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Singapore's restrictions on ipso facto clauses: what comes next?

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Guan Feng Chen and Jonathan Tang (Credit: Morgan Lewis Stamford)

Singapore's new restrictions on *ipso facto* clauses are welcome news to the local restructuring community, and a strong step towards establishing it as one of the region's premier restructuring hubs. But how will these restrictions affect innocent counterparties and existing commercial contracts, ask partner **Guan Feng Chen** and associate **Jonathan Tang** at Morgan Lewis Stamford?

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New restrictions on ipso facto clauses

By passing the Insolvency, Restructuring and Dissolution Act 2018 in November 2018, Singapore followed the path set by (among others) the United States, Canada, and latterly, Australia, in imposing legislative regulations on *ipso facto* clauses in insolvency.

Section 440(1) of the Act provides that, following the commencement and before the conclusion of any scheme of arrangement or judicial management proceedings by a distressed company, no person may (i) terminate or amend, or claim an accelerated payment or forfeiture of the term under any agreement with the distressed company; or (ii) terminate or modify any right or obligation under any agreement with the distressed company.

Section 440(3) of the Act further provides that, as of the date that the Act comes into effect, any provision in an agreement that allows the non-defaulting party to modify contractual obligations in contravention to the above is of no force or effect. This prohibition will have an effect on all contracts moving forward, even those that have already been entered into prior to the commencement of the Act.

Two legislative safeguards have been built into the Act to balance the contractual interests of stakeholders. First, certain types of contracts are exempted from these restrictions. These include, for example, (i) any contract that is a licence, permit or approval issued by the Government or a statutory body; (ii) any contract that is likely to affect the national interest, or economic interest, of Singapore; and (iii) any commercial charter of a ship.

The legislature has further included an exception for any "eligible financial contract as may be prescribed", granting it the option of extending exemptions to certain classes of commercial contract at a future date if necessary. The term "eligible financial contract" has not been defined in the Act. However, some clues as to what classes of financial contracts may eventually fall under this provision may possibly be gleaned from the corresponding Canadian rules set out in the Eligible Financial Contract General Rules (Bankruptcy and Insolvency Act). That Canadian law defines "eligible financial contracts" as being, among other things, derivatives agreements; agreements to borrow or lend securities or commodities; repurchase, reverse repurchase or buy-sellback agreements with respect to securities or commodities; margin loans insofar as they are in respect of a securities account or futures account maintained by a financial intermediary, and master agreements relating to the foregoing.

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The second safeguard contained in the Act is the "significant financial hardship" exception. This provides that any party may apply to the Singapore courts for a declaration that the restriction on *ipso facto* clauses does not apply, or applies to a limited extent, if the applicant satisfies the courts that the restriction would likely cause the applicant significant financial hardship.

The Insolvency Law Committee's report

It should be noted that Singapore's Final Report of the Insolvency Law Committee in 2013, which eventually formed the basis for the enactment of the Act, recommended against the adoption of such restrictions on *ipso facto* clauses.

The Committee recognised that there were obvious benefits to the local restructuring regime if such clauses were restricted. For example, if the enforcement of *ipso facto* clauses were restricted, key contracts of the company may be kept alive and all creditors would benefit. This would also reduce the bargaining power of key-contract holders, and incentivise management of distressed companies to seek restructuring earlier.

Balanced against this were concerns that the Committee raised, chief among them that existing counterparties would be locked-in to unfavourable contracts, and compelled to perform their contractual obligations even where there may be no hope of being paid. A second key concern raised by the Committee was that a legislative provision would be too encompassing, and not suited to regulating the myriad of contractual relationships that arise between counterparties to modern commercial contracts.

On balance, the Committee recommended that restrictions on *ipso facto* clauses not be imposed through legislation. In the time since the publication of the Committee's report, however, Australia imposed its own *ipso facto* regime, which came into effect on 1 July 2018; and the United Kingdom has indicated that it will legislate to prohibit the enforcement of *ipso facto* clauses in limited situations. Singapore followed suit.

Effect on existing commercial relationships

The Committee's concerns were legitimate. *Ipso facto* clauses on the insolvency of a contracting party are wide-spread and integral to modern commerce. The imposition of restrictions may result in unforeseen consequences on various classes of commercial relationships, examples of which we examine below.

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Financial institutions and suppliers

One example is the situation where the distressed company is a wholesale trader of goods such as oil. Such business operations commonly involve two significant contractual relationships: supply contracts between the supplier and the distressed company, and the grant of facilities from a lending institution, such as a bank, to the distressed company.

Without the ability for a supplier to terminate on the commencement of scheme or judicial management proceedings, the supplier will be compelled to keep performing its contractual obligations even though it knows that the distressed company is undergoing restructuring proceedings. While it may be the case that the supplier will eventually be entitled to terminate on the occurrence of other events of default, such as the inevitable non-payment of the consideration under the supply contract, the supplier could very well be out-of-pocket in the short term, without any possibility of recompense against the distressed company.

