REMEDIES OF SECURED CREDITORS APPOINTING A RECEIVER & MANAGER, THE CONSEQUENCES THEREOF, INCLUDING EXERCISING THE POWER OF SALE

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PREAMBLE

This paper is written in an environment of the author's experience of being besieged (usually as one of a number of defendants, the others include bankers who appointed me) with proceedings for wrongful appointment and failure to take care, selling at an under-value, mala fides, or any other injustice the debtor and his solicitors perceive has been perpetrated against the debtor. It is my prediction that as the Australian smaller business scene continues on its downward slide, these types of proceedings will proliferate. I do not believe that I or the creditors who have appointed me have been singled out any differently from the environment, possibly it is just our turn. My attention has however been drawn to the recent decision of Mr Justice Kearney in the New South Wales Supreme Court in Butler Pollnow Pty Ltd & Anor v. Garden Mews - St Leonards Pty Ltd & Ors which indicates that me and mine are not alone in our plight.

My intention in this paper is to promote awareness and caution and as a means of avoiding panic, rectification and defeat.

DEFINITIONS

DEBTOR: includes director of debtor company.

RECEIVER: includes Receiver and Manager.

BANKER: any secured creditor entitled by virtue of his security to appoint a Receiver.

DEBENTURE: includes all securities or charges over any asset which gives power to appoint a Receiver.

I begin with the banker's dilemma. He has a debtor who has committed what the banker perceives is an atrocity that if discovered by his superiors (whoever they may be) will cause him considerable aggravation. What does the banker do? The debtor

may be either, on the one hand, a charming dunce towards whom the banker is personally sympathetic or a raging lunatic whom the banker is petrified of, or someone in between. This may sound trite but it is important to categorise the debtor to enable appropriate strategies to be formulated.

The situation we are concerned with here is different from those where remedial management or intensive care or whatever you call it can be used. These remedies rely on co-operation from the debtor. The atrocity I refer to is a recalcitrant debtor - one who will not co-operate, etc or a situation where the debtor needs motivation from his unsecured creditors.

After considering and discarding for whatever reason the prospects of transferring either himself or the debtor to a faraway place, the banker, at this stage in a state of some frustration and annoyance decides upon the debt collector or his equivalent, the receiver. The effect of appointing a receiver over the assets of a business must be addressed earlier rather than later. By this I am referring to the damage that will result to the value of goodwill, work in progress or other assets which depend for the recovery of their cost, the ongoing business. Whilst the appointment of a receiver may not cause the termination of the business it does give persons dealing with the debtor the right to terminate their contracts and it causes the community to deal with the debtor as an entity with a serious, if not terminal, disability. The banker must decide if these so-called effects are a state which he will unjustifiably cause or whether the financial state of the debtor is such that they are either an unacknowledged fact or an inevitable event.

It is common practice in this enlightened age to seek legal advice when storm clouds loom. In the light of my preamble and what follows it is wise to check before proceeding further that the debenture is enforceable, that an act of default has taken place and to ascertain the formalities required to bring about the appointment of a receiver. A sound legal maxim to adopt at this time is "possession is 9 points of the law". The debtor has the bank's money and the bank wants it back. If the bank really does want its money back it must not allow its lawyer to paralyse the banker with fear of the consequences of taking positive action for recovery of the debt where the circumstances are not legally perfect. Is the bank happy to allow the debtor to use the bank's money to delay and defeat it or would he rather have its money back and leave it to the debtor to do the chasing?

No debtor will freely admit to an act of default or volunteer to surrender his business to a receiver (some have however abandoned them, taking no doubt as travelling and entertaining expenses some of the corporate assets for safe keeping). Some debtors have to be leant on and some must have it thrust upon them. Very rarely will a debtor even thank their bank for appointing a receiver.

My co-speakers may have covered the alternatives available, i.e. exercising power of sale, mortgagee acting by agent or merely coercing the debtor. I am not concerned with the alternatives in this paper, merely that they have been properly, legally and commercially considered and explored and that the proper decision is that a receiver must be appointed.

