the operation of *ipso facto* clauses is the Bankruptcy Code ("**Code**"). Notably, the organisation and phrasing of the Code's provisions differs significantly from both the Singapore and Canadian statutes.

13 The *ipso facto* prohibitions in the Code arise in two contexts. The first concerns the determination of property forming the debtor's estate. However, this article focuses primarily on the second context, which concerns the inability of counterparties to terminate or modify contracts solely on the basis of certain trigger events. Under the Code, the trustee or debtor-in-possession may assume or reject any executory contract or unexpired lease of the debtor. This is useful if the debtor has certain contracts which would be unduly onerous to perform while undergoing a restructuring. In this regard, Section 365(e)(1) provides that executory contracts and unexpired leases (or any rights and obligations thereunder) may not be terminated or modified solely because of any provision that is conditioned on the debtor's insolvency or financial condition, the commencement of a bankruptcy case, or the appointment of a bankruptcy trustee. Overall, this allows the trustee or debtor-in-possession to take advantage of favourable contracts by assuming them, and rejecting those that do not aid in the debtor's restructuring.

14 The exemptions to these *ipso facto* prohibitions are located in various parts of the Code and include, *inter alia*:

- Such executory contracts or unexpired leases if the applicable law excuses the counterparty from accepting performance from or rendering performance to the trustee or assignee of such contract or lease (Section 365(e)(2)(A)).
- Contracts to make a loan, extend debt financing or financial accommodations to or for the benefit of the debtor, or to issue securities to the debtor (Section 365(e)(2)(B)). This exemption does not extend to contracts that only incidentally provide for extension of credit, e.g., supply contracts providing for credit periods.
- Contracts found in the "safe harbour provisions", including securities contracts (Section 555), commodities contracts or forward contracts (Section 556), repurchase agreements (Section 559), swap agreements (Section 560) and master netting agreements (Section 561). Counterparties may exercise their rights to liquidate, terminate or accelerate these contracts as triggered by the company's insolvency or financial condition, or the commencement of a bankruptcy case. This is similar to Section 440(5)(a) of the Insolvency Act, which likewise exempts certain financial contracts from the general restriction.

Australia

15 Australia's restriction on the operation of *ipso facto* clauses came into force on 1 July 2018, and applies to contracts entered into on or after that date. The organisation and phrasing of the provisions of the Corporations Act 2001 differ significantly from the statutes described above, but their effect is largely similar.

16 By operation of Sections 415D(1), 434J(1) and 451E(1), a stay arises against the enforcement of rights against a company for the reason that it has entered into a scheme of arrangement for the purpose of avoiding being wound up, receivership or voluntary administration, or on the basis of its financial position while in one of these processes. This restriction does not affect a counterparty's ability to enforce rights that are premised on other contractual grounds, operates on a suspensory basis while the aforementioned processes are on-going, and cannot be contracted out of. Further, a company's ability to enforce its contractual right for a "new advance of money or credit" is stayed for the same duration (Sections 415D(9), 434J(8) and 451E(8)).

17 The exemptions provided for are notably different. In addition to exempted contracts (see the Corporations Amendment (Stay on Enforcing Certain Rights) Regulations 2018), there are also exempted contractual rights (see the Corporations (Stay on Enforcing Certain Rights) Declaration 2018). This means that even if the contract as a whole is not exempt from the stay, certain rights therein might be and thus remain enforceable.

- Exempted contracts include arrangements relating to national security; certain netting and close-out arrangements; and derivatives, agreements governing syndicated loans, securities financing transactions, flawed asset arrangements, margin lending facilities and covered bond arrangements.
- Exempted contractual rights include rights under a financing arrangement to change the basis of calculation of an amount (e.g., default interest); termination rights in standstill or forbearance arrangements; rights of set-off and to net balances; and certain step-in rights.

18 As an additional safeguard, the court may lift the stay if satisfied that it is “appropriate in the interests of justice” to do so (Sections 415E(1)(b), 434K(1) and 451F(1)) or, in the case of a scheme, if it was not for the purpose of avoiding being wound up (Section 415E(1)(a)). Alternatively, the court may order that one or more specific contractual rights remain enforceable (Sections 415F, 434L and 451G).

