Ernst & Young (Reg) v Tynski Pty Limited (ACN 008 162 123) (Receivers and Managers Appointed) [2003] FCAFC 233: Directors versus Receivers: the Battle Continues!

Lynden Griggs, Senior Lecturer in Law, Faculty of Law, University of Tasmania, Australia

Introduction

The appointment of a receiver or receiver-manager has been described as having an 'anaesthetizing effect upon the management structures of the corporation.'[1] In effect, the powers of the directors will be suspended.[2] By contrast to the rather limited role that this visual image provides, it is equally well recognized that receivership will not necessarily terminate the entire managerial capacity of the directors. The conflicting nature of these positions sought to rationalized and made coherent by Street J. in *Hawkesbury Development Co Ltd v Landmark Finance Pty Ltd.*[3]

> Receivership and management may well dominate exclusively a company's affairs in its dealings and relations with the outside world. But it does not permeate the company's internal domestic structure. That structure continues to exist notwithstanding that the directors no longer have authority to exercise their ordinary business-management functions. A valid receivership and management will ordinarily supersede, but not destroy, the company's own organs through which it conducts its affairs. The capacity of those organs to function bears a direct inverse relationship to the validity and scope of the receivership and management.

Conceptually, this relationship between the receiver and the directors is understandable. The practical primary role of the receiver will be to ensure that the interests of the chargee are in no way prejudiced – the fact that directors may continue to have a say in how the company is managed may well not be inconsistent with this function.[4] 'The real question is whether the directors ... can [exercise any powers] without prejudicing the legitimate interests of the receiver and the secured creditor in the realization of the assets.'[5] Practically, however, the broad nature of modern debenture documents has seen any residual power of the directors severely and bluntly circumscribed. Despite this, common law courts have held steadfast to the idea that directors may retain some rights. This has included the right to challenge, in the name of the company, the appointment of the receiver,[6] or to pursue the chargee for wrongful appointment.[7] It has also been held that the directors may act to wind up the company, or to have an administrator appointed.[8] Notwithstanding these small incursions, the contemporary balance was articulated by Owen J. in *Re Geneva Finance Ltd (Receiver and Manager apptd)*:[9]

> The question is not who has the higher duty, as between receiver and directors, in relation to assets which are subject to the security and which the receiver has in his possession and control. That

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1 R. Tomasic, S. Bottomley & R. McQueen, *Corporations Law in Australia,* (2nd edition, Federation Press, Sydney, 2002) at 764, with reference to *George Barker (Transport) Ltd v Eynon* [1973] 3 All ER 374 at 380.

2 *Re Emmadart Ltd* [1979] Ch 540; 2 WLR 868; 1 All ER 599.

3 (1970) 92 WN (NSW) 199 at 209.

4 See the comments by LA Badham, 'Directors Versus Receivers: Control of Litigation on Behalf of Companies in Receivership', (1998) 16 *Companies and Securities Law Journal* 508 at 509.

5 *Re Geneva Finance Ltd: Quigley v Cook* (1992) 7 WAR 496 at 511 per Owen J.

6 *Bunbury Foods Pty Ltd v National Bank of Australasia Ltd* (1984) 153 CLR 491.

7 *Newhart Developments v Cooperative Commercial Bank* [1978] 1 QB 814; *Deangrove Pty Ltd (Receivers and Managers Appointed) v Commonwealth Bank of Australia* (2001) 108 FCR 77; 37 ACSR 465. Compare *Tudor Grange Holdings Ltd v Citibank NA* [1992] Ch 53; [1991] 3 WLR 750; [1991] 4 All ER 1.

8 *Re Genasys II Pty Ltd* (1996) 19 ACSR 435; 14 ACLC 729.

9 (1992) 10 ACLC 668 at 678-679.

question must always be answered in favour of the receiver unless the receiver has abandoned the asset or is acting in breach of duty.

The interesting feature of the Australian Full Federal Court decision in *Ernst & Young (Reg) v Tynski Pty Limited*[10] is not that it presents a markedly different rule to the present doctrine, but the dispute arose in a context slightly different to that of the traditional area of dispute. In this matter, the directors had caused the company to institute proceedings against a third party – this occurring at the same time as the more traditional challenges were being made to the appointment of the receivers and the conduct of the chargee. The legal issue squarely faced was the extent to which a third party could assert that the proper plaintiff in such an action was the receiver and not the directors.[11] The other matter was the extent to which an indemnity for legal costs could be mandated from the directors in bringing such an action. The significance of this decision will be in where it leads, as much as what it presently says.

