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Insolvency of Resources Companies: A Financier's Perspective

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SUMMARY

The focus of this paper is the position of a financier to a resources company in insolvency. The first part of the paper addresses the general legal considerations and assesses the various courses of action available to a financier upon the insolvency of a borrower. In particular, this paper analyses the remedies of receivership, voluntary administration, liquidation and informal workouts. The procedural requirements of each are discussed and particular issues that arise in their application are considered. For example, the paper looks at the risk of de facto and shadow directorships in the context of informal workouts and the proper appointment of a receiver. The paper then draws on the principles developed and seeks to apply them to various scenarios. For example, the position of a financier to a project company is considered, as is the effect on a financier of the insolvency of a participant in an unincorporated or incorporated joint venture. The role of the manager is examined in this context. Further, the effect and role of securities provided by parent companies are analysed in the context of insolvency. Finally the paper considers the factors that a financier should bear in mind when entering into the financing transaction, in order to protect its position in the event of the insolvency of the borrower.

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Appointment of a Receiver

Nature of remedy

The financier may appoint a receiver to manage and realise the security taken in respect of a debt. The right to appoint a receiver, most often derived from the security, usually arises following the occurrence of an event of default occurring under the security.[1] The court also has an inherent power to appoint a receiver on the application of a creditor who does not have such power pursuant to the loan documents or security.[2] A receiver is usually appointed as agent of the company rather than of the creditor.

It must be borne in mind that the replacement of the company management with a receiver and manager may have consequential effects on the company and may trigger events of default or termination events under project documents. Further, given the specialised nature of the industry within which the receiver and manager will be operating, the financier will have to take care in selecting a person with sufficient experience and knowledge of the industry.

The powers of a receiver are expressed in the security document or court order under which the receiver is appointed. Receivers are also granted extensive powers under the *Corporations Law*.[3] A receiver's powers usually include taking control of the company, carrying on its business and borrowing money on the security of its assets.

The receiver of a company or certain of its assets would have to decide whether a better return would be achieved by exercising the power of sale over the charged assets or by carrying on the business of the company.

A receiver is not normally liable for contracts entered into prior to the receivership.[4] However, a receiver is personally liable for debts incurred during the receivership in respect of services rendered, goods purchased or property used.[5] It is general practice for a receiver to require an indemnity from the chargee for any personal

1 *Canberra Advance Bank Ltd v Benny* (1992) 115 ALR 207.

2 Section 66, *Supreme Court Act* 1970 (NSW); s 37, *Supreme Court Act* 1986 (Vic); s 5(8), *Judicature Act* 1876 (Qld); s 29, *Supreme Court Act* 1935 (SA); s 25(9), *Supreme Court Act* 1935 (WA); s 11(12), *Supreme Court Civil Procedure Act* 1932 (Tas); s 26, *Australian Capital Territory Supreme Court Act* 1933 (Cth, for ACT); s 69, *Supreme Court Act* 1979 (NT).

3 See s 420 of the *Corporations Law*.

4 *Diesels & Components Pty Ltd* [1985] 2 Qd R 456.

5 Sections 419 and 419A, *Corporations Law*.

liability incurred in the conduct of the receivership except where that liability arises from the receiver's negligence, breach of duty or fraud. This indemnity will usually extend to indemnification for personal liability of the receiver incurring debts in the course of receivership for services rendered, goods purchased, or property hired, leased, used or occupied or any other contracts which are adopted or entered into in the course of the receivership. It may also extend to any liability of the receiver under environmental laws.

Any funds obtained by the receiver upon realisation of the secured assets will have to be used to repay certain obligations in priority to any payment to be made to the secured creditors.[6] To the extent that the charge is a floating charge, prima facie, the following persons have priority (in the order set out below) over the secured creditor's claims.

The Commonwealth of Australia

This priority subsists where the Commissioner of Taxation on behalf of the Commonwealth has given a direction under s 218 or s 255 of the *Income Tax Assessment Act* 1936 or s 74 of the *Sales Tax Assessment Act* 1992.

Employees' claims

This is relevant where an insolvent company's property available for the payment of creditors other than secured creditors is insufficient to meet the payment of employees' wages, superannuation contributions, sick leave and retrenchment payments. Pursuant to s 433 of the *Corporations Law,* these debts will have priority over the claims of the holder of a floating charge.

Procedural and timing requirements

1. The provisions of the security documentation will generally provide that on an event of default under the charge the chargee may appoint a receiver. It is important to ensure that this power of appointment is exercised properly. This is discussed in more detail below.
2. Where the facility is repayable on demand the financier must make demand on the chargor for money owing under the charge before the appointment of the receiver so as to render all moneys secured by the mortgage presently due and payable. This matter is discussed in more detail below.

[6] Section 433, *Corporations Law.*

3. A receiver will generally be appointed in writing by the chargee and will normally take possession immediately or a few days after the appointment depending on the facts and circumstances surrounding the appointment.
4. It is general practice for the chargee to provide the receiver with an indemnity for any personal liability incurred in the conduct of the receivership as discussed above.

Proper appointment of a receiver

Provided a financier has a contractual right to appoint a receiver, in deciding whether to exercise that right, it does not owe a duty of care to the company.[7] However, a financier may owe a duty as to the manner in which this contractual right is exercised.[8]

The appointment of the receiver must be justified by the terms of the agreement and will be invalid if an event stipulated for an appointment has not occurred.[9] If the appointment of the receiver is invalid, the receiver will be personally liable to the company in damages for trespass over or conversion of the property of the company.[10] This is discussed in more detail below.

The financier may also be held liable jointly with the receiver for invalid appointment of the receiver.[11] Alternatively, the financier would be liable under the express indemnity which it would usually be required to provide in favour of the receiver in relation to the liabilities of the receiver associated with the appointment and the administration of the receivership.

There is authority for the proposition that both the receiver and the financier will be held liable as constructive trustees to account for property which comes into their hands, if they have actual or constructive knowledge of the invalidity of the appointment.[12]

A limited form of relief is available under s 419(3) of the *Corporations Law* to a person who believes on reasonable grounds

[7] *Cryne v Barclays Bank plc* [1987] BCLC 548.
[8] *Shamji v Johnson Matthey Bankers Ltd* [1986] BCLC 278; aff'd [1986] 1 FTLR 329; [1991] CLC 36, CA.
[9] *Canberra Advance Bank Ltd v Benny* (1992) 115 ALR 207.
[10] *Re Goldburg (No 2)* [1912] 1 KB 606; *R Jaffe Ltd (in liq) v Jaffe (No 2)* [1932] NZLR 195; *Harold Meggitt Ltd v Discount & Finance Ltd* (1938) 56 WN (NSW) 23; *Rinbar Pty Ltd (in liq) v Nichevich* (1987) 11 ACLR 737; *Poignand v NZI Securities Australia Ltd* (1994) 120 ALR 237; *Re Simms; Ex Parte Trustee* [1934] 1 Ch 1.
[11] *Re Goldburg (No 2)* [1912] 1 KB 606; *Ford & Carter Ltd v Midland Bank Ltd* (1979) 129 NLJ 543; *Benny v Canberra Advance Bank Ltd* (1991) 5 ACSR 55; *Jesseron Holdings Pty Ltd v Middle East Trading Consultants Pty Ltd* (1994) 13 ACSR 455; *Pan Foods Company Importers & Distributors Pty Ltd v Australia & New Zealand Banking Group Ltd* (1996) 14 ACLC 698.
[12] *Rolled Steel Products (Holdings) Ltd v British Steel Corp* [1986] Ch 246; *Agip (Africa) Ltd v Jackson* [1991] Ch 547; *Eagle Trust plc v SBC Securities Ltd* [1992] 4 All ER 488.

that he or she has been properly appointed as a receiver. The receiver is relieved in whole or in part of any liability incurred by the receiver that would not have been incurred if properly appointed.

It is possible under s 418A of the *Corporations Law* to obtain a declaration that an appointment is valid on a ground specified in an application to the court or on some other ground. If a receiver has any doubt as to the validity of the appointment, it would be advisable to apply for such a declaration.