19 Notably, in response to these legislative changes, the Australian Branch of the Asia Pacific Loan Market Association in October 2018 published a document titled “New Riders for Syndicated and Bilateral Facility Agreements to Take Account of the Ipso Facto Provisions”, prescribing amendments to Australian law-governed facility agreements. These riders deal with the scenario where an “*ipso facto* event” has occurred in respect of a borrower (and the facility agent may be stayed from accelerating loans against it), and assists lenders by providing that the outstanding loans, accrued interest and other amounts may be accelerated *vis-à-vis* the guarantor on demand by the facility agent. (These riders have been updated on 17 May 2019.)

<u>UK</u>

20 As mentioned, the UK also intends to restrict the operation of *ipso facto* clauses in the restructuring and insolvency context. While the relevant legislation has yet to be published, the broad strokes of the regime can be gleaned from the August 2018 Government Response Paper. In summary:

- The restriction will not prevent suppliers from terminating on grounds that are unconnected to the company’s financial position, or the fact that the company has entered into a moratorium, restructuring plan or insolvency procedure.
- There will be at least two categories of exemptions: (a) certain financial products and services; and (b) licenses granted by public authorities.
- As a safeguard of last resort, a supplier may apply to court for permission to invoke an *ipso facto* clause on the ground of undue financial hardship. The court will consider: (a) whether, as a consequence of being compelled to continue supply, the supplier is more likely than not to enter into an insolvency procedure; and (b) whether exempting the supplier is reasonable in the circumstances, having regard to the effect of non-supply on the debtor company and its prospects of rescue. Thus, the threshold is high: a supplier will only be exempted if continued supply threatens its own solvency. It remains to be seen whether the “significant financial hardship” requirement in Section 440(4) of the Insolvency Act will be interpreted in a similar manner.

21 As can be seen, there is a high degree of convergence across various jurisdictions. Generally, the restriction on *ipso facto* protection in the restructuring and insolvency context is subject to the statutorily-prescribed exemptions, as well as the court’s discretionary power to grant relief. The intention is not to tip the balance in favour of the debtor seeking to restructure itself at the expense of third parties, but to ensure that the debtor is able to do so without one hand tied behind its back—which would be the case when counterparties to contracts that are crucial to the business elect to terminate those contracts not because the debtor has defaulted on performance, but because the debtor is facing

financial problems. These counterparties are not prejudiced since they remain fully able to terminate their contracts for events of default such as non-performance or non-payment.

The Section 440 regime in practice

22 Turning back to Singapore, so as to appreciate how Section 440 might operate in practice, consider a scenario involving Company A and Bank B. Suppose they have entered into a plain vanilla revolving credit facility ("**RCF**") agreement, which allows Company A to draw down at any time during the availability period of the facility, subject to the maximum commitment set by Bank B. What happens if Company A encounters financial difficulties and files for a scheme of arrangement?

23 To begin with, on the basis that none of the exemptions in Section 440(5) apply, Section 440(1) would prohibit Bank B from terminating or amending the RCF agreement or claiming an accelerated payment or forfeiture of the term thereunder by reason only that Company A has filed a scheme application. This means that Bank B would not be able to rely on, for instance, a clause defining the commencement of scheme proceedings as an event of default to terminate the RCF agreement. Unless Bank B can invoke other grounds for termination that are distinctly unrelated to the commencement of the scheme or Company A's insolvency (for example, non-payment of any amounts payable under the finance documents or breach of any other covenant), it must continue with its obligations under the RCF agreement until the scheme proceedings conclude.

24 Section 440(2)(b) further clarifies that nothing in Section 440 is to be construed as requiring the further advance of money or credit. This means that Section 440 does not itself impose a positive obligation on Bank B to perform by allowing Company A to draw down. Rather, parties will continue operating in line with the existing terms of the loan agreement regarding utilisation of the facility. That said, there would still be value in categorising insolvency and insolvency-like events as "defaults" in loan documentation, which in turn allows for the exercise of certain rights pegged to the occurrence of such "defaults". For instance, under typical Loan Market Association-style loan agreements, banks have the right to exercise a drawstop and prevent further utilisation of the RCF if "a default is continuing or would result from the proposed loan".