Having decided to appoint a receiver, our banker must decide upon what powers to give the receiver. What will he do, how much will he charge, will it be necessary for the receiver to be indemnified and if so, to what extent? When, who and how does the banker appoint a receiver?

Beware of anybody bearing gifts and particularly the debtor who comes to his banker with his friendly insolvency accountant in tow and asks for the same friendly insolvency accountant to be appointed receiver. Whilst it is good that the debtor has taken steps to resolve his own problems and better still that he has saved the banker from making the fateful decision and forcing implementation thereof, the banker should view any such plan critically to ensure that it will resolve the banker's problem.

In selecting the receiver and granting powers, I draw the attention of bankers to a clause which is common to virtually every debenture, having been taken (no doubt) from the various Conveyancing (or equivalent) Acts:

> "The receiver shall be deemed to be the agent of the mortgagor who alone shall be solely responsible for his acts or defaults".

What does this mean? I suspect that it was intended to relate to obligations incurred by receivers in the conduct of the administration and even possibly to distance the receiver from the mortgagee's obligations to take care. Does it however have the effect of imposing upon the receiver a duty of care to the debtor in priority to the obligations the receiver has to the banker who appointed him? This proposition may seem unfair to the banker who has extended a generous indemnity covering the receiver's remuneration.

Jim O'Donovan in the 1981 edition of his book "Company Receivers & Managers" in Chapter 10 canvasses this problem, referring to it as the receiver's "schizophrenic status". Jim quotes the authorities at that date which do not seem to identify a conflict which would prevent the receiver faithfully serving his appointor whilst at the same time complying with his obligations but he does sound a note of warning as to developments in this area.

As a practical matter, in many instances the assets which are the subject of the charge will obviously not realise sufficient to repay the bank and hence unless there are guarantors who are going to be called to make good the shortfall, what the receiver does is subject to the duty of care imposed by s.229 of the Companies Codes between him and the banker. However, in cases

where there are likely to be funds for the unsecured creditors or the guarantors will be called to contribute, it is my view that the duty of care imposed upon the receiver is greater than that of the mortgagee. As a lay person, I am scratching for an authority for this proposition other than Expo International v. Chant but I perceive that the modern law in this area is developing at a rate equal to the increase in the incidence of corporate failures and as so called insolvency experts are involved, it seems to me to be inevitable that an expert must have a heavy obligation to treat the debtor's property with proper respect or pay the price. Clearly where the debtor is in liquidation, the receiver becomes agent of the mortgagee and thereby inherits at the very least the mortgagee's obligations in relation to care.

This perception by a receiver as to an obligation to treat the debtor's property responsibly and with some respect may cause our anxious banker some further frustration. After all, the banker has gone to great lengths to assist the debtor and he has only as his last resort embarked upon a course of direct action to collect his debt. What more can be expected of a banker who is owed vast sums? Patience? Gordon Barton was reported to have said: "A gentleman never loses his nerve or his temper".

In addition to his delinquent debtor, our banker is faced with the prospect of employing as his weapon against adversity a receiver who has responsibilities to other persons and furthermore there is talk of indemnity. It is now appropriate for the banker to look again at the debtor and check for another way to refinance the debtor and the prospects of transfer.

On the assumption that he has no alternative our banker should now instruct his prospective receiver by conference on:

1. events leading up to present position;

2. debtors business and financial position;

3. the security and any limitations therein, including its composition and details of any guarantees;

4. the powers the banker proposes to give the receiver - or not give;

5. how the banker sees the receivership proceeding and his reporting requirements;

6. the indemnities the banker is prepared to offer.

It is important that this be by conference as these matters form the basis of the banker/receiver relationship. As far as the banker is concerned, he must fully emphasise his position and his expectations of the receiver and judge from the receiver's response to the problem and the banker's proposed solution, what the receiver will do. In the interests of protecting himself

from attack on that fateful day when he faces cross-examination from the debtor's evil counsel the banker must forget the antics of the debtor and remain objective and ensure that his receiver sets out with a proper perception of the problem and its solution. The receiver must also understand the banker's reporting and other requirements.