Facts of *Ernst & Young (Reg) v Tynski Pty Limited*[12]

In November of 2001, a cluster of companies known as the Gartner group executed a debenture in favour of the National Australia Bank (NAB). This debenture was registered in accordance with Part 2K.2 of the *Corporations Act 2001* (Cth). One member of that corporate group was Tynski Pty Limited. The debenture executed by Tynski Pty Limited was representative of the mortgages executed by all companies within the Gartner organization. Clause 4.3 of the debenture provided that:

> Without the consent of the Bank, the Mortgagor may not:
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> (a) dispose of, part with or deal with the whole or any major part of its undertaking, or ...
> (g) dispose of, part with or deal with any Mortgaged Property upon which the charge created by this Deed is fixed.

Clause 14.1 provided that the Bank may, should default occurs, appoint a receiver to the whole or any of the mortgaged property. Clause 17.4 went on to provide the receiver with very extensive powers, including the power to act as an absolute owner, and to take, defend, compromise or appeal proceedings in the name of the mortgagor. The background to the seeking of this debenture was professional advice provided by Ernst & Young in association with the development of a winery. It was alleged that this advice led to the borrowing of $24.91 million (AUD) by Gartner from NAB, these funds secured by a series of interlocking guarantees and mortgages against realty. When default occurred in repayment, the NAB appointed receivers to the Gartner family companies. On August 13, 2002, the Gartner group commenced proceedings against Ernst & Young and the National Australia Bank in which it claimed relief against Ernst & Young pursuant to ss51 (unconscionability) and 52 (deceptive and misleading conduct) of the *Trade Practices Act 1974* (Cth) as well as common law relief for breach of contract and negligence. The remedies sought against the Bank included a declaration that the mortgages and debentures had been validly rescinded. On October 4, 2002, Ernst & Young sought an order to dismiss the proceeding brought against them.

The argument

Two arguments were put forward as to why the directors had no power to instruct solicitors to instigate legal proceedings against Ernst & Young on behalf of the company:

(1) That no indemnity had been provided to the receivers in respect of the costs of the action; and
(2) That the directors could only act in such a manner if the receivers had given permission for such an action to be brought.

The primary judge[13]

Mansfield J. concluded that no indemnity was required. Applying the English decision of *Newhart Developments Ltd v Co-operative Commercial Bank Ltd*[14] this was a matter for the commercial judgement of the receivers. If no indemnity was sought by them, then it was not for the Court to substitute its own judgement.[15]

As to the second matter, provided that there was 'no apparent clash' between what the directors regard as being in the best interests of the company, and what the perception of the receivers is to the same matter,

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10 [2003] FCAFC 233: decision of the Court of Branson, Marshall and Stone JJ.

11 Many readers would no doubt hear the echo of the decision of *Foss v Harbottle* (1843) 2 Hare 461; 67 ER 189 in this argument.

12 This summary is largely drawn from the judgement of the court at [5]–[14].

13 [2003] FCA 152.

14 [1978] 1 QB 814 at 819, 821.

15 [2003] FCA 152 at [29].

then directors cannot be said to have no power in law to institute the proceedings.[16]

The decision of the Full Federal Court

The argument on appeal of Ernst & Young was as follows:[17]

(1) a chose in action may be secured in the same way as any other item of property;
(2) the right of the debenture holder to take proceedings in the name of the company was part of the security;
(3) the effect of the appointment of a receiver and manager was to divest the directors of their management powers in respect of assets the subject of receivership; and
(4) the powers of the receivers and managers are exclusive in relation to the assets the subject of appointment.

