CASE REVIEW SECTION

420A and the Receiver's/Controller's Duty of Reasonable Care

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Introduction

What is the duty of a mortgagee when selling property over which they have obtained control? Traditionally, in Australia the test is stated as merely one of good faith.[1] By contrast, English courts have alternated between a test of good faith[2] and that of reasonable care.[3] Whatever the resolution of this may be, the purpose of this case note is to explore the impact that s420A of the Corporations Act 2001 (Aus) has had in resolving or contributing to the jurisprudence surrounding this debate. What will be demonstrated is that whilst the parameters of the legislation are unclear, in the scenarios that come within the ambit of the section, the debate may well have little practical impact.

The legislation

Section 420A of the Corporations Act 2001 provides that:

> In exercising a power of sale in respect of property of a corporation, a controller must take all reasonable care to sell the property for;
>
> (a) if, when it is sold, it has a market value – not less than that market value or
> (b) otherwise – the best price that is reasonably obtainable, having regard to the circumstances existing when the property is sold.

A number of issues arise in relation to this:

- What are the consequences of breach (particularly given that the legislation does not specify any);
- Does a guarantor have protection of the statute, or is limited to the mortgagor corporation;
- Does this legislation statutorily provide for the equivalent of a common law duty of care, (thus rendering any debate redundant); and finally,
- Does the section dictate that market value is a relevant consideration in determining any breach, or is it simply the case that examination extends to the process designed to achieve market value?

Two recent decisions[4] (the judgments delivered one day apart) demonstrate, not only the unpredictability of a Federal system of jurisprudence (the State courts diametrically opposed on certain aspects), but also that the parameters of s420A are rather ephemeral in nature, and that many more decisions will be required to tease out the boundaries of this section.

Jovanovic, Jovanovic and Fortson Pty Ltd v Commonwealth Bank of Australia[5]

The Jovanovics controlled Forston Pty Ltd. Through this company they had purchased a property on which a hotel business was conducted. The vendors were the Govedaricas and a company controlled by them, Roclin Developments Pty Ltd. At this time, the Govedaricas and the Jovanovics were said to be in a close friendship – this friendship complicating the business arrangements with allegations of a secret agreement between the parties to disguise the 'true' owners of the property. Documentary evidence indicating the existing of the following term:[6]

> The Jovanovics agree that notwithstanding any arrangement that involves their possession of sole legal title of the property, that they hold on trust for the benefit of the Govedaricas, ownership of the property based upon the proportions of ownership

Notes

1 *Pendelbury v Colonial Mutual Life Assurance Society Ltd* (1912) 13 CLR 676.

2 *Parker-Tweedale v Dunbar Bank plc* [1991] Ch 12 at 18–19; *Downsview Nominees Ltd v Citicorp Ltd* [1993] AC 295 at 315.

3 *Cuckmere Brick Co Ltd v Mutual Finance Ltd* [1971] Ch 949.

4 *Jovanovic, Jovanovic and Fortson Pty Ltd v Commonwealth Bank of Australia* [2004] SASC 61; *Ultimate Property Group Pty Ltd v Lord* [2004] NSWSC 114.

5 [2004] SASC 61.

6 [2004] SASC 61 at [13].

outlined above [the Jovanovics holding a one-third entitlement, the Govedaricas the remainder].

The respondents, the Commonwealth Bank of Australia, advanced AUD 750,000 to Forston Pty Ltd to purchase the property, with the Jovanovics guaranteeing this debt. Forston Pty Ltd went into default, with the Bank then seeking to exercise its power of sale. Ernst and Young were engaged by the Bank to consider the options to recover the monies outstanding – with three possibilities being identified. These were stated as follows:[7]

- As the tender process is running, if one of the parties [the Jovanovics or the Govedaricas] can confirm that finance is able to be independently obtained then the sale of the property to this party is clearly the preferred option.
- Extend the timeframe to either party to obtain finance. (The Bank should probably go straight to the market unless there is a reasonable opportunity for one of the parties to obtain finance in the next four to eight weeks).
- Appoint an agent and put the hotel to the market.