A failure to apply for such a declaration in these circumstances may make it difficult for the receiver to satisfy the court under s 419(3) of the *Corporations Law* that the receiver believed on reasonable grounds that it was a proper appointment. Moreover, a failure to seek a declaration under s 418A of the *Corporations Law* might in some cases persuade the court that the receiver had not made a case for relief under s 1318 of the *Corporations Law* on the grounds that the receiver acted honestly and ought fairly to be excused for negligence, default, breach of trust or breach of duty.

Consequences of improper appointment of a receiver

The company could seek an injunction to prevent an invalidly appointed receiver from acting as a receiver but the balance of convenience would probably favour an award of damages as the appropriate remedy.[13]

The company would possibly be entitled to the following types of damages for trespass and conversion.

Compensatory damages

The rationale of this head of damages is to ensure that the company is put in the position it would have been in if the wrong had not been committed. The attempt to restore the company to its original position by awarding compensatory damages would encompass compensation for property damage and economic loss. The general rule is that damages are assessed at the date of the breach, with an award of statutory interest (if available) compensating the plaintiff for not having received the damage at the date of the breach.

The court would also attempt to compensate the company for unlawful entry, wrongful sale and detention of its property and damage to its business.[14] Even if there is no evidence of specific monetary loss, the court may award more than nominal damages.

[13] *Galnom (No 8) Pty Ltd v G & L Warehouse Pty Ltd* (1991) 105 FLR 395.
[14] Ibid.

The fact that the company had operated unprofitably before the receivership is no defence. Nor is the difficulty of calculating the damage to the company's viability and trading reputation.

Nominal damages

Nominal damages may be awarded in recognition that a wrong had been done to the company even where no injury had been occasioned by that wrong.[15] These damages can be awarded in cases of trespass to land that causes no damage to the property.

Exemplary damages

Exemplary damages differ from ordinary damages in that the object of ordinary damages is to compensate and the object of exemplary damages is to punish and deter.[16] Exemplary damages can be awarded in actions for trespass to land,[17] trespass to chattels[18] and conversion.[19] However, a plaintiff will not be compensated for any loss that can be avoided by mitigation.

Aggravated damages

Aggravated damages are designed to compensate the plaintiff for increased loss rather than to punish the defendant (as is the case with exemplary damages).[20] Such damages have been awarded for trespass to land[21] and chattels.[22]

Consequential loss

Subject to general principles limiting the recovery of damages, all consequential losses of an economic kind are recoverable in an action for trespass or conversion.[23] In light of *Sellars v Adelaide Petroleum NL,*[24] the court may even be prepared to award damages to the company for loss of corporate opportunity as a result of an invalid appointment of a receiver and manager. The court will

15 *Jesseron Holdings Pty Ltd v Middle East Trading Consultants Pty Ltd* (1994) 13 ACSR 455.
16 *Gray v Motor Accident Commission* (1998) 73 ALJR 45.
17 *Schumann v Abbott* [1961] SASR 149; *XL Petroleum (NSW) Pty Ltd v Caltex Oil (Aust) Pty Ltd* (1985) 155 CLR 448; *Gazzard v Hutchesson* (1995) Aust Torts Reports 81-337.
18 *Pargiter v Alexander* (1995) 5 Tas R 158; *Private Parking Services (Vic) Pty Ltd v Huggard* (1996) Aust Torts Reports 81-397.
19 *Egan v State Transport Authority* (1982) 31 SASR 481; *Dymocks Book Arcade Ltd v McCarthy* [1966] 2 NSWR 411.
20 *Gray v Motor Accident Commission* (1998) 73 ALJR 45.
21 *Greig v Greig* [1966] VR 376.
22 *Private Parking Services (Vic) Pty Ltd v Huggard* (1996) Aust Torts Reports 81-397; *Makryllos v George Laurens (NT) Pty Ltd* (1992) 111 FLR 204.
23 *Egan v State Transport Authority* (1982) 31 SASR 481.
24 (1994) 179 CLR 332.

require clear proof that the invalid appointment caused the loss of the commercial opportunity. But in an appropriate case, the damages arising from an invalid appointment may be in excess of the secured debt. The court may award substantial damages for the company's loss arising from the forced sale of its assets by the receiver and the loss of future profits from the business.

Demand for payment

In the case of a facility which is repayable on demand, either in its terms or because no repayment time is stipulated, the financier must make demand on the chargor for money owing under the charge before the appointment of a receiver so as to render all moneys secured by the charge presently due and payable. This is not to be confused with the situation where the occurrence of an event of default entitles the financier to declare all moneys immediately due and payable and forthwith exercise its remedies, including appointing a receiver.

It is difficult to resolve the question of how much time is required to be provided to a borrower. Nevertheless, the authorities in Australia on this question give some degree of comfort for a demand permitting 24 hours as being a reasonable amount of time in which a borrower can repay a financier.[25]

Duties and obligations of the receiver

Notwithstanding that the appointment of the receiver is normally at the request of the chargee, the receiver will be acting as agent of the chargor unless such agency has been expressly excluded in the terms of the security document or by the chargee's behaviour. Accordingly, the receiver owes certain duties to the chargor which are enforceable by the latter directly against the receiver.[26] These include the duty to exercise the receiver's powers in good faith (including a duty not to sacrifice the chargor's interests recklessly); to act strictly within the conditions of the appointment; to account to the chargor after the chargee's security has been discharged not only for any surplus assets but also for the conduct of the receivership.

Where the receiver chooses to exercise the power of sale over the property subject to the charge the receiver must follow the duties as discussed below.

[25] *Bunbury Foods Pty Ltd v National Bank of Australasia* (1984) 58 ALJR 199; *Bank of Baroda v Panessar* [1986] 3 All ER 751 and *Cripps (Pharmaceutical) Ltd v Wickenven* [1973] 2 All ER 606, which does not appear to have been cited to the High Court in the *Bunbury Foods* case.
[26] *Expo International Pty Ltd v Chant* [1979] 2 NSWLR 820.

Exercising the power of sale

In imposing duties on the chargee in the exercise of the power of sale, the courts have attempted to balance the interests of the chargee (who desires to recover or protect its investment) and the interests of the chargor (who desires to retain its property or at least obtain the best return possible on sale). The burden of proof is on the chargor, or other person seeking to set aside the sale, to prove breach of duty by the chargee. The receiver's duty in exercising the power of sale is similar to that of the chargee exercising that power.[27]

Section 420A of the *Corporations Law* provides that, when exercising the power of sale, a receiver must take all reasonable care to sell the property for the market price, or if it does not have a market price then the best price that is reasonably obtainable having regard to the circumstances existing when the property is sold.

The intention behind this provision is to ensure that receivers do not sell property at a lower price than the best obtainable, simply because the sale would cover the debt of the chargee that has appointed them.[28] In order for a receiver to know the market price, it is usual for them to obtain independent valuations of the property and advice as to the appropriate method of sale. Section 420A also implicitly requires sufficient advertising to bring the property to the attention of prospective purchasers.[29]

Section 420A(2) provides that nothing in s 420A(1) limits the generality of s 232. Thus, if a receiver breaches the receiver's duty of care in exercising a power of sale, then pursuant to s 232(6B) of the *Corporations Law* the civil and criminal consequences of breach will apply.

Appointment of receiver by prior chargee

If a receiver appointed by a prior chargee is to exercise the power of sale, then certain issues arise.

A first chargee may exercise a power of sale without consent or concurrence of other chargees but must account for surplus proceeds (if any).

It has been held that any person interested in the proceeds of sale may seek the court's assistance if the power is exercised improperly.[30] As subsequent chargees are persons "interested in the

[27] Ibid.
[28] Corporate Law Reform Bill 1992 — Public Exposure Draft and Explanatory Paper (CCH, 1992), p 414.
[29] *Commercial and General Acceptance Ltd v Nixon* (1981) 152 CLR 491.
[30] *Jarrett v Barclays Bank Ltd* [1947] Ch 187 (CA) and *Clark v National Mutual Life Association of Australasia Ltd* [1966] NZLR 196.

proceeds of sale" the receiver's duties, discussed above, are also owed to subsequent chargees who may be prejudiced by an improper exercise of the power of sale.[31] In the *Alliance Acceptance* case, the third mortgagee made out a sufficient prima facie case to entitle him to an interlocutory injunction restraining the exercise of the power of sale in the manner proposed. The first mortgagee proposed to sell the land to the brother of the first and second mortgagee at a price far below its real value.

