MORTGAGEES IN POSSESSION VERSUS RECEIVERSHIPS

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INTRODUCTION

I have chosen as the main theme of this commentary a highlighting of the pitfalls that in the current litigious environment await lenders. It is of considerable interest to contrast the relative liabilities of receivers on the one hand and mortgagees in possession on the other.

In the time available I will look at three examples of such differential liability -

(a) the historical equitable obligation of mortgagees compared with a receiver's obligations;

(b) one of the statutory obligations imposed by the *Companies Code*;

(c) a potential tortious liability.

1. HISTORICAL

Mortgagees classically avoided going into possession because they knew this carried with it an obligation to "account". This obligation was known to mean not simply accounting for returns actually received but also those returns which would have been received but for wilful neglect and default. In the UK the duty of a mortgagee to a mortgagor has been recast so as to be a duty to take reasonable care in selling the mortgaged property to obtain true market value in the interests of the mortgagor (*Cuckmere Brick Co Ltd v Mutual Finance Ltd* (1971) Ch 949). This more onerous duty has not been adopted by the High Court (*Commercial and General Acceptance Ltd v Nixon* (1981) 38 ALJ 225).

A duty to take reasonable care has, however, been imported into Queensland law by s 85(2) of the Queensland *Property Law Act* 1974 which provides that it is the duty of a mortgagee "to take reasonable care to ensure that the property is sold at the market value".

The only other attempt by a legislature expressly to address the extent of a mortgagee's duty is to be found in s 77 of the Victorian *Transfer of Land Act* 1958. This section imposes on a mortgagee an obligation to sell "in good faith, and having regard to the interests of the mortgagor ...".

Mr Justice Murphy in *Goldcel Nominees Pty Ltd v Network Finance Ltd* [1983] 2 VR 257 held that the words "having regard to the interests of the mortgagor" required, at least, that the mortgagee took "reasonable steps to ensure that, at the time of sale, he is getting the best price then available for the mortgaged property ..." (at page 261).

This obligation falls short of a duty of care, however, and it may be that the section merely distils earlier judicial opinion (see Griffith LJ and Burton J, *Pendlebury v Colonial Mutual Life Assurance Society Ltd* (1912) 13 CLR 676) and that the obligation to have regard to the mortgagor's interest is merely one aspect of an emerging view of the content of the duty to act "in good faith" (see Menzies J, *Forsyth v Blundell* (1973) 129 CLR 477 at page 481, Aicken J, *Nixon*, supra at page 243).

The receiver on the other hand, appointed by a mortgagee, is almost invariably characterised as an agent of the company and as such agent cannot render the mortgagee liable. The receiver will typically have required an indemnity from his appointing mortgagee but that indemnity will however not typically extend to negligent acts.

Let us walk through an example which contrasts the position of a particular say, accountant, appointed on the one hand as the agent for a mortgagee going into possession and on the other as a receiver. Let us assume that such accountant then, through wilful neglect or default, fails to receive income from the property the subject of the mortgage. Where the mortgagee has gone into possession and appointed the accountant as agent, the mortgagee would seem liable to the mortgagor to account for the income which, but for such wilful neglect or default, would have been received. The mortgagee may well have an action against the accountant.

Where the accountant has been appointed as a receiver, he will be the mortgagor's agent - it may be that the mortgagor could hold the receiver liable for such forgone income which as its agent it could have been expected to realise. The mortgagor could not however go beyond the receiver to hold the mortgagee liable as the mortgagee in these circumstances would not owe a duty to the mortgagor.

Finally, the receiver could not turn to the mortgagee and hold the mortgagee liable for the extent of the receiver's liability to the mortgagor. True it is that the mortgagee will have given the receiver an indemnity in respect of liability arising from the receivership but the indemnity would not in normal

circumstances extend to negligent acts or acts of wilful neglect or default of the receiver.

The moral for bankers therefore, if you must appoint an accountant who is through wilful neglect or default going to denude a mortgagor of income otherwise receivable, ensure the accountant is appointed as receiver - do not appoint him as the agent of the bank as mortgagee in possession. The latter, as we have seen, could sheet home to the mortgagee liability to account for such forgone income.

