ALLEN & OVERY

Lender enforcement in Australia

Overview

Australia is considered a creditor friendly jurisdiction, and has developed an effective legal framework for lenders to recover debts owed to them by distressed borrowers. There are a wide range of out-of-court and 'self-help' options available to lenders, especially so for secured lenders. The purpose of this note is to provide a high-level overview of these enforcement options together with some practical takeaways.

In addition to a well-developed legal practice and procedure concerning lender enforcement, Australia has access to expert judges with substantial experience in restructuring and insolvency issues. This is complemented by a deep bench of local experts across the accounting, investment bank and selling agent professions.

This publication provides a useful guide to both unsecured and secured lenders looking to understand some of the potential recovery strategies or enforcement options available to them. In light of the current state of business in Australia, as a result from the outbreak of COVID-19, these avenues of recovery may become increasingly relevant as we approach the gradual winding-back of government support to businesses at the end of March 2021.

It is noteworthy that lender liability principles (such as environmental considerations and shadow directorship) are well established; however, detailed discussion on those principles is beyond the scope of this note.

Enforcement – secured loans

Appointment of an investigating accountant

When a business encounters financial or operating difficulties it may often breach its financial covenants under borrowing facilities provided by its creditors. While lenders may obtain financial information through an information request to the borrower, they may in some instances not have the relevant expertise or resources to assess and analyse the financial information for the purposes of determining the financial position of the borrower and the existence of any default. If lenders require assistance with analysing the financial information they have received regarding the borrower, they may appoint an Investigating Accountant (**IA**), who is usually a professional accountant with specialist insolvency and/or forensic experience. Depending on the scope of the engagement, the IA would typically conduct a thorough analysis of the financial records and prepare a report for the lenders to outline the potential issues of the company (such as the borrower's serviceability) and also determine if there is any default or breach of financial covenants.

Standstill and milestones as an informal option

When there is an event of default on the part of the borrowing company, the parties may nevertheless want to consider entering into a standstill agreement under which the lenders agree not to exercise their enforcement rights following the event of default within n agreed standstill period. In exchange, clauses that are more favourable to the lenders may be included in such agreements. For example, the lenders may demand a standstill fee, heightened information reporting, partial debt pay down, or even processes and milestones for a sale. In the midst of COVID-19, standstill agreements are becoming even more prevalent – though, the appropriateness of a standstill should be determined on a case-by-case basis.

Receivership

The most common method for a secured lender to enforce its security in Australia is through the appointment of a receiver or a receiver and manager to the secured property of the borrower. The process of appointing a receiver is relatively simple and can be done quickly; usually the terms of the security document will provide the right of the secured party to make the appointment of a receiver. In Australia, it is market practice for the receiver to be granted an indemnity from the secured lender in favour of the receiver during their period of appointment to the secured property.

However, while the appointment of a receiver to take possession of the secured property is a powerful tool for a secured lender there are issues that arise in circumstances where the debtor is also under administration. Section 440B of the *Corporations Act 2001* (Cth) (the **Corporations Act**), also known as the "statutory moratorium" provision, restricts the ability of certain secured lenders to enforce a charge on the secured property unless they obtain consent of the administrator or are granted leave from the court to do so.

Secured lenders with security over all or substantially all of the debtor's property are however exempted and are able to continue to enforce their security even when the debtor is also under administration. Other secured lenders are subject to the statutory moratorium against creditor action and are prevented from enforcing their security while the debtor is under administration.

If a secured lender has security over all or substantially all of the debtor's assets and wishes to appoint a receiver, it should be aware that certain time restrictions apply for making such an appointment, if, for example, the company has first entered into administration. If an administrator is appointed, the secured lender has 13 days from that appointment to decide whether or not to appoint a receiver.

Receivership can often be an attractive option to secured lenders because a receiver is generally answerable to their appointor only (subject to various statutory obligations such as payment of employee creditors from any realisation), which allows the secured lenders to control the enforcement process.