In relation to powers, these are usually contained in the debenture (unless the debenture specifically limits the powers to be given to receivers) plus those contained in section 324A of the Companies Codes. The powers prescribed by the section are all those a receiver would generally need including the power to use "a seal of the corporation" and to call uncalled capital where this has been charged. The Conveyancing Act of New South Wales is very restrictive and I should hope that this is not to be relied upon except for the collection of rents.

The indemnity. Remember Fitzgerald & Williams Pty Ltd v. Commercial Banking Co. of Sydney Ltd? Probably not, because the judge hearing the case became terminally ill and the matter was settled. The bank's receiver who did not have a written indemnity, claimed to be indemnified in respect of substantial liabilities incurred by him for which he was personally liable by virtue of section 188 of the UCA now section 324 of the Code. My point is that the receiver made serious errors of judgment but the evidence was inconclusive as to whether the bank had agreed to indemnify the receiver against the liabilities. These matters should not be left in doubt.

Contrary to what many insolvency practitioners might tell bankers a receiver is not entitled to an indemnity from the banker, either morally or by law. He is indemnified from the assets of the debtor. The receiver will seek an indemnity to protect himself against losses he may suffer as a result of:

(a) invalid appointment or an invalid debenture which results in an award against him for damages and costs, and his fee for acting and defending himself - in other words, damages flowing from the errors and omissions of the banker;

(b) there being insufficient charged assets to cover his remuneration and expenses;

(c) an inability to satisfy liabilities he incurs or for which he is found to be liable.

I submit that it is right and proper for an independent receiver requested to act by the bank to expect to be offered an indemnity against liabilities incurred as a result of (a). It follows that if the banker expects the receiver to carry out any task involving time and skills, he should negotiate a fee or quid pro quo. Whilst the debtor may have assets, the law covering statutory priority creditors, i.e., group tax, employees, etc., the incidence of redundancy payments, can be quite substantial.

Also the receiver has duties imposed on him by statute as well as those he inherits by virtue of being an officer of the mortgagor.

In relation to (b), bankers please note that the receiver's remuneration only has the same status in terms of priority as the bank's charge. Whether the banker indemnifies the receiver is however a matter for negotiation between banker and prospective receiver. Just remember the old maxim: "You get what you pay for".

Where however the debtor comes with his own receiver, the position is somewhat different in that it is often the debtor who is seeking to achieve some advantage for himself. The banker may not be privy to all aspects of the true position. In these circumstances, it is for the banker to decide what is appropriate. Where the banker asks a prospective receiver nominated by him to investigate and report and the prospective receiver recommends receivership, it is for the prospective receiver to convince the banker as to what is reasonable in the circumstances.

In the third instance (i.e. the indemnity against receiver's liabilities), the problem is more complicated and is a matter for negotiation between the banker and the receiver. Remember that the receiver is indemnified (if properly appointed) from those assets of the debtor which are not required to satisfy those creditors preferred by statute. If however the banker finds it necessary to request the receiver to take a course of action which involves incurring debts and which the prudent receiver determines is contrary to proper management of the debtor's affairs in the circumstances prevailing (e.g. complete a contract) it would be proper for the bank to indemnify.

Whilst banker and receiver will act with great care to guard against the mortgagor taking proceedings against them, some debtors are desperate men who will grasp at anything to defeat a banker. As I have said earlier one course which seems to be readily available to the debtor is to take proceedings for failure to take care or something similar against the banker, the receiver and usually both. The legal costs alone of such proceedings in a State Supreme Court are significant (about $10K per day) but when added to an appeal to a State Court of Appeal and the High Court a total of $100K+ is not unreasonable. Whilst the receiver and the bank may win with an award for costs, as defendants they must firstly fund their whole costs then recover only taxed costs, leaving them to bear the difference between taxed costs and the fees paid, then often the plaintiff is found not to have sufficient funds to reimburse even the taxed costs.