In *Tomlin v Luce*,[32] the second mortgagee took action against the first mortgagee who misdescribed the property and as a consequence the purchase price was reduced. The second mortgagee in that case was treated as being in the same position as a mortgagor.

Permitted purchasers

A chargee with a power of sale cannot sell to itself either alone or with others, nor to a trustee for itself even if the sale price is for the full value of the property[33] nor to anyone employed by the chargee to conduct the sale.[34] The basis of this rule is that a sale to oneself is no sale at all and cannot be authorised even if the price is the full value for the property. The interposition of a trustee for the mortgagee does not affect the substance of the transaction.[35]

However, it has been held that a sale to a related company of the chargee may, in certain circumstances, be a valid exercise of the power of sale.[36] This matter was considered by the High Court in *ANZ Banking Group Ltd v Bangadilly Pastoral Co Pty Ltd*[37] where a second mortgagee instituted proceedings against the purchaser of the property which was controlled by the first mortgagee. Where the relationship of the first mortgagee and the purchaser is so close the onus lies on the purchaser to prove that the sale is made in good faith.[38] In the *Bangadilly* case there was no independent bargain because the controllers of both companies knew what the prospective purchasers were prepared to pay and knew the reserve price. In addition, there was no local advertising (the property being outside metropolitan Sydney) nor advertising in Sydney where the auction was itself held.

31 *Midland Bank Ltd v Jolliman Finance Ltd* [1967] *Estates Gazette Digest* 612 and *Alliance Acceptance Co Ltd v Graham* [1974] 10 SASR 220.
32 (1889) Ch D 573.
33 *Downes v Grazebrook* (1817) 36 ER 77 and *Farrars v Farrars Ltd* (1888) 40 Ch D 395.
34 *Martinson v Clowes* (1882) 21 Ch D 857.
35 Per Lindley LJ in *Farrars & Farrars Ltd* (1888) 40 Ch D 395 at 409.
36 Ibid at 410.
37 (1978) 52 ALJR 529.
38 Per Atkin J at 541.

Conclusions

From the financier's perspective, there may be difficulty in establishing the market value of the shares and (especially in the early stages of a project or in the low part of the business cycle) that value may be significantly lower than the secured debt.

If the financier appoints a receiver to act as manager, then depending on the length of the project and the size of the debt, this may leave the financier exposed (under the indemnity) and indirectly involved for a significant period of time. Further, the financier may have a practical difficulty in locating a receiver and manager who has sufficient expertise and who is willing to act as manager for a significant period of time.

Further, if the financier appoints a receiver and manager, this may have other consequences for the company, in the sense that it may trigger cross defaults or termination events.

Workout

Nature

A company and its creditors may seek to enter into an agreement as an alternative to formal enforcement procedures. Statute law does not offer any help to a company and its creditors who enter into such an agreement. The agreement of creditors cannot be secured on a majority basis, because any creditor who does not agree will not be bound by an agreement entered into by the others.

To the extent that some creditors may not agree or where the size of their debts does not warrant their agreement, it may often be necessary to pay them out, failing which those signing could be exposed to the risk that another creditor will enforce its rights against the company which may bring about the collapse of the arrangement.

Procedural requirements

There are a number of preconditions to successfully implementing an informal arrangement. The more important of these are:

(a) a distinct willingness and commitment on the part of management of the company to facilitate an arrangement;
(b) the financier and the other participants perceiving some greater collective benefit in pursuing the possibility of an arrangement;
(c) the support of the major creditors to an arrangement. In appropriate cases this may require not only support to preserve

the status quo but a commitment and willingness to provide further financial support; and

(d) a willingness on the part of both management and creditors alike to the appointment of extra functionaries to watch over the affairs of the company such as a financial adviser and a task force of concerned and motivated creditors.

Documentation

Informal arrangements are usually recorded in a moratorium agreement between the debtor company and the major creditors. The moratorium agreement will include a freeze upon the rights of creditors and possibly an obligation on the part of creditors to maintain existing financial facilities to the company. It will impose certain obligations on the company and possibly require the company to revert to an additional functionary appointed to the company such as the financial adviser.

It will provide for a committee of inspection or a task force which will maintain a watching brief over the affairs of the company for all the other creditors. The functions of such a committee are to be informed of and enquire into the financial affairs and business of the debtor company for the purpose of making recommendations to the creditors at large.

The committee would also normally appoint the person who is to act as financial adviser. The responsibilities of that person are therefore to the committee. Among other things, the company would covenant to:

- provide the financial adviser with free and unrestricted access to all the financial and accounting records of the company;
- provide the financial adviser with all of the financial information of the company;
- invite the financial adviser to attend meetings of the directors; and
- enable the financial adviser to generally inform itself in relation to the business and affairs of the company.

The agreement would also contemplate the formulation of a plan for dealing with the assets of the company and would contain indemnities for fees, costs and expenses incurred by the financial adviser and the committee.

The risk of shadow directorship

There is a risk that members of the committee of creditors or a financial adviser may be characterised as shadow directors of the company.

Section 60(1) of the *Corporations Law* provides that a reference to a director in relation to a company, includes a reference to "…a person in accordance with whose directions or instructions the directors of the [company] are accustomed to act".

The purpose behind this provision is to ensure that those who control the conduct of a board of a company are required to undertake the obligations placed by the law on directors.[39]

The elements of a shadow directorship

The following elements of a shadow directorship may be distilled from the Australian and English cases on the issue:

Pattern of behaviour — In *Re Hydrodan (Corby) Ltd*,[40] Millet J was of the view that what is required to constitute a shadow directorship is "a pattern of behaviour in which the board did not exercise any discretion or judgment of its own, but acted in accordance with the directions of others".

The requirement for a "pattern of behaviour" or a "course of conduct" means that occasional instances of compliance will not be sufficient. The decision in *ASC v AS Nominees Ltd*[41] illustrates that the converse is also true. In that case, Finn J held that there was such a pattern of compliance and that the occasional exercise of independent judgment by the board did not excuse the shadow director.

It should be noted that this element does not require that the alleged shadow director provide directions or instructions on all matters. Rather, it requires that as and when the directors are directed or instructed, they are accustomed to act in accordance with those directions or instructions.[42]

Directions or instructions — It is not necessary to show that formal directions or instructions were given by the third party.[43] The provision is concerned with the ends rather than the means;

[39] It is important to note that s 60(2) of the *Corporations Law* contains an exception to s 60(1)(b) for persons who give advice in pursuance of their business relationship and that advice is regularly acted upon by directors.
[40] [1994] BCC 161.
[41] (1995) 18 ACSR 459.
[42] *ASC v AS Nominees Ltd* at 508.
[43] Ibid at 509.

substance over form. Nevertheless, it is necessary to adduce evidence of command or some instruction or direction that is generally followed by a compliant board.

Control — A shadow director must have influence over the entire board of directors, and not merely over an individual director or some of the directors.[44]

Intention to control — Whether a conscious intention to control a company through its board of directors is necessary to constitute one a shadow director is questionable.

This issue was indirectly considered by Hodgson J in *Standard Chartered Bank of Australia Ltd v Antico*,[45] whose judgment implies that it is not necessary to question the alleged shadow director's intention or motives. That is, if the ability to control exists and the evidence objectively shows control over the board then a court would be prepared to impose a shadow directorship.

Positive acts — The decision in *Harris v Shepard* [46] suggests that s 60(1)(b) will only be satisfied if the directors perform positive acts in accordance with the instructions of the shadow director. Where the directors simply do not act at all through forbearance or desistence, the person giving the instructions cannot be said to be a shadow director. However, the situation would be different if the instruction from the shadow director is a negative one (in which case desistence may well be a positive action).

Factors relevant to determining whether there is a shadow director

The facts and decision in *Standard Chartered Bank of Australia Ltd v Antico*[47] provide an insight into the factors that the courts see as relevant when applying s 60(1)(b).