The Court began its analysis by noting that the normal requirement of an indemnity for costs exists for the benefit of the debenture holder.[18] If neither the debenture holder, nor the receiver requests this, then it may be assumed that the interests of the chargee do not require this.[19] Similarly:

> the contention of the appellants that a purported proceeding in the name of a company, instituted by the directors in their residual capacity without the consent of the receiver and without the provision of a suitable indemnity against costs, would be invalid and unable to be validated by the retrospective approval of the receiver must be rejected.[20]

As for the second issue, the capacity of the directors to cause this proceeding to be brought in the name of the Gartner companies, the Full Court agreed with the destination of Mansfield J., but travelled a different journey. It was not a question of whether there was any 'apparent clash', but more a practical consideration that the resolution of the question who had the capacity to instruct solicitors to act for the Gartner group, and whether or not that capacity was exclusive, '[could not] be conclusively determined ahead of the determination of the challenge to the validity of the appointment of the receivers'.[21] The Court continued:

> We are not persuaded that the Gartner companies are required to await the determination of their challenge to the appointment of the receivers before they can validly retain solicitors to initiate and maintain a proceeding in the name of the companies against the appellants in respect of the causes of action identified in the application and statement of claim. The receivers did not and have not taken steps to pursue the causes of action. The limitation periods in respect of the causes of action have commenced to run[22].

The appeal was therefore dismissed.

Practical implications of this decision

This decision at its most base level affirms the accepted position. Directors have the capacity to institute legal proceedings in the name of the company when they are seeking to challenge the appointment of the receivership, the conduct of the chargee or some related aspect. To this end, the Full Federal Court accepted that since the receivership was also under challenge, then it could not be said that the directors must necessarily have been deprived of their capacity to bring the action against Ernst & Young. After all, if the challenge to the receivership is successful, then it will be the directors with the capacity to institute proceedings on behalf of the company. The primary question that is left unresolved by this decision is as follows: What if the receivership is not under challenge – will this singular aspect be sufficient to deprive the directors of their capacity to instigate legal proceedings? Or, is this factor, the challenge to appointment, the controlling feature on this type of litigation? Badham suggests the following resolution:[23]

> Three circumstances where it is suggested that the directors' power to control the proceedings should have precedence [over the receiver] are:
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> (1) defending proceedings brought by the chargee;
> (2) bringing proceedings against the receiver; and/or

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16 [2003] FCA 152 at [39].

17 [2003] FCAFC 233 at [19]

18 [2003] FCAFC 233 at [26] quoting *Brooklands Motor Co Ltd (in rec) v Bridge Wholesale Acceptance Corporation (Australia) Ltd* [1993] MCLR 448; *Newhart Developments Ltd v Co-operative Commercial Bank Ltd* [1978] QB 814.

19 [2003] FCAFC 233 at [26].

20 [2003] FCAFC 233 at [27].

21 [2003] FCAFC 233 at [32].

22 [2003] FCAFC 233 at [33].

23 Badham, above n 4 at 513.

(3) bringing proceedings against the chargee that do not challenge the validity of the receivership.

In one respect, *Ernst & Young v Tynski Pty Limited* represents an extension of this analysis. The mere fact that proceedings remained on foot against the receiver and chargee permitted the proceedings against the third party to stand.

The second practical implication concerns the indemnity. Both the Primary Judge and the Full Court accepted that this was a matter for commercial judgement, this despite the Superior Court recognizing that the receivers or the Bank may have sought this.[24] One result of this litigation may be that this indemnity will be more keenly sought in the future.

Conclusion

The relationship between receivers and directors will always be a fertile battleground. For the receivers, the relationship between them and the company is, most likely, simply a commercial arrangement. The same cannot be said for the directors. They may well be the major shareholders, the controllers, and the owners. The status of these people and their wealth may be perceived, either appropriately or not, to be mirrored in the fortunes of the entity that is now controlled by another. To this end, the decision of *Ernst & Young v Tynski Pty Limited* indicates that the strength of the anaesthetic supplied by the concept of receivership is uncertain, its effect still, despite centuries of litigation, unknown. *Ernst & Young v Tynski Pty Limited* representing another success story for directors in their constant battle to argue, test and limit the boundaries of the receivers' power. The continuing attempt by modern financial institutions to limit the capacity of the directors when a company has been placed in receivership has been, once again, restricted. Whilst this individual battle may have been won by directors, the continuing struggle is such that the response of financial institutions is likely to be an ever more onerous debenture deed, and greater emphasis placed on obtaining an indemnity. The anaesthetic may be applied, but one must wonder to what extent does it paralyse the patient.

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24 [2003] FCAFC 233 at [34]. It should be noted that, in related proceedings, an attempt by the Bank to obtain security for costs was unsuccessful. See *Gartner v Ernst & Young (No 3)* [2003] FCA 1437.