Apart from Expo v. Chant, which related to failure to take care, I now know only of Butler Pollnow (mentioned earlier) where a banker was found to have wrongly appointed a receiver. I do not know the extent of any damages being awarded against either banker or receiver for wrongful appointment. I am sure that

there have been actions and decisions and that many more have been settled.

I therefore conclude that it is not unreasonable to expect the banker to at least formally acknowledge that he will pay the receiver's legal costs in any such proceedings to the extent that they are not covered from the debtor's assets provided that the receiver is not found to have been negligent or equivalent.

In the face of the foregoing, considerable adversity, consideration and negotiation, our banker has now appointed his receiver. The banker and the receiver are firm friends linked in mutual loathing of the banker's debtor and are resolved that the receiver (who is totally and absolutely indemnified by the banker) will keep the banker fully informed in writing of all significant developments.

I referred earlier to what Jim O'Donovan called the receiver's "schizophrenic status". This is the time it comes into practice. Having joined a pact with the banker of hate and loathing, the receiver must now present the face of absolute reason and fairness to the debtor. The receiver must be careful not to align himself in any way to the banker, but all decisions and actions must be and must be seen to be those of the receiver except where the bank has clearly instructed the receiver to complete some project which will involve far more funds than the debtor has at its disposal.

So hopefully armed with all the relevant history of the loan, the default, the business and the assets of the debtor, our receiver is in a position to review the debtor's financial plight in an objective and informed way. Meanwhile the debtor is on the phone to his solicitor urging legal action for wrongful appointment, breach of contract, damages for ruining his business and then to the receiver, saying that the fool banker has just sabotaged a new financing package, the introduction of new equity or sale at some incredible price. Why is it then that when he actually conducts his review of the position our receiver finds that the scene goes something like this. The debtor can't pay the week's wages, the stock has been denuded of virtually all the popular lines, the contracts have been overdrawn, the builder is in the process of terminating the project, the major debtors have no intention of paying the amounts shown as they have paid all they owe and are disputing the other claims against them, the unions have lodged a log of claims including 8 weeks redundancy pay, the landlord, Telecom, the gas and electricity suppliers are all waiting to cancel supply, there is no costing system, and the books have not been written up for 9 months. Just to round things off there is $400K group tax due (equal to 1 year).

To digress for a moment on this point. When faced with these situations, I often wonder why it is that a banker's view of the debtor's business is the same as the debtor's notwithstanding that there is often no tangible evidence available to the objective observer to support viability. When told the true

position, bankers often become irritated to the point of becoming irrational and start to doubt the receiver. There is some defence which bankers, investors and other outsiders may call upon here in that the debtor has only an obscure legal obligation to run up the white flag embossed "This debtor is broke".

In fact it is a law of nature that "when the going gets tough, the tough get going". The debtor's variation of this is to create a position as they believe it ought to be. The obsolete stock is now antique, the bad debts and contracts will pay and come good (respectively), the project will be refinanced or sold because somebody expressed some superficial enthusiasm over a boozy lunch or we are just about to crack a super new contract. The debtor tells lies and the bankers and creditors find it convenient to believe him. I guess everybody becomes creative when things aren't going according to plan.

So, bankers please remember that where losses are being incurred unless the underlying financial strength in the form of capital and reserves is in the organisation or the banker becomes effectively the equity, the world will ultimately close in on our debtor as the creditors ultimately demand payment. When a deteriorating position is allowed to continue it will accelerate and more often than not, bankers and creditors will not act until it is too late and there is only one option left.

It is in this situation that the receiver enters amid cries of debtors and their solicitors threatening legal action for wrongful appointment and failure to take care. It conjures up a vision of suing a pilot appointed to guide the Titanic after it had rammed the iceberg.

Faced with the situation described, an uninitiated receiver may do one or more of a number of things:

1. Phone his solicitor who advises him to propound a scheme of arrangement.

2. Shut the doors and phone the auctioneer.

3. Tell everybody to remain calm as he is about to trade the debtor out.

4. Spend the next 3 months talking on the phone to the unsecured creditors about the scheme of arrangement he is creating.