Pioneer owned 42 per cent of Giant Resources Ltd and three of Giant's directors were nominees of Pioneer. Standard Chartered had granted a facility to Giant which was subsequently extended. When the facility was made available, Standard Chartered did not know certain facts (including that Pioneer had taken security over some of Giant's assets to secure advances made to Giant). Giant failed to repay the money it owed to Standard Chartered before it was wound up. The relevant issue before the court was whether Pioneer had been a shadow director of Giant.

[44] *Kuwait Asia Bank v National Mutual Life Nominees Ltd* [1990] BCLC 868.
[45] (1995) 131 ALR 1.
[46] [1971-76] ACLC 28614.
[47] (1995) 131 ALR 1.

Hodgson J found that Pioneer was a shadow director of Giant at the relevant time, and in doing so enumerated the following factors as relevant to his conclusion.

Effective control — It was relevant that Pioneer had effective control of Giant by virtue of its 42 per cent shareholding (and that the other significant shareholders held respectively 10 per cent, 6 per cent, and 3 per cent of shares).

Financial reporting requirements — Pioneer had imposed financial reporting requirements on Giant that were consistent with those required for the Pioneer group (including a monthly report and full access to records).

Management and financial control — Pioneer's decision to lend Giant $10 million was made on a number of conditions, including that Giant instruct outside consultants, that no new financial commitments be entered into without Pioneer's approval and that all payments were to be approved by Pioneer's finance manager.

Taking security — The decision to fund Giant on the basis of security provided by Giant, was effectively made by Pioneer and accepted by Giant.

Application of the shadow director principles to financiers

When a company is in financial ill health and a financier agrees to continued financial support, it is usual that some form of agreement will set out the conditions attached to this support. In this situation, although the relationship between the financier and the company is purely contractual (with the financier having no interest in the company other than to obtain its agreed rate of interest or return on capital), there may exist a degree of compulsion. Whether this environment of necessity is sufficient for the financier to amount to a shadow director must be determined on the facts of each case. Nevertheless, some general guidance may be gleaned from an article written by Millet J, and the decisions *Re PFTZM* [48]and *Standard Chartered Bank of Australia v Antico*.[49]

Millet J, an influential English judge, has made the extra-judicial suggestion that while a financier has no business in managing its customers' affairs, it is entitled to attach conditions to the continuation of its financial support.[50] Even though there may be some degree of compulsion in that the company really has no option but to accede to the financier's demands if it wishes to have financial

48 [1995] 2 BCLC 354.
49 (1995) 131 ALR 1.
50 (1991) 1 *Insolvency Practitioner* 14.

support, the ultimate decision as to whether to comply with the financier's conditions is left with the board. For this reason, Millet J believes that (provided the financier is not doing something that it does not normally do in telling the customer what it requires for continued facilities) the financier cannot be said to be one in accordance with whose instructions or directions the directors are accustomed to act.

In *Re PFTZM*, when the company was unable to pay its rent, it was agreed that weekly management meetings would be held concerning the trading of the business (which the company's financier attended). After two years of these weekly meetings, the company was liquidated. The liquidator contended that, through its involvement in the management meetings, the financier was a shadow director. The court disagreed, finding that the financier was not acting as a director of the company, but rather in the defence of the financier's commercial interests.

In *Standard Chartered Bank of Australia v Antico*, the financier was a controlling shareholder of the company in which it was held to be a shadow director. Importantly, Hodgson J made the following comment:

> "it is not uncommon for lenders to impose conditions on loans, including conditions as to the application of funds and disclosure of borrower's affairs; and it is even less uncommon for lenders to require security for a loan, and then to require the sale of property over which the security is given. Certainly, these factors on their own would not amount to assuming the position of a director, or taking part in the management of a borrower company".[51]

The risk of de facto directorship

A further risk to consider is that of a de facto directorship where persons, rightly or wrongly, conduct themselves as directors.

Section 60(1)(a) of the *Corporations Law* provides that a reference to a director, in relation to a company, includes a reference to "a person occupying or acting in the position of a director of the [company], by whatever name called and whether or not validly appointed to occupy, or duly authorised to act in, the position".

The assumption of the role of director is likely to be factually rather more obvious than the donning of the mantle of a shadow director but is a matter to which the financier must be alert, especially in relation to the activities of a financial adviser or other representative

[51] Ibid at 70.

or consultant who may work collaboratively with the directors and whom the financier has indemnified.

The professional adviser exemption in s 60(2) of the *Corporations Law* does not apply to a de facto director as opposed to a shadow director.

The risk of insolvent trading

The directors of the company may be exposing themselves to a liability under s 588G of the Corporations Law for permitting an insolvent company to continue trading under an agreement with its creditors. This liability would extend to any shadow or de facto directors. Amounts recovered by a liquidator for breach of s 588G must be used by the liquidator to pay out unsecured creditors.[52] A payment cannot be made to secured creditors out of those amounts unless all of the company's unsecured creditors have been paid out in full.

The risk of insolvent trading may be an incentive for the directors of the company to appoint an administrator (discussed below under the heading "Individual Shareholder in an Incorporated Joint Venture"). This is because the timely appointment of an administrator may in some circumstances constitute a defence to insolvent trading under s 588H of the *Corporations Law.*

The risk of voidable transactions

A financier may be no better off under the arrangements if it receives a payment on account which ultimately turns out to be a voidable transaction if the company is wound up.

Section 588FE of the *Corporations Law* provides that the following types of transactions are voidable by a liquidator within the following suspect periods prior to the commencement of the winding up:

Type	**Suspect period**
Insolvent transaction which is an unfair preference	6 months
Insolvent transaction which is an uncommercial transaction	2 years
Insolvent transaction for the purpose of defeating, delaying or interfering with creditor's rights on a winding-up	10 years
Unfair loan	whenever made

The definition of "transaction" in s 9 of the *Corporations Law* is very wide and includes transfers of property, making payments, incurring obligations and granting releases. Section 588FE also extends to acts done for the purpose of giving effect to a transaction.

[52] Section 588Y of the *Corporations Law.*

A transaction will be an "insolvent transaction" if it is an unfair preference given by a company or an uncommercial transaction of the company where at the time of entering into the transaction the company is insolvent or where the company becomes insolvent because of the transaction. The word "insolvent" means an inability to pay debts as and when they become due and payable.

Unfair preference

Under s 588FA of the *Corporations Law* a transaction is an unfair preference if it is a transaction to which a company and a creditor are parties and which results in the creditor receiving a larger number of cents in the dollar (in respect of unsecured debt) than it would have received in respect of the debt if the transaction were set aside and the creditor were to prove for the debt in the winding up of the company. As the financier and the other shareholders are secured creditors, any payment made to them in relation to their secured debt is unlikely to constitute an unfair preference.

Uncommercial transactions

Under s 588FB of the *Corporations Law*, a transaction is an uncommercial transaction if it may be expected that a reasonable person in the circumstances would not have entered into the transaction taking into account the benefits for the company, the detriments to the company, the respective benefits to other parties to the transaction and other relevant matters.

Essentially, the provision is concerned to prevent transactions which involve clear inequality of exchange (for example, the company receives insufficient consideration for its property). Section 588FB contains no specifications as to what is commercial and uncommercial. Rather, it focusses on issues of value and whether a party has received a bargain of such magnitude that it cannot be explained by normal or ordinary commercial practice.

Exceptions to voidability

In the event of the company going into liquidation, a transaction entered into during the suspect period would not be voidable as against another party, if that other party:

(a) entered into the transaction in good faith. Good faith would be absent if there were fraud or if there subsisted an intention on the part of the non-defaulting party to obtain an advantage vis a vis the other creditors of the company. A transaction entered into as part of the ordinary course of business would not of itself result in the inference that there was an absence of good faith;

(b) had no reasonable grounds for suspecting that the company was insolvent at the time when the transaction was entered into or would become insolvent if it entered into the transaction; and

(c) provided valuable consideration under the transaction or changed its position in reliance on the transaction. In this context the valuable consideration must be real and not colourable in the sense of being contrived or without substance.

Void dispositions

Under s 468 of the *Corporations Law*, any transaction into which a company in liquidation purports to enter is void if it is effected after the date of the winding up order referable to that company or (in the case of a voluntary winding up) after the date of the resolution for the winding up.