Despite these options being aligned with the Commonwealth Bank's initial strategy, it was subsequently decided to adopt a closed tender process (open only to the Jovanovics and the Govedaricas). This process had advantages to both the Bank and the parties. As agents and receivers would not be involved, associated costs would be minimized. Furthermore, the Bank would benefit if, as it turned out, the Govedaricas purchased the property – the Commonwealth Bank thereby obtaining the benefits of further personal guarantees and a registered security over the assets of another corporate entity (Roclin Developments Pty Ltd). The Bank did exercise the power of sale against the Jovanovics and Forston Pty Ltd, with ownership of the freehold property being returned to the Govedaricas (the hotel business, the plant fittings and equipment not being part of the tender). The Commonwealth Bank financed this purchase by the Govedaricas and Roclin Developments. The result of this saw the Bank with personal guarantees from the Jovanovics and the Govedaricas, as well as a registered charge against the assets of Forston Pty Ltd and Roclin Developments Pty Ltd. Accordingly, whatever the conclusion as to formal legal title would be, the Commonwealth Bank would have security for the repayment of its loan(s).

Proceedings were brought by the Bank to recover the money's outstanding from the loan to the Jovanovics (AUD 39,615.09), with the trial judge entering judgment for the Bank and dismissing a counterclaim brought by the appellants. The Jovanovics and Fortson appealed to the Supreme Court of South Australia arguing that the trial judge had failed to consider or apply what is now s420A of the Corporations Act 2001.

The Full Court of South Australia unanimously decided that the Bank had been in breach of its obligations under the legislation[8] – with the matter being remitted to the trial judge for the determination of the market value of the property that would have been obtained had the bank not been in breach.

The Court recognized that equitable duties were owed to Forston Pty Ltd and the Jovanovics. This duty was to act in good faith, and as part of that duty, the bank could not act with calculated indifference or reckless disregard to the rights of the debtors.[9] Furthermore, it was recognized that 'the extent to which the equitable duty owed by a mortgagee to a mortgagor involves a duty to take reasonable steps to obtain the best possible price for the property has been the subject of considerable debate in the authorities.'[10] However, it was not necessary to decide this issue, it being recognized that the duty under statute was at least as extensive as the broadest formulation of the equitable duty.[11]

> The [Trial Judge] appears to have rejected any suggestion that the Bank, in exercising its power of sale, owed the common law duty of care to take reasonable care to secure the best possible price for the property. I think the judge was right to take this approach. In my respectful opinion, the weight of authority in this country is that a mortgagee exercising a power of sale does not owe a common law duty of care .... In view of the fact that it was common ground that the bank owed the duty in s420A, the issue is of *little practical significance* in this case in terms of the content of the bank's duties. However, it is relevant to the question of the appropriate remedies.[12] (emphasis supplied)

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7 [2004] SASC 61 at [31].

8 The point of difference between the judges concerned the capacity of the Jovanovics to pursue a counterclaim, the majority indicating that the section merely allowed an accounting to occur, whereas Gray J considered that the remedial nature of the legislation permitted the guarantors to bring a counterclaim.

9 [2004] SASC 61 at [91].

10 [2004] SASC 61 at [91].

11 [2004] SASC 61 at [91].

12 [2004] SASC 61 at [92] per Besanko J.

In addition, the correct focus in looking at this section was to look at the process that the holder of the power goes through in selling the property.[13] It involves a determination as to whether the controller, 'has failed to do what a reasonable and prudent person would do, or has done what a reasonable or prudent person would refrain from doing in the circumstances'.[14] In undertaking this, and in determining to whom s420A was aimed, consideration had to be given to the remedial nature of the legislation, and should any ambiguity arise, then the legislation had to be given a beneficial interpretation.[15] Accordingly, in applying this understanding of the legislation to the facts of this case – the Court concluded that the process of sale was in breach of the obligations stated in the Corporations Act 2001. In particular:[16]

- The process was contrary to the usual practice of the bank;
- It was against the advice of Ernst & Young;
- The bank had negotiated with only one potential purchaser;
- The bank had failed to test the market;
- The bank received considerable benefits from a closed tender process;
- The transaction was not at arm's length;
- The sale was for less than the banks internal valuation;
- The bank had failed to resolve the doubts over ownership of the property.

Ultimate Property Group Pty Ltd v Lord[17]

Inglewood the first plaintiff had mortgaged its land to the St George Bank. The second, third and fourth plaintiffs guaranteed the mortgage. In April of 2000, the Bank appointed Lord as controller of the mortgaged property pursuant to the Corporations Act 2001. Subsequently, this land was sold by auction for AUD 1,350,000 with final receipts of AUD 1,227,273 after deducting AUD 122,727 GST (Goods and Services Tax). This meant that there was a shortfall of some AUD 342,188.77 for which the guarantors would be liable. The issue before the New South Wales Supreme Court was whether the defendants had acted in accordance with s420A of the Corporations Act 2001. In particular, the plaintiffs attacked the price on two fronts:[18]

- That the controller had made a manifest error in assuming that GST was payable on the rentals; and
- That the property should have been sold so as to legitimately avoid paying GST.

