

IT BYTES

ANSWERING YOUR COMMON IT CONTRACT LAW QUESTIONS

WHAT IS THE IPSO FACTO RULE?



WHEN DOES THIS QUESTION TEND TO ARISE?

You are in the midst of negotiations with a supplier for some business critical software. The supplier isn't one of the bigger players in the market but they offer a market leading software product for a specific function in your business. One of the protections you're relieved to have in the terms with the supplier is a termination right if the supplier is subject to an insolvency event, like voluntary administration, receivership or liquidation. However, your lawyers have mentioned that the termination right might not be able to be relied on in some cases and may in fact be unenforceable against the supplier even if one of those insolvency events happen. This is due to the 'ipso facto' rule. So when does the ipso facto rule apply and how can you protect yourself as a customer if it may apply?

WHAT DOES THE LAW SAY?

The term 'ipso facto' is a Latin phrase directly translates as 'by the fact itself'. An 'ipso facto' clause is a contractual provision that triggers a right to terminate or modify the operation of a contract simply because the counterparty becomes insolvent or specified insolvency related events occur affecting the counterparty, even if there has been no breach of the contract.

Under the ipso facto rule, certain contractual rights are rendered unenforceable against a company during a specified period after the commencement of certain types of insolvency events:

- voluntary administration;
- schemes of arrangements (to avoid insolvent liquidation); and
- substantial receiverships (where the receiver is appointed over the whole or substantially the whole of the property of the company).

The ipso facto rule is aimed at allowing the insolvent company to restructure successfully, preserve the enterprise value when entering administration, or otherwise sell the business as a going concern. The intention is to assist viable but financially distressed companies to continue to operate while they restructure their business.

The ipso facto rule applies to arrangements entered into on or after 1 July 2018 and novations or variations of pre-1 July 2018 contracts entered after 1 July 2023.

The rule applies for contracts for the supply of goods or services (for example, outsourcing agreements, software licence and maintenance agreements) and a range of other agreements and arrangements, subject to some specific exceptions (including software escrow arrangements that may be triggered when a software vendor goes into administration).

In addition, where the ipso facto rule applies, it will not render all types of contractual rights unenforceable. For example, step-in rights, set-off rights and assignment / novation rights are not subject to ipso facto protection.¹



WHAT ARE THE PRACTICAL IMPLICATIONS FOR YOUR CONTRACT?

If the contract you are negotiating is subject to ipso facto protection, rights of a counterparty to terminate or modify the operation of the contract only based on an insolvency event may be held unenforceable if challenged.

However, it is important to remember that the counterparty may still be able terminate for other breaches or defaults under the contract (for example, for non-performance or failure to pay debts when due). Other rights and remedies under the contract may also still be enforceable, including step-in rights.

If, as a customer, you are concerned about insolvency risk of your supplier, then drafting can be included in the contract which preserves rights which are triggered on other grounds, including non-payment and non-performance. The supplier should also have an obligation to notify the customer if it is subject to an event which may impact on its ability to continue to perform under the contract or to pay any amounts as they fall due. Similar considerations apply for suppliers who are negotiating these types of provisions with customers.

Including a right for a party to terminate for an insolvency event (which is typical in many services and software arrangements) will not in itself affect the enforceability of other provisions in the contract but you should be aware that (depending on the nature of the contract and the insolvency proceedings affecting a counterpart) it may not be possible to enforce the right as the sole grounds to terminate the contract.

¹ The complete list of the types of excluded contracts for the purposes of section 451E of the Corporations Act can be found in Regulation 5.3A.50(2) of the Corporations Regulations 2001 (Cth) and the complete list of the types of excluded rights can be found in the Corporations (Stay on Enforcing Certain Rights) Declaration 2018 (as amended).

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