The risk of environmental liability

A further concern is liability for environmental breaches, including clean-up costs. The greater the degree of control which a financier has over the management of a borrower, the greater the risk that the financier or a person indemnified by it will face personal sanction for environmental issues relating to the borrower. This is particularly likely in the case of shadow directors (where they control the whole board), mortgagees in possession and receivers. For example:

- many environmental offences are drafted to punish the person who caused or permitted the relevant act, or is the occupier of the relevant property.
- numerous environmental statutes allow the relevant regulatory authority to prosecute a director of a company or person concerned with the management of the company if the company contravenes the legislation.
- under certain environmental legislation[53] an "appropriate person" may be liable for the costs of investigation and/or clean up of contamination. That appropriate person will be the "notional owner" if the polluter or owner of the land cannot be found, or cannot bear the relevant costs. The notional owner includes a mortgagee in possession but not a financier who is acting solely as the holder of a security interest in the land.

[53] For example, the *Contaminated Land Management Act* 1997 (NSW).

A financier could also have to indemnify the receiver or financial adviser it appointed where the receiver or financial adviser becomes personally liable for environmental problems while the borrower is in receivership. Consequently, the financier must carefully take into account the costs of any environmental problems when considering whether or not to enforce the project securities.

Conclusions

The advantages of an informal workout include:

(a) the continued existence of the company;

(b) the continued existence of the business and in particular where the liabilities of the company are deferred, barred or compromised the provision of a basis for the preservation of work in progress and the sale of the business as a going concern;

(c) possibility of less expense and consumption of time. The main costs in informal schemes are consumed largely in negotiations. Most participants bear their own costs. The documentation is often less formidable than that required for a formal scheme. The absence of formal statutory requirements tend to shorten the time for implementation;

(d) the arrangement is capable of being more responsive and flexible towards commercial demands and changes which may dictate alterations over a period of time; and

(e) a possibility of improving creditors' priority positions.

The disadvantages of an informal scheme include:

(f) uncertainty in the sense that not all creditors may be bound by the arrangements;

(g) creditors may be in no better position than they would be in a liquidation or receivership in the event of a collapse; and

(h) the risks of shadow or possibly de facto directorships, with the attendant risks of insolvent trading, voidable transactions and environmental liability, as discussed above.

Voluntary Administration

If a company is in financial difficulties, the directors of the company may appoint an administrator pursuant to s 436A of the *Corporations Law*. The directors are likely to take such an action if the company's solvency is questionable. This is because of the positive duty on directors to prevent insolvent trading under s 588G of the *Corporations Law*. The timely appointment of an administrator may in some circumstances constitute a defence under s 588H of the *Corporations Law* in proceedings for the contravention of that duty.

Nature

Part 5.3A was introduced into the *Corporations Law* in 1992,[54] in response to the recommendations made by the Law Reform Commission of Australia in their General Insolvency Inquiry Report.[55]

As courts have relied on the stated objects of Pt 5.3 as an aid to interpretation, it is instructive to set out the terms of s 435A, which says that the object of the voluntary administration procedure is:

> "to provide for the business, property and affairs of an insolvent company to be administered in a way that:
> (a) maximises the chances of the company, or as much as possible of its business, continuing in existence; or
> (b) if it is not possible for the company or its business to continue in existence — results in a better return for the company's creditors and members than would result from an immediate winding up of the company".

Procedure

First meeting of creditors

The administrator must convene a meeting of creditors within five days of their appointment.[56] The purpose of this meeting is to determine whether to appoint a committee of creditors and, if so, how this will be constituted.[57]

Enforcement of charge

If the financier has a charge over the whole or substantially the whole of the company's assets, then it may enforce the charge in the 10-day decision period from the appointment of the administrator.[58]

The term "the whole or substantially the whole" is not defined in the *Corporations Law* and there have been no reported judicial comments as to its meaning. Perhaps the interpretation of this phrase adopted in the United Kingdom will be taken in Australia. That is, that the phrase is adjudged from the point of view of the value of the company.[59] Alternatively, the test may focus on whether a chargee, if it were to appoint a receiver, could effectively control the company.[60]

54 Act No 210 of 1992, s 56. The Part came into operation on 23 June 1993.
55 The Law Reform Commission, *General Insolvency Report (No 45)* (Vol 1, AGPS, Canberra, 1988), Ch 3.
56 Section 436E(2).
57 Section 436E(1).
58 Section 441A.
59 Lightman and Moss, *The Law of Receivers of Companies* (Sweet & Maxwell, London, 1986), p 3.
60 Suggested by K Lightman, "Voluntary Administration: the new wave or the new waif in insolvency law?" (1994) 2 ILJ 59 and 61.

Similarly, if the cross charge constitutes a charge over the whole or substantially the whole of the company's assets, then it may be enforced within the 10-day decision period.

Administration period

After the first meeting of creditors and before the second (major) meeting of creditors, the administrator will investigate the financial affairs of the company and form an opinion on the possible courses of action open to the company.[61] During this period, the administrator has control of the company's business, property and affairs[62] and acts as the company's agent.[63] The company's officers cannot exercise any function except with the consent of the administrator.[64]

During the administration period, there is a moratorium on actions or proceedings against the company and its property, without leave of the court. This would operate to prevent, inter alia:

- the company from being wound up voluntarily;[65]
- a chargee from enforcing a charge over the assets of the company;[66]
- a lessor from recovering property which is being used by the company;[67]
- a supplier from recovering property which that supplier owns (due to a retention of title clause) which is being used by the company;[68] and
- the enforcement of any guarantees provided by (natural person) directors of the company or their relatives.[69]

The financier and the cross chargee could seek the court's leave to enforce their rights during the moratorium period.[70] However, the cases illustrate that, for the court to grant such leave, the applicants have to show that:

- they have an exceptional case;

[61] Section 438A.
[62] Section 437A.
[63] Section 437B
[64] Section 437C.
[65] Section 440A.
[66] Section 440B.
[67] Section 440C.
[68] Section 440C.
[69] Section 440J.
[70] Under the sections specified above.

- no prejudice would be caused by the implementation of the arrangement if leave were to be granted and;
- that their interests are not protected under the administration.

In *Re Grenadier Constructions (No 2) Pty Ltd (admin appointed),*[71] the court considered when the court will exercise its discretion to grant leave to enforce a guarantee. Williams J held that the circumstances would have to be quite extraordinary for the court to depart from the presumption underlying s 440J that a creditor ought not be able to proceed against the guarantor when the company is under administration. His Honour said:

> "there must be something which takes the case beyond the ordinary situation where there is a company in financial difficulties and the directors have given personal guarantees securing the debt in question. If all that the creditor has to show was that it had a good cause of action and that it would be denied the fruits of the guarantee if it were not granted leave, there would be no reason at all for requiring the Court to exercise a discretion".[72]

Such extraordinary circumstances existed in *Vital Finance Corporation Pty Ltd v Abor,* [73] where the company went into administration and executed a deed of company arrangement without the creditors' knowledge. The court held that it would be absurd in these circumstances not to grant the creditors leave nunc pro tunc.[74]

In *Stegbar Pty Ltd v Mayfield,*[75] the court focused on the positive obligation to show that the administration would not be prejudiced by the granting of leave. Williams J said:

> "I am not persuaded that if leave was given that it would not have as a necessary consequence the prejudice of the implementation of the deed of company arrangement which has been entered into. I would at least have to be positively satisfied that there would be no prejudice to the arrangement before I could grant leave."[76]

In *Osborne Computer Corporation Pty Ltd v Riddell,*[77] the court did not grant a party leave to disturb the moratorium, because their

71 (1994) 12 ACLC 460.
72 (1994) 12 ACLC 460 at 462.
73 (1994) 12 ACLC 973.
74 (1994) 12 ACLC 973 at 976.
75 13 ACSR 354.
76 13 ACSR 354 at 356.
77 (1995) 13 ACLC 1210.

interests were protected under the administration.[78] In this respect, if a supplier seeks leave to recover goods that are subject to a retention of title clause during the moratorium period, the court will consider that their interests are protected if the administrator provides an undertaking to put the amount of the cost of the relevant goods into a separate account upon their sale and to pay this amount to the supplier once the claim to the title has been accepted or established.[79]

It may be that the other shareholders could establish an exceptional case under the presently assumed facts, on the grounds that the failure to make the contribution may lead to the insolvency of the project company and the fact that the cross charge ranks ahead of the charge given to the financier.

