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Australian Indemnitees from the Perspective of US Noteholders

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Introduction

In representing US noteholders and other creditors in more than a dozen ***Australian*** workouts and insolvencies over the past 20 years, our consistent advice is, "when in Australia, do as Australians do." Meaning, of course, that Australia has a fully-developed workout and insolvency legal system and culture, as well as lawyers, practitioners and others who are the peers of the top-flight professionals throughout the world, including the US. Thus, to maximize recoveries, US noteholders should both understand "how things are done" in Australia and engage the best local advisors to work with the US advisors in order to achieve their objectives. Australian administration, receivership and schemes of arrangement may not be ***Chapter 11***, but they work just fine within the Australian system and culture and can be applied to the benefit of US noteholders.

While in the past "US noteholders" have typically been institutional investors making par investments in Australian corporate credits, the landscape has changed considerably over the past 5-6 years. Both these original US noteholders and the main Australian banks have increasingly been engaged in selling their credits on the secondary markets, and when the corporate borrower is in distress, these sales are increasingly to US hedge funds and other distressed debt purchasers. In Centro Properties, by the time we concluded the 4-year on-and-off restructuring discussions with Australian schemes of arrangement, so many of the Australian bank loans and US notes had been sold (and often re-sold) that no more than a handful of the 95 debt holders in our group were original lenders or noteholders. Whereas Australian banks accustomed to the usual insolvency procedures and their trappings are at ease, US investors (both par and distressed debt) can suffer both from a lack of understanding and reluctance and/or difficulties in seeking internal approvals that would be commonplace in Australia. One area where these differences are especially relevant is in the context of the appointment by secured lenders of a receiver and the role of the receiver in carrying out its statutory and customary duties.

One such familiar aspect of insolvency in Australia is the grant of an unlimited indemnity by the secured lenders to the receivers they appoint. While a matter of course for banks, granting an unlimited indemnity and grappling with quantifying its risk is a bitter pill for many foreign non-traditional lenders to swallow. This brief article identifies the difficulties that lenders such as US noteholders face in connection with the appointment of a receiver and suggests some measures for addressing the real and perceived hurdles appurtenant thereto, both at issuance and as is sometimes the case, alas, at insolvency.

Insolvency Down Under

Voluntary administration and receivership, fundamental Australian insolvency regimes, have an arguable advantage over other court-based regimes such as US chapter 11. While they belie an assumption that management is to blame for financial failure, avoiding major court involvement should in theory reduce fees and allow the parties to determine the best course of action more efficiently. However, the individuals assigned to take the reins—the administrators and the receivers—do not have the authority and immunity of the courts. While they have authority by appointment and statute to exercise their duties, these individuals may be held personally liable for debts incurred on their watch, and it is the individual appointees who are liable, even though they may be partners in a much larger firm. Accordingly, and without surprise, such professionals expect to be indemnified—both from the assets of the distressed company as well as their appointers. When a receiver is appointed by secured creditors over the assets secured by their charge, Australian banks, among other secured lenders, typically grant indemnities in the normal course without a second thought. In the ordinary course, they select a receiver they trust, retain the ability to replace the receiver and take the risk of further losses if the receiver (or the company in receivership) has exposure not covered by the charged assets. The regime, including an unlimited indemnity, is acceptable for many lenders. But a different story emerges when the holders of the secured loans and notes are primarily US investors who are not accustomed to providing indemnities in the context of US distressed credits.

The Typical Appointment Scenario

Exceptions abound, but a large Australian corporate borrower in administration typically has a bank facility secured by a fixed and floating charge over substantially all of its assets. After failed attempts to restructure the debt, the directors of an Australian borrower in financial difficulty face potential personal liability for debts incurred once the company is insolvent and, therefore, may voluntarily **appoint** an administrator. Under the Corporations Act, secured lenders with a valid charge over substantially all of the borrower's assets have 13 business days to commence enforcement by appointment of a controller—often a receiver—and lenders will likely have prepared in advance to ensure that a receiver is appointed almost immediately after a company voluntarily appoints an administrator. Such appointment of a receiver generally requires the banks or other secured lenders to indemnify and direct the security trustee to appoint a receiver with a deed of appointment and indemnity for the receiver, and the banks may likewise extend an existing or new working capital facility to cover expenses during receivership. The receiver represents the banks' interests while backed by a full indemnity from the charged assets and the banks. The security trustee assumed no risk performing its perfunctory appointment duties; even if the appointment was wrongful, any liability rests on the banks as beneficiaries of the security trust deed and who directed the security trustee to appoint a receiver.