5. Have his staff create the accounting records.

All of the foregoing, if conducted with flair, will generate sufficient evidence to protect the incompetent from successful legal action. These courses of action are almost guaranteed not to produce a result in the short term. A surprisingly large number of creditors seem to gain some relief from a bad situation

that remains unresolved - it must be the "whilst there is life, there is hope" syndrome.

What this "delaying" approach ignores is the effect of the continuing fixed costs - the interest, insurance rates, wages of people who are not generating income - every cost computed on time. The fact is that very few assets left unattended appreciate over time.

The decision to sell all or any of the debtor's assets, at what price and when, should (morally) rest with those that in fact own them - that is not necessarily the registered owner but the person that will receive most of the sale proceeds and pay most of the costs associated with holding these assets.

This comment includes a partly secured creditor for the assets which are his security, e.g. a lender with a charge over a specific asset who will claim against the general fund of assets for the shortfall on the sale of his security.

In my opinion it is not only business courtesy but defensive business practice that before a receiver embarks upon any course of any action, that he reports first to his banker then to the general body of creditors. If possible he should make every effort to make the debtor through its board aware of his proposed course of action even before reporting to the banker.

A receiver's reporting should be in writing setting out all available relevant material to support the conclusions reached. Depending upon the situation and circumstances, the volume of this report will vary considerably, and obviously the detail submitted to the banker will not be made available to the unsecured creditors. Invariably this material will not include the Report as to Affairs which the Companies Codes require the directors to prepare. This document usually takes forever to prepare, leaving the receiver to his own resources to compile the material needed to support the conclusion he reaches. The essence of this report is speed and sufficient accuracy to demonstrate the factual position, not voluminous detail. The report can, but will not necessarily include valuations of assets - it is initially intended to determine what if any action must be taken quickly to arrest a deteriorating position.

The report can become a blue print for the receivership and in this instance should be updated regularly. From this the banker can instruct the receiver of his requirements and the receiver can advise the banker of any problems associated with compliance.

Other creditors should be circularised with major creditors invited to attend an informal meeting at which the position, developments and alternatives can be discussed. Creditors will usually voice their violent disagreements thus warning the alert receiver of impending and potential legal actions. If possible and appropriate the debtor should be invited to participate in

the creditors' meeting. It is suggested that follow up circulars be issued where appropriate.

Not only does this procedure produce evidence to support a course of action, it communicates facts to creditors who seem to prefer to avoid facts and listen to rumour. By communicating legal action is often avoided, or at least the thrust blunted.

The debtor is often in a separate and difficult category. Invariably he does not want to know or face the truth - he would prefer to seek his own counsel. Every effort should be made to include the debtor in decisions or at least to warn him of what is to occur.

I personally find it very difficult to do other than to take positive steps to resolve or determine the situation in which as a receiver I find myself. This however quite often exposes the receiver to the proceedings that we are endeavouring to protect him and his indemnifying banker from. In such proceedings the banker and his receiver are faced with an adversary who is able to attack a situation with the benefit of hindsight - usually about 2 years hindsight - and say "What you should have done is this, or why didn't you do that?". The analogy of the Titanic can be used to demonstrate - what would our pilot do? Attempt to keep the ship afloat by driving it at full steam while he conducted repairs - the scheme of arrangement approach? Who knows, it might have worked - the captain didn't even try it. Save the furniture and fittings and the people by keeping the ship afloat longer, or simply abandon the ship and save some of the people - being the approach taken. Clearly the pilot should be sued by (a) the surviving passengers for discomfort and loss of possessions, (b) the relatives of the dead for loss of everything, (c) the owners of the ship for the loss of the furniture and fittings, and (d) the captain (who crashed the ship) for the loss of everything sufficient to cover any damages awarded against him for crashing the ship into the iceberg. I make no apology for this seemingly trite and silly story but I assure you proceedings that have been taken and are being taken are just as silly.

The receiver's task involves his finding out what amongst the assets and business is saveable and saleable by whatever means available to him, the realising by whatever means its optimum value. This includes in my opinion a determination of value using discounted cash flow, i.e. it is obviously better to realise $500K now than $1 million in 10 years.