Second meeting of creditors

The administrator must call the second meeting of creditors, within 21 days of their appointment, to decide the fate of the company.[80] When providing notice of this meeting, the administrator must give the creditors, among other things:

- a report about the company's business, property, affairs and financial circumstances;[81]
- a statement setting out the administrator's opinion (with reasons) about whether it would be in the creditors interests for the company to execute a deed of company arrangement;[82]
- if a deed of company arrangement (Deed) is proposed, then the administrator must provide details of it.[83]

The fate of the company, as determined by this meeting may be one of three things — that the administration cease; that the company be wound up; or that the company execute the Deed proposed by the administrator.[84]

If the creditors resolve that the company execute the Deed,[85] then it must in fact be so executed within 21 days or such further time as

[78] (1994) 13 ACLC 1210 at 1215. Note that during the administration period, the administrator has the power to sell goods that are subject to retention of title clauses, in the ordinary course of business. However, if the supplier demands the return of the goods and terminates the authority to sell the stock, then the administrator would not be able to sell the goods. This is because the suppliers demand would render such sale no longer in the ordinary course of business. The supplier would then have to apply to the court to recover the property.

[79] *Osborne Computer Corporation Pty Ltd v Riddell* (1995) 13 ACLC 1210.

[80] Section 439A(1),(5).

[81] Section 439A(4)(a).

[82] Section 439A(4)(b).

[83] Section 439A(4)(c).

[84] Section 439C.

[85] Section 444A(4) provides the requirements as to a Deed's contents.

the court allows.[86] Upon its execution, the administration comes to an end and the moratorium provisions are replaced by the provisions of the Deed.

Enforcement after the execution of the Deed

Sections 444D, 444E and 444F of the Law operate to establish a code, the broad aim of which is to ensure that the court has general control over proceedings in relation to matters concerning claims arising on or before the specified date.[87]

Section 444D(2) provides that a Deed does not prevent a secured creditor from realising or otherwise dealing with their security, except so far as:

- the Deed so provides and the creditor has voted in favour of the resolution to execute the Deed; or
- the court orders (under s 444F(2)) that the creditor not realise or otherwise deal with the secured property.

The court will make an order under s 444F(2) if it is satisfied that:

- for the creditor to realise or otherwise deal with the property would have a material adverse effect on achieving the purpose of the Deed; and
- having regard to the Deed, the terms of the order and any other relevant matter, the interests of the creditor will be adequately protected.

The application of s 444F(2) arose in *Hamilton v National Australia Bank*.[88] In that case, a condition precedent to the operation of the Deed was that a charge over all present and future property held by the bank be released. The bank did not vote in favour of the Deed and sought leave from the court to enforce it,[89] on the grounds that its interests were not adequately protected under the Deed (because if the company went into liquidation its return would be greater).[90]

[86] Section 444B.

[87] The Specified Date is the day that is required to be specified in the deed as the day (no later than the day when the administration began) on or before which claims must have arisen if they are to be admissible (s 44A(4)): *J&B Records Ltd v Brashs Pty Ltd* (1995) 13 ACLC 458 at 166; cited with approval in *Roder Zelt-und Hallenkonstruktionen Gmbh v Rosendown Park Ltd* 13 ACLC 776 and *Lam Soon Australia Pty Ltd (admin appointed) v Molit (No 55) Pty Ltd* 22 ACSR 169.

[88] 19 ACSR 647.

[89] Note that had the release not been a condition precedent the bank would not have had to sought leave, because enforcement of the charge would be extra-curial (see below).

[90] 19 ACSR 647 at 661-664.

The company argued that, as it had no remaining assets, the bank would not recover anything from its security if the company went into liquidation.[91] Therefore, it said that the bank's interests were protected by the administration because (unlike with a liquidation), it would "in common with all other creditors, receive a distribution, however small or even derisory it may be".[92] It further argued that if the bank enforced its charge the purposes of the deed would obviously be destroyed, because there would be nothing left to be distributed to other creditors.[93]

In considering the case before him, Lehane J noted that there were no Australian authorities on the matters that the court should bear in mind when deciding whether a secured creditor's interests are protected.[94] His Honour then considered some United States and United Kingdom cases, and concluded that:

> "in so far as the authorities indicate a reluctance to deprive a secured creditor of its proprietary rights or to sanction an arrangement which will cause those rights to depreciate substantially in value, that approach is, no doubt, equally applicable under the Law: it is unlikely to be the case that a secured creditor who, in a significant way, is deprived of its interest, or the value of its interest, without substantially equivalent compensation, is adequately protected".[95]

However, his Honour went on to say that, in respect of secured creditors, the relevant interests are those that derive from its interest in the company's property, and "if it is of no value, it may be that nothing would be required for their adequate protection".[96]

The decision in *Hamilton*, makes it clear that when leave is sought under s 444F(2) the court is faced with the very difficult task of balancing the rights and interests of the parties (both individually and collectively). In this respect, it is important to bear in mind that the burden of satisfying the court that an order should be made rests on the Deed administrator.[97]

By importing the standard of "material adverse effect", the first element of s 444F(2) requires the administrator to adduce weighty evidence as to the detriment caused to the purpose of the Deed.[98] This high standard seems reasonable, given that the creditors' proprietary interests and rights should not be restrained in other than

[91] This was because there was another chargee who ranked ahead of the bank.
[92] 19 ACSR 647 at 661.
[93] 19 ACSR 647 at 661.
[94] 19 ACSR 647 at 667.
[95] 19 ACSR 647 at 667.
[96] 19 ACSR 647 at 669.
[97] See *Hamilton v National Australia Bank* 19 ACSR 647 at 669.
[98] This is apparent from *Hamilton*, where the administrator attempted to show that the Deed could have no effect if the bank enforced its charge, because this would soak up all of the assets.

extreme cases. With respect to the second element, when reservation of title clauses are in issue and the order is made with respect to the owner of the goods, the court's decision would probably be based on whether the administrator had undertaken to pay the cost of the relevant goods which are sold, and whether the sale proceeds will be paid into a separate account.

Even if an administrator has not sought leave to restrain the creditor from commencing an action, s 444E(3) must be considered. This section provides that a person must seek the leave of the court, if that person wishes to:

- begin a proceeding or proceed against the company or its property;[99] or
- begin or proceed with the enforcement process in relation to the property of the company.[100]

This requirement is not waived in respect of creditors who have supplied goods subject to a retention of title clause, who may seek to argue that the relevant property is not the property of the company but, rather, that it is their property.[101]

From the above discussion, it seems that even if the relevant creditors do not vote in favour of the Deed and even if the administrator does not bring an action restraining them, before they can bring an action against the company to enforce their rights as secured creditors, there is a positive obligation to seek the leave of the court under s 444E(3). As to when the court will grant leave to commence proceedings, the discussion above may be relevant.

It is important to note that s 444E does not apply to the extra-curial or self-help rights and remedies.[102] In *Hamilton v National Australia Bank*,[103] Lehane J said that:

> "it is evident that the exception in subs 442D(2) to the binding effect of a deed on a secured creditor, and equally on an order under subs 444F(2), is directed towards the exercise of proprietary and contractual rights and powers that the secured creditor has under its security in relation to the property it

[99] "Property" is widely defined in s 9 of the Law. Section 444E(4) provides that "property" in the present context includes property that is used by or occupied by or in the possession of ABC.
[100] Section 444E.
[101] See *J&B Records Ltd v Brashs Ltd* (1995) 13 ACLC 458.
[102] *J&B Records Ltd v Brashs Ltd* (1995) 13 ACLC 458 at 466; *Roder Zelt-und Hallenkonstruktionen Gmbh v Rosendown Park Ltd* (1995) 13 ACLC 776 at 781; and *Lam Soon Australia Pty Ltd (admin appointed) v Molit (No 55) Pty Ltd* 22 ACSR 169 at 177.
[103] 19 ACSR 647.

affects…they are referring to steps that the creditor may take without the assistance of the court".[104]

Usefulness of the remedy

If the financier has a charge over all or substantially all of the assets of the company, then it may have an incentive to enforce this security during the 10-day decision period. This is because failure to enforce during this time will mean that the financier is then barred from taking enforcement action during the moratorium period. However, as has been illustrated above in the context of receivers, it may be quite difficult (and not fruitful) for the financier to enforce its security in any case, especially if the cross charge has priority.