Voluntary administration

Under section 436C of the Corporations Act, it is also possible for a secured lender to appoint administrators to the debtor, provided that the secured lender has security over all or substantially all of the debtor's property and has a validly perfected security interest registered on the Personal Property Securities Register as enlivened under the *Personal Property Securities Act 2009* (Cth) (the **PPSA**).

As mentioned above, upon the appointment of an administrator, a statutory moratorium is in place which bars the enforcement of certain secured lenders and all enforcement actions of unsecured lenders. Additionally, upon entry into administration, secured lenders are prevented from relying on ipso facto provisions to modify or terminate their agreements with the debtor, unless an exception applies or permission from the court is granted or consent of the administrator is obtained.

The primary role of the administrator is to investigate the affairs of the debtor and propose a plan for the creditors to consider concerning the future of the company. There are three options that are available to creditors when voting at the second meeting of creditors of the company: (1) that the company be wound-up and liquidated; (2) that the company enter into a Deed of Company Arrangement (**DOCA**); or (3) that control of the company is returned to the directors (this option rarely occurs).

In contrast to the receivership option, a voluntary administrator needs to be impartial during their appointment and is required to act in the best interests of all creditors, including employee and trade creditors. This is one of the reasons why a secured lender holding security over all or substantially all of the debtor's assets may prefer to appoint a receiver to gain better control of the distressed situations.

A DOCA can be used as a flexible restructuring tool to recapitalise the borrower or to facilitate a sale of major assets of the borrower. Detailed discussion around the operation of a DOCA is beyond the scope of this note.

Interaction where both in receivership and administration

Where both receivers and administrators are appointed to a company, generally, the receivers will have control of the company and its property and have the ability to enforce against the secured property, including to exercise their power to sell the secured property. Concurrently, the administrators will deal with the claims of the remaining creditors through the administration process.

It is important to note that the statutory moratorium against creditor enforcement will also be afforded to the receivers as well as to the administrators during their appointment.

Creditors' scheme of arrangement

While not particularly common in Australia (in comparison with the United Kingdom), creditors' schemes of arrangements are becoming more widely used as a means of achieving a restructure where much of the debt held is secured (particularly with respect to multi-tiered capital structure). A creditors' scheme of arrangement is a formal court-sanctioned procedure under the Corporations Act which binds all creditors of the company and compromises their claims against the company. It is usual for a debtor to propose a creditors' scheme, but creditors also have the right to propose a creditors' scheme.

A creditors' scheme will not bind creditors unless they are expressly impacted. However, a creditors' scheme is binding upon minority creditors who do not vote in favour of the scheme in situations where the scheme expressly states that all creditors are impacted. In this way, it is possible that a targeted creditors' scheme can apply only to restructuring, for instance, senior secured loans.

For a scheme to be presented to the court for consideration, the vote must pass by a majority of creditors who represent 75% of the total amount of the debts and claims of creditors present and voting. If that vote is successful, then the scheme is presented to the court, which will then determine whether to approve the scheme or not.

The court's obligation in determining whether to approve the scheme is based on a number of factors. Generally speaking, this includes ensuring that all procedural requirements for the scheme have been followed and that the scheme would not be unfairly prejudicial to creditors or a particular class of creditors.

A creditors' scheme of arrangement is often used in an insolvency context where creditors (or a class of creditors) have determined that they will benefit from the company continuing in existence as opposed to being wound-up.

Mortgagee in possession

Under the *Real Property Act 1900* (NSW) (the **RPA**), a registered mortgagee of land governed by the RPA has a right of possession, provided the mortgagor is in default and the mortgage contains nothing to the contrary. To commence the repossession process following a default, a lender must serve on the borrower a written notice giving it 30 days to remedy the default.

For individual borrowers, a default notice under the National Credit Code is also required, which allows the borrower 30 days to remedy the arrears (unless an exception applies). Provided the necessary notice procedure is complied with and the borrower has not responded or remedied the default in 30 days, the lender can commence court proceedings for repossession of the land under the RPA. Where a court has issued a judgment for possession, the mortgagee is entitled to take possession of the property.