In holding that there was no breach by the defendant, the Court saw it as of the utmost importance that a precise classification of the duty owed by the mortgagee to the mortgagor and the guarantors be specified.[19] In undertaking this analysis three sources of the duty were posited:

i) A duty at common law;
ii) A duty in equity; and/or
iii) A duty pursuant to statute.

Common law duty

Young CJ first considered the possibility that common law duty may be owed by mortgagee in negligence. After examining the Australian and English authority[20] in this regard the view of his Honour was succinct: '[A]uthority compels me to say that there is no common law duty in negligence on a mortgagee in NSW which makes a mortgagee liable in common law damages if he fails to get a good price for the mortgaged property.'[21]

Duty in equity

By contrast, the equitable duty to act in good faith was recognized. Quoting from *Hawkesbury Valley Developments Pty Ltd v Custom Credit Corporation Ltd*:[22]

> ... in exercising its power of sale, a mortgagee must act in good faith, which involves an obligation to deal fairly with the interests of the mortgagor, which in turn involves an obligation to refrain from acting in wilful or reckless disregard of those interests ....

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13 [2004] SASC 61 at [95].

14 [2004] SASC 61 at [96] per Besanko J quoting from *Commercial and General Acceptance v Nixon* (1981) 152 CLR 491 at 501.

15 [2004] SASC 61 at [62] per Gray J.

16 [2004] SASC 61 at [64].

17 [2004] NSWSC 114.

18 [2004] NSWSC 114 at [6].

19 [2004] NSWSC 114 at [15].

20 [2004] NSWSC 114 at [17–25].

21 [2004] NSWSC 114 at [26].

22 (1994) 8 BPR 15,581 at 15,583.

> If a failure by a mortgagee to take reasonable steps to obtain a proper price is sufficiently serious to be characterized as unconscionable as that expression is understood in equity, then in the taking of accounts between the mortgagee and the mortgagor, the mortgagee will be accountable on the basis of wilful default for the price which would have been obtained if the mortgagee had not been guilty of unconscionable conduct.

Statutory duty

The statement of the equitable duty was followed by a historical excursus into the development of the statutory duty enacted in s420A. The Australian genesis for this provision commonly cited as the Australian Law Reform Commission Report into Insolvency.[23] This report recognized that, despite the theoretical difficulties inherent in adopting a common law based approach (the power to sell deriving from the branch of equitable jurisprudence),[24] a receiver or controller should be under some form of duty of reasonable care.[25] Young CJ commented:

> In my view it would be a complete nonsense to say that s420A was inserted into the Corporations Act with no consequences at all … if there was a breach …
>
> The legislature could not have meant a solemn farce. The Act does not provide any realistic scheme for controlling controllers with respect to price. The purpose of the section, viewed in the light of its drafting history was to give some protection to borrowers. I thus conclude that the legislature intended that there be a private action …
>
> The next question is what sort of private action?[26]

Young CJ held that the trend of authorities was away from the *Cuckmere*[27] or tort type damages to the idea of equitable compensation; and that s420A gives rise to an equitable action for damages against a controller in the same way as an action to recover surplus proceeds from a sale originating in equity.[28] However, this was of limited value to guarantors. '[T]he plaintiffs claim must wholly fail as neither the general equitable duty nor s420A operate to give a wronged party damages or compensation. Their only effect is to adjust the accounting.'[29]

Furthermore, in answering this, his Honour considered that market value was a relevant consideration, despite earlier authorities arguing that the key issue is one of whether reasonable care was taken in the process of selling, and not whether the market value was achieved.[30] Given this background, his Honour found no breach of the legislation – there was no need to account as the land had not been sold at an undervaluation, nor was there any obligation to sell in a tax-effective way.[31]

Summary on these cases

A number of questions were posited at the start:

- What are the consequences of breach of the legislation;
- Does the legislation provide a remedy to guarantors;
- Does the legislation provide for the enactment of a statutory duty of reasonable care; and,
- How relevant is determining what the market value would or should be in the court's deliberations?

Consequences of breach

There is a majority in these courts that see the consequences of breach as rather limited. Whilst it was likened in *Ultimate Property Group* to a claim for equitable damages, this was limited to the sense of seeking an account.[32] The judges in *Jovanovic* differed in their opinion. Whereas Gray J provided for an expanded operation of the legislation,[33] Besanko J considered that the legislation's operation was rather more limited in line with Young CJ in *Ultimate Property Group.*[34]

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23 ALRC, *General Insolvency Inquiry,* Report No 45, 1988 at [236]. See *Ultimate Property Group Pty Ltd v Lord* [2004] NSWSC 114 at [52]; *Jovanovic, Jovanovic and Forston v Commonwealth Bank of Australia* [2004] SASC 61 at [44].