If the other shareholders take action to enforce the security within the decision period, then the financier will probably seek to enforce its security as well. This is because, if there is enforcement over all or substantially all of the assets, there may be little point in any rehabilitation through administration.

Depending on the financier's understanding of the underlying financial state of the company, it may decide that the best course of action is not to enforce its security. This will allow the administrator to propose a deed of company arrangement, for the rehabilitation of the company, that may benefit the financier in the long run.

Liquidation

Nature

The financier may apply to the court for an order that the company be wound up in insolvency.[105] The court may grant the order if it is satisfied that the company is insolvent, that is if the company is unable to satisfy its debts as and when they become due and payable.[106]

A rebuttable presumption of insolvency is established if in the three months before the application to the court for a winding up order:

- the company fails to comply with a statutory demand (in essence, a demand served on the company by a creditor requiring that a debt of over $2,000 be duly repaid);
- execution of a judgment of a court against the company is returned unsatisfied; or

[104] 19 ACSR 647 at 666.
[105] *Moor v Anglo-Italian Bank* (1879) 10 Ch D 681.
[106] Section 459B.

- a receiver is appointed to the company, or a chargee goes into possession (personally or by agent), pursuant to a floating charge over the property of the company.[107]

During the time between the application to the court and the granting of the winding up order, a provisional liquidator may be appointed to the company to preserve the assets of the company pending the hearing of the winding up application.[108] Should this occur, the provisional liquidator may assume control from the directors although the directors do retain certain residual powers.[109]

Upon the granting of a winding up order, the court appoints a liquidator, who assumes control of the company.[110] The directors' powers are suspended. Contracts with the company are not affected unless liquidation is specifically identified as a termination provision under the contract. However, with the court's leave, the liquidator may disclaim a contract which is onerous from the company's viewpoint.[111] Except with the leave of the court, proceedings against the company (or its property) or enforcement processes against the company's property may not be commenced or continued.[112] Claims of a secured creditor are not affected by liquidation, provided the claims are valid against the liquidator.[113]

The liquidator must conduct an impartial investigation of the company's affairs and do everything necessary to increase the assets of the company available to creditors (including the setting-aside of "voidable transactions" and seeking compensation from directors for breach of duty). These assets are available for distribution to the company's creditors provided that they are not secured by a charge or lien or held under trust. They are distributed pursuant priority provisions contained in the *Corporations Law*.[114]

Usefulness of the remedy

It is difficult to perceive how the appointment of a liquidator maximises the return available to the company's assets. While liquidation may remove management from a company it should be viewed as the last alternative available after all the other options have been explored.

Apart from those identified above, it is possible to identify the following additional "downsides" of this procedure:

[107] Section 459C(2).
[108] Section 472, *Corporations Law*.
[109] Section 471A, *Corporations Law*.
[110] Section 472, *Corporations Law*.
[111] Section 568, *Corporations Law*.
[112] Section 471B, *Corporations Law*.
[113] Section 471C, *Corporations Law*.
[114] See Div 6 of Pt A 5.6 of the *Corporations Law*.

(a) inflexibility. The liquidator's conduct is dictated very much by the provisions of the *Corporations Law*;
(b) diminution in asset values. Liquidation often has the result that certain property rights of the debtor company are diminished by the existence of cross claims against the company;
(c) liquidation may enable other parties to agreements with the company and which are not otherwise in default to terminate those agreements with the company; and
(d) any licences held by the company as part of its business could also be subject to revocation or suspension.

CONSIDERATIONS ARISING FROM DIFFERENT PROJECT STRUCTURES

Single Project Company

If a single project company defaults under the loan to the financier, the options available to the financier are essentially those set out above. There is not the complication of the existence of a cross charge given to the other participants (see below). However, as the financier will be enforcing its security directly against the project company (rather than an investor in it), a number of other issues arise.

Trade unions

It can be expected that the relevant trade unions will be vitally important in any enforcement action taken by financiers from the point of view of any or all of:
(a) reduction of the labour force in the short-term;
(b) closure of the project with resulting loss of jobs;
(c) endeavours by the financiers to reduce the benefits currently held by the employees; and
(d) long term plans of the financiers, including the identity of any buyer and the employment record and labour relations record of any such buyer.

Historically, unions operating in the Australian resources industry have been prepared to take action to support their claims and, if the unions consider that the action taken by a financier would disadvantage a union member in same way, the unions would be unlikely to co-operate and may actively resist change. Financiers should consult the relevant trade unions during the course of any enforcement action.

Government

As part of any sale, the various mining or petroleum tenements, and any infrastructure agreements with government departments, would have to be transferred to the purchaser. A transfer of ownership of these could not take place without the approval of the relevant government minister or department. Further, depending on the nature of the project, it may be that the government takes an interest in any enforcement action from an employee relations and trade perspective. Financiers should consult the relevant state and federal government during the course of any enforcement action.

Public relations

Strict control should be maintained over the public disclosure of information taken relating to actions of the financiers. Such control will minimise the risk of allegations that the financiers have engaged in misleading or deceptive conduct or defamed any person. It may also assist in maintaining good relations with the relevant regulatory authorities and the government.

Financiers should consider:

- having all public announcements pre-vetted by their solicitors;
- whether a single person should be authorised to liaise with the press and regulatory authorities;
- whether a detailed list of potential questions that might be asked by the press, together with recommended responses, be prepared in anticipation.

Effect on project agreements and tenements

It will be vital to analyse the effect of the various options on the main project agreements and the project tenements, and particularly whether the appointment of a receiver would lead to terminability or other consequences, for example, posting of security, or whether payment or performance default would also be necessary to give rise to such things.

Careful attention would need to be paid to the position of long-term sales contracts. Where these are genuine long-term contracts with committed off-take amounts for many years the situation should be less delicate (but see below). However, when a true analysis shows the "long-term" contract to be only a frame contract (that is, the general terms and conditions applicable to shipments of product if actually ordered by the buyer in its discretion) or to reflect only a pattern of dealing made up of consecutive short-term contracts which are habitually renewed, the effect of the insolvency option on the relevant relationship needs careful consideration.

Crucial employees

The effect of the relevant option on crucial employees needs to be considered in advance and their retention suitably managed, bearing in mind that their importance may arise not only from skill and competence but also statutory requirements, for example, the need to have a registered mine manager under mine safety regulations if the mine is to continue to operate.

Sponsor support

Again care must be taken in respect of the continued availability of sponsor support where the project company, whether a special purpose vehicle or a substantial operating company, is nevertheless dependent on other members of the sponsor group for essential services, such as management, labour, accounting and information technology. In the last connection, the right to use mine planning, financial modelling, accounting and other software can be critically important.

Individual Participant in an Unincorporated Joint Venture

Single purpose vehicle

While the considerations in relation to a single project company will also be of general relevance in the case of an individual participant in an unincorporated joint venture (UJV), there will be a number of differences and in particular some important additional factors.

Joint venture agreement

The UJV is constituted by the relationship embodied in the joint venture agreement among the individual participants (JVA).

This is usually accompanied by cross charges under which each individual participant charges its project interest, product entitlement and sales proceeds in favour of each other joint venturer and the manager (see below) as security for compliance by it with its obligations.

The JVA will frequently have a number of other features to be taken into account:

- default by the individual participant in contributing to capital or operating costs of the UJV, as called for by the manager, may give rise to a dilution of the individual participant's interest so that its project share will equate to the proportion in which it has actually contributed to costs;
- such default can also give rise to an option for the other joint venturers to purchase the project share of the defaulting joint venturer at fair market value or some discount from it; and
- a sale of a project share by or on behalf of an individual joint venturer will be subject to rights of first refusal or pre-emption in favour of the other joint venturers and the outside financier will usually have been required to enter into a deed of covenant with them and the manager agreeing to observe those rights on the exercise of a power of sale by the financier or a receiver appointed by it, as well as acknowledging the priority of the cross charges among the joint venturers and the manager.