25 Now, consider an RCF agreement that provides that tiered maximum borrowing amounts are applicable, depending on Company A's leverage ratio as at specified testing dates.

26 Suppose that Company A's total borrowings (from Bank B and other banks) exceeds the prescribed borrowing amount for its leverage ratio bracket and its interest expenses concurrently increase to the extent that it cannot pay its debts as they fall due (i.e., Company A becomes insolvent). Can Bank B rely on the arrangement in the RCF agreement to "reduce" (i.e., seek prepayment of) Company A's outstanding loans?

27 Could such an arrangement be perceived as having the effect of providing for, or permitting the "amendment" of the RCF agreement or the "modification" of rights thereunder by reason only that Company A is insolvent? From the perspective that the purpose of Section 440 is to prevent counterparties from changing the existing parameters of their contractual relationship and thereby jeopardising any restructuring efforts, it may be that such an arrangement—which in effect seeks to "water down" the counterparty's contractual commitments to the distressed company—may be considered "in substance" contrary to Section 440. If so, then pursuant to Section 440(3), the entire arrangement will have "no force or effect".

28 On the other hand, such an arrangement is arguably not an "amendment" or "modification" of the kind envisioned by Section 440 given that the reductions are hardwired into the document at the outset and are scenarios which may occur independent of insolvency. The arrangement simply contemplates several different scenarios, and provides that a different set of rights and obligations should arise in each. In that sense, no "amendment" of the contract or "modification" of rights *per se* occurs by Bank B's invocation of rights that have already been expressly provided for in the contract.

29 Bank B could further argue that such an arrangement is not "in substance" contrary to Section 440 because it is not premised on Company A's insolvency, but instead on Company A's worsened leverage ratio. Leverage ratios are not directly tied to the company's solvency status. They also say nothing about whether the company has commenced a scheme of arrangement or judicial management. Section 440 therefore does not even enter the picture because Bank B is not invoking a contractual right on the basis of Company A's solvency status or entry into restructuring proceedings. To buttress this argument, Bank B must adduce sufficient evidence to prove that it is invoking its rights specifically on the basis of Company A's worsened leverage ratio.

30 Finally, on a macro level, a question could arise as to how the Section 440 regime would apply when issues of conflict of laws enter the picture. Suppose that both Company A and Bank B are locally-incorporated. Each is thus a "company" within the meaning of Section 440, defined as any corporation liable to be wound up under the Insolvency Act (Section 440(6)). If their contract is governed by Singapore law, then the Section 440 regime—being a part of Singapore's domestic statutory law—must apply. But what if their contract is governed by foreign law? Would Bank B still be able to rely on an *ipso facto* clause to terminate its contract with Company A? Strictly speaking, the enforceability of the clause should be determined in accordance with that foreign law. So, if there is no applicable restriction on *ipso facto* clauses under the foreign law, then nothing prevents Bank B from enforcing it. Notwithstanding this, if the issue came before the Singapore courts (say, pursuant to an exclusive jurisdiction clause), would the court prohibit Bank B from enforcing the *ipso facto* clause on the basis that to do so would be contrary to Singapore's public policy? Clarity on these issues is only likely to be provided through the development of Singapore's case law dealing with *ipso facto* clauses in both domestic and foreign restructurings taking place outside of Singapore.

A welcome development?

31 The consignment of *ipso facto* protection to a thing of the past may not necessarily be a thing to be mourned, and should perhaps be viewed as a way of bringing the legislative framework in line with business reality in today's world. With the global economic downturn and the cross-border impact of businesses facing liquidity problems and financial distress, the "knee-jerk" reaction of pulling the plug on a performing contract may not be commercially beneficial. A strategic and measured response to businesses that fail may better serve all stakeholders in the long term, and make for a healthier economic landscape.

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