2. STATUTORY

Now let us turn to one of the *Companies Code's* provisions of relevance and which John Spark has mentioned. It may be useful to indulge ourselves with a detailed consideration of its provisions.

Section 229

As John has said s 229 imposes four major statutory duties on an officer of a company:

- to act honestly;
- to act with due care and diligence;
- not to make improper use of information obtained in that position; and
- not to abuse his position.

Quite clearly, a receiver is an officer of a company because s 229(5)(b) includes within the definition of "officer" a "receiver, or receiver and manager". But is the agent of a mortgagee in possession included as such an officer? John notes that it is arguable that such an agent is so included. It may be helpful to consider in detail arguments tending to indicate that such an agent is not so included. Who knows, one day soon some of our banking clients may need us to be quite convincing on this point.

As we have seen, the definition of officer in s 229(5)(b) refers specifically to "receiver, or receiver and manager". Undeniably therefore s 229 applies to them. That sub-section goes on to refer to "any authorised person who enters into possession or assumes control of property of the company for the purposes of enforcing any charge". That seems fairly squarely to include the agent of a mortgagee in possession. Perhaps then there is no argument but that the whole of s 229 obligations must equally apply to the agent of a mortgagee in possession? True? False. Let us disaggregate the duties imposed by s 229.

Section 229(1) when describing the officer's duties refers to "the duties of his office". Now all the people specifically

named in s 229(5) are people who have been appointed to an office in relation to the company in which they owe duties beyond any duties owed to their appointors. Let us quickly tick them off: directors, secretaries, executive officers, office managers, liquidators and scheme administrators. What about receivers or receivers and managers? Typically such a receiver or receiver and manager when appointed by a mortgagee will be acting as agent of the company. Even where the receiver or receiver and manager is not declared to be the agent of the company (which is unusual) the receiver or receiver and manager will derive his powers from the charging instrument and the *Companies Code* and not by delegation from the appointor.

Consider then an agent for a mortgagee in possession - he derives his powers directly from the mortgagee and owes duties only to his appointor. His office is in relation to the mortgagee not the mortgagor. If this argument is correct then insofar as the various s 229 duties apply to an office of the company, then they will not be applicable to a mortgagee in possession. Of the four enumerated duties in s 229, three of the duties contain reference to "office"; it is only s 229(2) which contains no such reference. Section 229(2) prescribes a duty to exercise a reasonable degree of care and diligence. Notwithstanding that s 229(2) does not refer to "office" there is an argument that it may yet not apply to a mortgagee in possession. (Our quick historical skip through the obligations of a mortgagee in possession identified the obligation of a mortgagee in possession to account - and perhaps a higher obligation in equity to act in good faith). If s 229(2) were to apply to mortgagees in possession of the property of corporate mortgagors that would impose on a particular class of mortgagees in possession a higher duty than that generally imposed on mortgagees in possession - it is difficult to believe that such a substantive amendment to the duties of one class of mortgagees in possession would be made in such a casual distracted manner.

The provisions in the *Companies Code* s 229 have been reproduced in the *Corporations Act* 1989 s 232 with very little change. The same questions about the application of s 229 to a mortgagee in possession will arise under s 232.

There is still uncertainty as to the future form of companies and securities legislation - as to whether the presently operating *Companies Codes* or the *Corporations Act* will contain the legislation in the future. That uncertainty can only be resolved in the current working out of the compromise between the Commonwealth and the States. But whether it will be the Codes that continue or the *Corporations Act* being brought into force in 1991 the question whether a mortgagee in possession is an officer is likely to persist for some time.

3. TORTIOUS LIABILITY

Now let us consider relative liability of a receiver on the one hand and an agent for a mortgagee in possession on the other in the context of a particular tort.

The tort of inducing a breach of contract

A mortagor may be party to existing contracts which a receiver or mortgagee in possession may wish to see terminated.

Liquidators are given by statute the right to disclaim onerous contracts (s 454) but the *Companies Code* is silent on the position of receivers and mortgagees in possession.

Where there is a breach of a contract, by one party, the party not in breach has a contractual right to sue the party in breach for damages. Where a third party has induced the breaching party so to breach, the innocent party may also have an action against that inducing party namely, an action for the tort of inducing a breach of contract. Will that action lie differently as against a receiver when compared with a mortgagee in possession? It seems, fascinatingly, yes!