In turn this gives rise to a number of other tactical considerations for the financier and by implication the other joint venturers:

- clearly the cross charge only impedes the rights of the financier if there is some contribution default by the individual joint venturer and, in cases where the project itself is cash-flow positive, there is little point in the financier allowing the default to continue. More careful judgments will be required in the case of capital cost contribution default during construction or a re-run of the updated financial model showing only a later possibility or mild probability of excess revenue; and
- if the project is fundamentally good and the other joint venturers would be more interested in acquiring the defaulter's project share then enforcement of the cross charge by way of sale is unlikely because of the difficulty for the joint venturers of selling to themselves or affiliates, though the appointment of a receiver to control and apply cash-flows may well be attractive until contribution default is cured. After that the other joint venturers can wait to acquire the project share through the exercise of first refusal or pre-emption rights in relation to a proposed sale by the financier or a receiver appointed by it.

Management agreement or provisions

The JVA in a UJV, or a separate management agreement (MA), will provide for the appointment of a company as the manager. The company may be one owned by the joint venturers in their proportionate shares or it may be one of the joint venturers or its affiliate.

In either case the JVA and MA will provide that the manager has exclusive possession, control and management of the UJV assets, so there will be no opportunity for the financier or a receiver appointed by it to take over management of the project. Only management of the defaulter's individual position will be possible.

Another aspect of this is that the concerns about trade unions, crucial employees and sponsor support will generally be less relevant.

Substantial company with other assets

While the matters discussed in relation to a single purpose vehicle will also be relevant in the case of a substantial company with other assets, a further significant factor emerges in the context of a financier providing project finance, namely, that of administration.

As mentioned earlier, where an administrator is appointed by the borrower, a secured creditor can only step in and appoint a receiver having precedence over the administrator if that secured creditor has security over all or substantially all of the borrower's assets. If security is taken only over the assets of the particular project, the secured creditor's position is at risk of the borrower appointing an administrator with priority rights of management and control for the administration period, unless the court allows otherwise (see above).

To overcome this difficulty, the technique has been developed in the United Kingdom and adopted in Australia of creating a "featherweight" floating charge. Its main features are that:

- it is expressed to create a floating charge over all the assets of the debtor and may not be converted into a fixed charge;
- it crystallises only on, and becomes enforceable on, the appointment of an administrator;
- it may only be enforced by the appointment of a receiver;
- in the meantime the debtor is completely free to deal with the charged assets entirely at its discretion (including by the creation of prior ranking securities), and the secured creditor is obliged to provide any necessary ancillary consents, releases and priority concessions;
- the receiver appointed by the secured creditor is obliged to realise only the project assets and if it receives moneys from the sale of other assets under the featherweight floating charge it must account for them to security holders over the other assets or hold them on trust for the debtor.

If the debtor also has another project being financed by a separate financier it will presumably require a similar form of security. If it is as limited as above there may not be any need for any priority agreement between the secured creditors as neither will have recourse to the general assets of the debtor but will realise under its project-specific securities, which confer the appropriate priority automatically.

Doubts have been expressed as to whether a court would uphold a "featherweight" floating charge as effectively creating sufficient security for the purposes of s 441A of the *Corporations Law*. The position is untested in Australia but its validity has been recognised in England.[115]

Security over the equity in the project company

To provide an alternative method of realisation a financier may require security from the parent over the equity in the project company. In order to cover the complete "equity package" this needs to extend not only to all the ordinary and preference shares on issue but also the benefit of any loans made by the parent to the project company. It will normally take the form of an equitable mortgage of shares and an assignment of receivables by way of security. Again the issue of administration risk and a "featherweight" floating charge arises in connection with such a security.

Individual Shareholder in an Incorporated Joint Venture

Single purpose vehicle

The position is comparable with that dealt with above under the heading "Individual Participant in an Unincorporated Joint Venture" but in terms of the management of the project it resembles more closely the situation in "Single Project Company" above, where the project company owns the project, manages it and employs staff and labour (though management and consequently employment may be outsourced).

The JVA will be in the form of a shareholders' agreement and will contain first refusal or pre-emption rights in favour of the other shareholders.

The financier takes security over the individual participant's "equity package" in the project company.

[115] *Re Croftbell Ltd* (1990) BCC 781; see also Vintner, *Project Finance: A Legal Guide* (Sweet & Maxwell, 1995), pp 81-86 and Greig (1996) 7 *Journal of Banking and Finance Law and Practice*.

Substantial company with other assets

The position is analogous with that dealt with above under the heading "Substantial company with other assets".

Security over the equity in the project company

There is no similarity with "Security over the equity in the project company" above as this is the primary security, there being no security over the project assets themselves or an interest in them.

All Participants

Whether in a UJV or an incorporated joint venture, a financier who is funding all participants can override in the financing documents all priority rights of cross charges and first refusal or pre-emption rights, such that the position is similar to that of a single project company.

WHAT SHOULD A FINANCIER BE AWARE OF WHEN PROVIDING FINANCE TO A RESOURCES COMPANY?

In light of the foregoing discussion, it is possible to extract a number of factors that financiers should be conscious of when providing funding to a resources company. As a fundamental principle, the financier should negotiate the financing documentation on the basis that the borrower will become insolvent.

A thorough analysis of the various project agreements and project tenements must be undertaken to examine the impact of insolvency, particularly if it permits the counterparty to terminate, or suspend performance under, the document. That analysis should also extend to checking that all goods and services required for the project, and which are not easily replaceable, are the subject of long-term written arrangements. Direct deeds of covenant should be entered into with the counterparties who must notify defaults, allow cure rights for the financier and maintain performance in the meantime. As insolvency is not remediable in the ordinary sense, substituted performance must be treated as an adequate cure.

In order to help minimise risks associated with environmental issues, it would be advisable for a financier to:

- ensure environmental risks are properly identified before the financing is approved;

- have provisions in the financing documentation warranting environmental compliance and condition at financial close and each drawdown, and provide for the financier to receive regular environmental audits and information about significant environmental problems at the relevant facility; and
- ensure that the company's directors and managers exercise proper due diligence and control during the term of the facility.

The financier should ensure that under the security documentation the company has an obligation to provide it with relevant and complete information. This is critical for the financier to be in a position to make an informed decision as to its enforcement options. This is particularly important in the context of the voluntary administration regime, as the financier will have to make a decision within 10 days as to whether or not it will enforce its security. It will be very difficult to make such a decision (which would ultimately be based on the chances of rehabilitation) unless the financier has a complete understanding of the current difficulties facing the company and its possible future success. Similarly, the ability to form a sound view as to the underlying structural fundamentals of the company will be important for the financier in determining whether to initiate or participate in a workout.

Further, the financier should be in a position to know at all times whether its charge extends to all or substantially all of the company's assets. If it does, then the financier may have the option to enforce its security if the company is in administration, whereas, if the charge does not extend all or substantially all of the assets, then the financier will not have the ability to enforce once the administration has begun.

It is not enough for the financier to simply obtain information from the company. It should put in place systems for analysing the information that is provided to it during the course of the loan.

The financier should also know about how the business of the chargor operates so that if it does appoint a receiver and manager, that person is equipped with enough information so as to properly perform their role. This would encompass understanding the chargor's employee relations position and the terms of its critical contracts with third parties. Knowing the chargor's business may involve requiring the provision of certain strategic information on a regular basis and also inspecting the operations to see from a practical perspective what would be required to manage the business.

Finally, if lending to a shareholder of a resources company, the financier should seek to obtain a charge that ranks ahead of the cross charge. However, this may be difficult to negotiate in practice.

CONCLUSIONS

The ramifications of insolvency must be considered thoroughly at the outset to ensure that the best possible documentary structure is put in place. Insolvency should be treated as a real risk at this point.

Continuing account management should focus on the gathering and analysis of project information flows, as well as payment administration.

If insolvency arises the various options must be weighed carefully to ensure the best selection is made. Usually there will be enough time for this. Where the 10-day decision period in relation to administration applies, the only option in any case will be to appoint a receiver, following which a more leisurely review can be undertaken.

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