This would not be an issue if the lender to the distressed company would be similarly precluded by the same proceedings from honouring its obligations under the relevant facilities agreements it had entered into. However, such facilities agreements often provide for multiple events of default, which may be easily triggered and relied upon by the lending institution to terminate the facility; or are governed by the lending institution's terms and conditions, which commonly provide for the discretionary review of the relationship between the bank and the customer at any time (including terminating the facility even if there is no default, solely at the lending institution's discretion). It is therefore disproportionately easy for the bank, on the occurrence of an insolvency event, to disclaim its obligations under the lending agreement.

The consequences for the innocent supplier may extend beyond simply missing a pay day. The supplier has its own obligations to its own creditors, and the lack of incoming monies may result in severe disruptions to the supplier's own cash-flow and business plans, resulting in calls upon it by its own creditors (and domino insolvencies).

Group companies

On a narrow reading of the restrictions, the prohibition on the enforceability of *ipso facto* clauses apply solely to parties in contractual relationships with the distressed company.

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Commonly, businesses in a group organisation will have several subsidiaries operating under a holding company's umbrella. These subsidiaries manage the business or own the assets that constitute the business of the group.

Ipso facto clauses in contracts entered into by these subsidiaries often provide for the possibility of termination on the occurrence of an "insolvency event" by any affiliated or group company. This means that a group of companies seeking to rely on these restrictions would be required to commence scheme or judicial management proceedings in respect of each company it wishes to protect.

The Singapore courts have been generally receptive to "group restructuring plans" from affiliated companies in scheme of arrangement proceedings, and are happy to treat them as such. However, given the clear wording of the Act, it is unlikely that the Singapore courts would be willing to extend the restrictions to cover contracts between affiliated companies where these companies have not commenced their own scheme proceedings.

Similarly, it is not presently common for judicial management proceedings to be filed in respect of each company in a group. Management of the group companies is often seated at the holding company level, and the installation of judicial managers at that level is (in most situations) sufficient to allow the judicial managers to carry out their prescribed duties. However, unless each key contract-holder within the group is similarly placed under judicial management, the judicial managers will not be able to rely on these restrictions to prohibit the termination of key contracts that may be integral to the continued survival of the group as a going concern.

This means that the planning stage of the restructuring is of the utmost importance. It is crucial that the management of group companies carefully identify each key contract within the group's operations, and decide if there is a risk that these contracts may be terminated by virtue of existing *ipso facto* provisions. Thereafter, relevant proceedings would have to be brought in respect of each of these identified companies in order to take advantage of the statutory restrictions.

A race to commence alternative insolvency procedures

The restrictions only apply to companies that have commenced either scheme of arrangement or judicial management proceedings. However, *ipso facto* clauses are typically widely drafted – definitions of an insolvency event commonly include the appointment of receivers and managers over property, winding-up proceedings, the enforcement of any security by any third party, and the aforementioned judicial management and scheme of arrangement proceedings.

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Counterparties who have, therefore, decided that it would be commercially favourable to exercise their termination rights under *ipso facto* clauses may find it attractive to engineer the commencement of winding-up proceedings against the distressed company. Under most widely drafted *ipso facto* clauses, this would allow the counterparty to terminate the contract as this would constitute an insolvency event. The courts may well be inundated with winding-up petitions by counterparties seeking to get a jump on the distressed company's commencement of restructuring proceedings.

In rare circumstances, the petitioner may even dispense with the issue of a statutory demand. The potential value in being able to terminate obviously unfavourable contracts may well outweigh the forewarning such a statutory demand provides to the distressed company, and the difficulty or potential costs in litigating a contested winding-up.

Conclusion

The new restrictions on *ipso facto* clauses will render all present *ipso facto* clauses unenforceable. It is inevitable that many contracting parties would be affected by these restrictions. In the coming months, we expect that there will likely be a raft of renegotiations on existing contracts, which would include the addition of more airtight "event of default" clauses to mitigate the impact of the new restrictions on the right of contracting counterparties to terminate contracts in such insolvency events.

It also remains to be seen how robust the Singapore courts will be in interpreting the "significant financial hardship" exception. Will this be an objective test based on the balance sheet of each applicant, and how will the courts prescribe guidelines for these scenarios? How high will the bar be set? It could very well be that the Singapore courts will wish to retain the flexibility to adjust the ambit of this exception based on the individual circumstances of each applicant; the exact manner in which they accomplish this remains to be seen.

To conclude, we would emphasise that these restrictions on *ipso facto* clauses are in their infancy. Singapore's body of law on the scope of these restrictions has yet to be developed. In the meantime, contracting parties would be well advised to take stock of existing contracts to determine how these restrictions might affect their existing contractual rights.

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