In some cases it is necessary to continue to trade a business to complete contracts or attract buyers or even new finance or new capital. In these cases it is important to determine the extent of any losses being incurred and to take every possible step to minimise same. If the losses will exceed the benefits, a close down must be effected.

Here my audience may become divided. The lawyers amongst you are, or are about to become, restless because they have no disagreement with my preachings - they merely say, bring me the evidence, if you can demonstrate that you have carried out the steps you describe, your case is won. The bankers however tend to adopt the approach that if the loan is repaid in full, the end justifies the means. However, if the loan is not repaid - like our Titanic pilot - the receiver has failed.

Exercising a duty of care involves finding out quickly what and where the market is and introducing the property to it. In my opinion this includes determining the most appropriate means of offering it for sale - not merely adopting sale by public auction. I have had the opportunity of reading Mr Justice de Jersey's paper on this point, so do not propose to elaborate other than to say that professional skill and care are required. It is necessary to recognise that the viability of any project or business is publicly exposed to question and doubt by the appointment of a receiver. Receivership is seen by the community as an act of the last resort signalling that the debtor is done for. The receiver and the debtor should try to work together to restore some credibility to at least some area of the debtor's business and to isolate this from the cause of the financial default. Having offered the property to the market, how to complete a sale at the best available price? Should "moral" issues have a place in a receiver's dealings? Clearly a receiver has no mandate to break any law, particularly in relation to misrepresenting the property he sells. Can and does a receiver warrant title or quality of assets and businesses he sells? There is no simple answer except to say that the circumstances and the price paid will determine the extent of the warranties given. It is reasonably obvious that if a receiver cannot warrant title, he will not sell.

In relation to "moral" issues - when has a sale taken place? In an auction, is it the fall of the hammer, or is it when the contract is signed? In some instances the relevant laws cover the point, for example, is it possible to convey goods without a written contract? It would be a very rash receiver who sells without a written contract even when he simultaneously collects 100% of the purchase price. A receiver should (and in my view, must) make it absolutely clear that there is no "deal" until a formal contract is signed by both parties. In this regard, I do not favour "heads of agreement" because by definition they are only a "statement of intention" to enter into a contract covering the items listed - not a binding agreement. Whilst some legal minds disagree, I do not favour heads because a doubt is created - and receivers should avoid doubts and unresolved situations. It is an unfortunate practice but at times, buyers will force a receiver to conduct what has become known as Dutch auctions, to gazump buyers and to renegue on verbal agreements. The market place in which receivers often have to deal is dominated by the avarice of the buyers. The buyers will, whilst feigning respectability, be using every tactic available to them to obtain a bargain, whilst the receiver is to some degree defenceless

against many of the tactics used. For example, buyers at a plant auction have been known to conspire together to prevent competitive bidding. Whilst receivers do exercise vendor's rights to bid, real buyers can usually determine the real bid from the dummy and they will withhold bids to allow the property to be passed in, then set upon the receiver at bargaining prices knowing that interest and losses are being incurred and the matter is urgently in need of resolution. I suppose these experiences have led to the expression "liquidation (or receivers) sale" meaning a sale at which everything goes without reserve. However, for a receiver to allow the assets in his care to be sacrificed in any situation is in my opinion a failure to take the proper care.

CONCLUSION

Like the Boy Scouts, receivers must do their best, be seen to have done so, then prove that it was the best.

Having taken my audience through the foregoing convoluted machinations let me give bankers recommendations for the bad debt dilemma:

1. Act early where trouble signs become apparent. In this regard, acting early means let the debtor know your concerns both verbally and in writing. He must have every chance of refinancing or taking steps to rectify the problem. Set a deadline if appropriate.

2. Act decisively. Do not procrastinate or apologise or offer carrots or compromises.

3. Appoint as your receiver a competent professional who is independent. Do not accept someone who is not a professional insolvency expert because they claim industry specialisation. No one knows the debtor's business and it is vital that an insolvent business be independently and objectively re-assessed from the ground up, quickly, without any preconceived ideas about rescue or anything else.