The *Conveyancing Act 1919* (NSW) (the **Conveyancing Act**) also provides for a mortgagee's right of possession. A mortgagee while in possession has the power to lease the land, which prevails over any other encumbrances and the mortgagor. The mortgagee is also entitled to, among other things, appoint a receiver over the income of the mortgaged property, sever and sell fixtures and sell any easement, profit à prendre, or any other right or privilege in relation to the mortgaged land.

In respect of a security interest over personal property, provided a financing statement in respect of that interest has been correctly perfected by registration on the Personal Property Securities Register (the **PPSR**) and the collateral in question is not excluded from the enforcement provisions under Chapter 4 of the PPSA, the secured party may be entitled to enforce the interest and seize collateral from the grantor. The secured party may also be entitled to appoint a receiver or receiver and manager (if provided for in the security agreement).

Mortgagee power of sale

Under the RPA, after taking possession in accordance with the procedure set out above, a lender may sell the mortgaged land (or any part of it) and all of the estate and interest in that land of the borrower either by public auction or by private sale (or both). The Corporations Act imposes a standard of care on the exercise of the power of sale in respect of a corporation's property. In such a situation, a "controller" must take all reasonable care to sell the property for not less than market value, or if it does not have a market value, the best price that is reasonably obtainable, having regard to the circumstances.

While the lenders are entitled to exercise their mortgagee power of sale themselves, it is more common in the market for them to appoint an appropriately qualified agent to conduct the sale process. This is to shield the lenders from unnecessary risks in connection with the sale, given that the agent is cognisant of the various statutory requirements and has the local knowledge to undertake the sale in an efficient manner.

Foreclosure

The Conveyancing Act confers on the mortgagee/chargee the power to sell or to concur with any other person in selling the mortgaged or charged property (known as foreclosure), or any part thereof, by public auction or private contract.

A statutory duty of care is imposed on a person exercising a power of sale under the Conveyancing Act: they must take all reasonable care to sell the property for not less than market value (if, when sold, the property has an ascertainable market value) or, otherwise, the best price that is reasonably obtainable, having regard to the circumstances.

Credit bid and debt/equity swap

A credit bid is the process by which a secured creditor takes control over the debtor (or the assets of the debtor) whereby most, if not all, of the sale proceeds are paid by way of a compromise of the secured debt owed to the secured creditor.

The use of credit bids is becoming increasingly common in the Australian market over the last couple of years. In some instances, special situation investors may acquire debts from existing secured lenders for below par and subsequently pursue a "loan to own" strategy through a credit bid in an insolvency-driven distressed sale process (whether through a voluntary administration/DOCA or receivership sale). The structuring of any sale of a distressed borrower often requires careful planning and would need to be conducted by independent receivers or administrators, due to the possible liabilities that may ensue should the sale not be achieved for market value. A court application may be required in some cases.

Enforcement options – unsecured loans

Statutory demand

A statutory demand is an instrument served by the lender on the debtor company, requiring payment of the debt set out by no later than 21 days after service has been effected. Failure on the part of the debtor to comply with the statutory demand within the prescribed timeframe provides a basis for the lender to make an application to the court for a winding-up order. This made the statutory demand relatively lender friendly with such a short timeframe for compliance with the demand, noting also that it is generally inexpensive to prepare one.

Winding-up petition (including for foreign companies registered here) and liquidation

As a result of a failure for a company to comply with a statutory demand, a creditor of a company may apply to the court for an order winding-up the company in insolvency. In order for such order to be made, the company must be insolvent in the first place (which is assumed as a result of the failure to comply with the statutory demand), that is, the company must be unable to pay all debts as and when they become due and payable.