24 *Commercial and General Acceptance Ltd v Nixon* (1982-1983) 152 CLR 491 at 515.

25 [2004] NSWSC 114 at [90].

26 [2004] NSWSC 114 at [90–92].

27 [1971] Ch 949.

28 [2004] NSWSC 114 at [93–94].

29 [2004] NSWSC 114 at [107].

30 [2004] NSWSC 114 at [68-69].

31 [2004] NSWSC 114 at [129], though the final resolution of this was left to another day.

32 [2004] NSWSC 114 at [107].

33 [2004] SASC 61 at [67].

34 [2004] SASC 61 at [114]. Mullighan J agreed with Besanko J see [2004] SASC 61 at [1].

Does the legislation provide a remedy for guarantors?

Again, there is a difference of opinion expressed between the two cases. In *Jovanovic,* Gray J was of the opinion that:

> To allow a guarantor to have the protection of the statute does not strain the language of the statute. Such an interpretation is fairly open on the words used. The position of a mortgagor, a mortgagee and a guarantor are inextricably linked.[35]

These strong words can be contrasted with the view of Young CJ in *Ultimate Property Group.* Quoting from the earlier decision of the New South Wales Supreme Court in *GE Capital Australia v Davis & Ors.*[36] no rights could be conferred on guarantors, though they may benefit from an accounting, in one of two ways – either equitable set-off, or the rights invoked in guarantors when a principal creditor has acted to lessen the value of the security.[37] It can be accepted that the prevailing view is in line with this more limited approach – Besanko J also accepting this line of thinking in *Jovanovic.*[38]

Does the statutory duty provide for the equivalent of the Cuckmere duty of reasonable care?

The answer from both cases is that it does not. Whilst Gray J in *Jovanovic* gave the broadest interpretation of the legislation, based on what his Honour saw as its remedial nature,[39] no court saw the legislation invoking the equivalent of a common law standard of reasonable care, despite this being the recognized direction that the *General Insolvency Inquiry* saw the legislation moving.[40]

How relevant is a determination of market value?

The issue that has arisen in relation to this concerns whether, in determining a breach of the legislation, the Court need only be concerned as to whether the process involved the taking of reasonable care, or whether an inquiry into whether market value was reached is required. Earlier authority[41] had suggested that it was only the process that was critical.

> In deciding whether there has been a breach of s420A, a court looks at the process that a controller of property of a corporation has gone through in selling that property .... [I]t is not necessary for me to find what actually was the market value of the property, to be able to find that s420A(1)(a) was breached, all that I need find is that the process gone through was not one where all reasonable care was taken to sell the property for its market value, whatever that market value might be.[42]

This reasoning was adopted in *Jovanovic,* but with one qualifier, whether market value was obtained will be relevant to final relief.[43] By contrast Young CJ in *Ultimate Property Group* was highly critical of any failure to consider market value – his Honour commenting:

> However, unless it can be demonstrated, at least in an inquiry before the Master, that the property in fact sold for under the market price, it is merely a case of *injuria sine damnum.* If, as his Honour says, by luck, the market price is achieved, then the mortgagor has suffered no loss.[44]

Conclusion

Given the divergences between the judges in these two cases, it could be said that we are little advanced in our understanding of the operation of s420A of the Corporations Act 2001. However, there is no doubt that there has been a firm rejection of any idea that it statutorily introduces a common law form of reasonable care, instead, it is perhaps sui generis in the way in which it adds a gloss to the equitable standard of good faith. No doubt further cases will add to the jurisprudence on this area, and build a more certain understanding of the parameters. Perhaps the most telling lesson that comes from these two cases is that when Parliaments enact laws of this nature, they need to be rather more mindful of identifying the consequences of not meeting that standard.

Notes

35 [2004] SASC 61 at [62].

36 [2002] NSWSC 1146.

37 [2004] NSWSC 114 at [75–78].

38 [2004] SASC 61 at [115].

39 [2004] SASC 61 at [62]

40 As noted in [2004] NSWSC 114 at [52]; [2004] SASC 61 at [44].

41 *Artistic Builders Pty Ltd v Elliot & Tuthill (Mortgages) Pty Ltd* (2002) 10 BPR 19,565.

42 *Artistic Builders Pty Ltd v Elliot & Tuthill (Mortgages) Pty Ltd* (2002) 10 BPR 19,565 at[126].

43 [2004] SASC 61 at [50].

44 [2004] NSWSC 114 at [68].