A receiver as we have seen, is characteristically the agent of the mortgagor company and indeed for this comparison, let us assume the receiver is such an agent. Let us take as an example that a mortgagor company breaches a contract with a third party which is in the nature of a service contract with a senior executive. The mortgagee decides the executive should go, no doubt having formed the view that the mortgagor's particular economic plight results from the executive's worst excesses. The receiver procures that the mortgagor breaches the service contract (eg. by failing to pay the executive's salary). The executive may well sue the mortgagor company for breach of contract. Can the executive also successfully sue the receiver? (He may have deeper pockets than the mortgagor). It seems not, as a person cannot be liable for the tort of inducing a breach of contract if that person acts as *agent* of the breaching party (the receiver is clearly agent of the breaching mortgagor in the example given). (*Said v Butt* [1920] 3 KB 497).

This underscores the wisdom of David Crawford's comment yesterday that financial advisers in workouts should see themselves appointed as agent of the company rather than as agent of the mortgagee.

But what of the agent of the mortgagee in possession? That person will not be agent of the mortgagor company which breaches the contract and as a result may well be liable for inducing a breach of contract. If the agent of the mortgagee in possession is liable, so too may the mortgagee in possession itself be liable as principal.

But there may yet be solace for the agents of mortgagees in possession and mortgagees in possession themselves. The tort of inducing a breach of contract was recently discussed in the 1988 English case of *Edwin Hill & Partners (A Firm) v First National Finance Corporation PLC* [1988] 3 All ER 801 which is useful to

consider in detail. That case identified the key attributes of the tort including that:

(i) there be direct interference such as persuasion, pressure, procurement or inducement which constitutes the wrongful act;

(ii) the interferer had knowledge of the existence of the contractual relations interfered with;

(iii) the interference was intentional;

(iv) the third party has suffered damage; and

(v) the interference was not justified.

That case interestingly considered what is fast becoming a familiar phenomenon in Australia - a work out or as the English describe it a "build out" arrangement. Let me quickly describe the facts and findings of that case.

In that case it had become apparent that neither the mortgagor nor the guarantor could pay the overdraft and accumulated interest owed to the mortgagee, First National, if the mortgagee called in the debt. The mortgagee, however, agreed to refrain from exercising its power of sale as mortgagee in possession or its power to appoint a receiver and to allow the mortgagor to continue its development project known as Wellington House, with continued finance from the mortgagee. A condition of this "build out" arrangement was the replacement of the architects for the project, Edwin Hill & Partners, by a more prestigious firm. The architects then sued First National in tort alleging the inducing of a breach of its contract with the developer of the project. The architects failed because First National was held to have an equal or superior legal right which provided a justification for its actions. It was accepted that had First National exercised its legal rights as mortgagee and sold the land or appointed a receiver, any interference with the developer's contract with the architects would have been justified. The Court of Appeal therefore reasoned that First National should not lose the benefit of this justification simply because it chose not to sell the land or appoint a receiver, but rather to agree to the "build out".

Thus, it seems, although theoretically a mortgagee is in more risk of liability for inducing a breach of contract where it is in possession through an agent, rather than where it has appointed a receiver, the "justification" defence may yet protect the mortgagee where it is in possession through an agent.

For safety's sake, however, where contractual relations of a mortgagor are to be interfered with, a receiver would appear a safer bet than a mortgagee in possession through an agent.

5. CONCLUSION

The examples I have given this afternoon demonstrate that a lender's liability differs depending on whether a mortgagee goes into possession through an agent or appoints a receiver.

That differential is important in today's environment in which borrowers are displaying considerable creativity.

In days gone by, a failed company would admit its mistakes, accept responsibility and take the rap.

In the current climate, there is a growing tendency for failed companies to look around for someone other than themselves to blame.

Typically, such borrowers zero in on the institutions which they believe have the deepest pockets.

Given this attitude, it is no wonder that banks are an obvious target. And it is no wonder that we are being a more litigious society.

What we are now seeing is a realisation by the banking community that it must match or surpass the creativity of those borrowers which choose not to play by the accepted rules.

In this context, the importance of analysing likely lender liability arising from different enforcement methods cannot be over-emphasised.