A court will and must presume that the company is insolvent if, during or after the three months ending on the day when the application was made: (1) there is a failure to comply with a statutory demand as discussed above; or (2) there is an unsatisfied writ of execution; or (3) a receiver has been appointed. In issuing a winding-up order, a court will also consider the commercial reality in light of all the circumstances along with the whole financial position of the company and all of the sources of funds. It is notable, however, that a temporary lack of liquidity is not insolvency.

Court proceedings against individual guarantors

A guarantor is a person that promises to the lender to repay the loan if the debtor refuses or fails to do so. In order for the guarantee to be enforceable, it must be given prior to or at the time the loan is made, unless the guarantee document is in the form of a deed. If the guarantee is procured by fraud, duress or any undue influence, or fails to comply with the requirements created under the National Credit Code (being Schedule 1 of the *National Consumer Credit Protection Act 2009* (Cth)), the guarantee may be avoided or unenforceable.

To enforce the debt against a guarantor, the guarantor must have been given a default notice and such notice remains unpaid. Lenders may then commence proceedings in a competent court in Australia, the jurisdiction of which will depend on the governing law of the guarantee as well as the quantum of the claim. For a debt that exceeds A$750,000.00, the proceedings must be commenced in Federal Courts of Australia or Supreme Courts of the States and Territories.

Other court enforcement mechanisms against companies and individuals

There are also other various court enforcement measures against both companies and individuals. These provide for a writ of execution against property of the debtor, garnishment of a third party for debts due by the debtor and examination of the debtor. While these mechanisms remain available to those looking to enforce their debt, use of these mechanisms is not common, especially against corporate debtors.

Various cross-border recognition of foreign debt judgments

In general, the recognition and enforcement of foreign judgments in Australia can be made under either a statutory scheme or common law principles. The statutory scheme is a more straightforward route for enforcement, though the applicability of that is dependent upon the jurisdiction in which the foreign judgments were obtained.

The *Foreign Judgments Act 1991* (Cth) (the **FJA**) provides a statutory scheme for the recognition and enforcement of foreign judgments that are enforceable in the Court in which they were made and have not already been satisfied in the foreign jurisdiction. This scheme only applies to specific countries that have entered into reciprocal arrangements with Australia, including the UK, Singapore, Italy, Germany, France, Korea and Japan, but does not apply to China, the US and India (among others). To be enforceable under this scheme, the judgment must be handed down by a superior court of a specified country (with some exceptions) and less than six years old. Such judgments must also be final and conclusive and require the payment of money. Similarly, a foreign arbitral award that is enforceable in a foreign jurisdiction can also be enforced in Australia under the statutory scheme.

In order to register a foreign judgment, an application needs to be filed in the Supreme Court of a State of Australia. Registration applications are typically made in the absence of another party. The Australian court is obliged to register the judgment if it satisfies the formal requirements prescribed in the FJA. The judgment debtor must be served with notice of the registration after the judgment has been registered.

For completeness, the enforcement of New Zealand judgments in Australia is regulated by the *Trans-Tasman Proceedings Act 2010* (Cth), which adopts a similar process as mandated under the FJA.

If the statutory scheme is not available, a lender can enforce a foreign judgment in Australia under the common law principles. Under the common law scheme, the judgment must have been made by a foreign court with an international jurisdiction that the Australian courts recognise. The judgment must also be final and conclusive and be for a fixed amount of money (with some exceptions). If the debtor raises a defence on the basis that the foreign judgment was obtained by fraud or contrary to Australian public policy, the lender will then need to commence proceedings in an Australian court to enforce the judgment.

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When considering which recovery or enforcement strategy best suits the lender's situation, it is prudent to engage with legal advisors early where a distressed situation has arisen. This enables the lender to best consider the available options and take prompt action to implement any recovery or enforcement strategy.

Allen & Overy can assist clients in analysing the situation and prepare and devise an appropriate restructuring plan and/or enforcement strategy from a lenders perspective from the outset. Engaging early with legal advisors can result in maximising recovery and protecting the interests of the lender.

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