Problem – Add US-based Investors

The tidy scenario in which a bank consortium easily appoints and indemnifies a receiver is turned on its head when security holders are non-traditional lenders. For example, Australian borrowers have issued publicly traded notes, secured by fixed and floating charges over substantially all of their assets, both on a pari passu basis with the banks and without banks—and US investors sometimes buy substantial portions of the secured bank debt. In such a scenario, where the borrower faces potential insolvency, the downside scenario for the lenders is problematic—not only in terms of return on investment but in the costs and difficulties associated with the procedure of appointing a receiver. While uncommon to date, this alternative lending scenario is not hypothetical. Unlike banks, the US investors face several unique hurdles to appointing a receiver, including the following:

- If there are US public notes (similar to shares in a public company except these are debt instruments issued in the public marketplace), it may be difficult or impossible to determine who all of the holders are. This can also occur even when there is only private bank debt and private US notes (meaning so-called "private placement notes" issued under an exemption to the US securities laws) if the debt has sold to distressed debt investors who do not wish to be identified for competitive market reasons.

- Assuming a majority or super-majority of the holders are, in fact, organized, many will not want to receive material non-public information about the company that could restrict their ability to sell some or all of their loans/notes or to purchase additional exposure—therefore some will be unprepared to consider an appointment and may be surprised when the company appoints an administrator.

- Those holders "inside the tent" (meaning willing to receive material non-public information) and engaged with counsel in restructuring discussions may hold insufficient notes to appoint a receiver without support from other holders. Under the typical US public note indenture, holders of a majority of notes are required to direct an indenture trustee to direct the security trustee to appoint a receiver.

- Even public holders who have non-public information and are ready to direct the trustee may not be able to direct the trustee directly. The indenture trustee will likely seek direction from holders via the Depository Trust Company (DTC, in whose name US public notes are typically registered on a nominal basis) in order to provide notice to all holders and to eliminate the risk of contradictory instructions from competing noteholder groups; the DTC consent process can take weeks, potentially longer than the statutory thirteen business day period allotted. While the administrator may agree to toll this period, lenders planning for a downside scenario have no certainty.

- Although wrongful appointment is unlikely in the event of a voluntary administration, the trustees will expect a full indemnity in connection with such appointment—and while US investors can often be persuade to hold the trustee harmless, most US investors are loathe to provide an indemnity against third party claims and costs associated with such claims.

- Receivers are accustomed to a full indemnity as well, both from the assets and from the appointing secured creditors. Given the personal liability of receivers, such an indemnity is commonplace; however, US investors may be unable to grant such an indemnity because of internal policies or parameters established in advance with underlying beneficiary investors such as limitations in hedge fund formation documents)—and such parameters would often require express consent of such beneficiaries to authorize any additional funding, especially in a theoretically uncapped amount.
- Public noteholders are not often in the business of providing working capital facilities and may not be able to easily provide receivership financing.
- Even if an organized group of US investors manages to surmount the hurdles above, it can be difficult to allocate the risk of indemnification and funding among all investors, some of whom are unknown, and there is the very difficult issue of how to deal with investors who sell out of the group or buy into the group at a later date. Thus, especially when public notes are involved, there is a substantial risk that any costs associated with enforcing security will be borne by a core group of active investors instead of spread pro rata amongst all investors—while "freeloaders," whether intentional or not, are still protected by provisions in the typical US public indenture barring unequal treatment with respect to the benefits of any disbursements.
- Finally, in addition to other hurdles not listed, non-traditional lenders bear the additional costs of professional fees associated with a complicated appointment.

Potential Solutions

There is insufficient space to thoroughly analyze and outline all of the potential problems and solutions in this article. Nonetheless, a few solutions present themselves. As is often the case, proactive preparation and client education, especially when documenting the original issuance, provides the broadest spectrum of solutions. But, of course, in the case of new issuances of US public notes, the notes are not issued based on the assumption that the issuer will default and that insolvency procedures will ensue. Further exacerbating this reality, a less established lending market (such as US secured public notes in Australia) and potential lack of experienced insolvency involvement in drafting front-end documents results in documentation that is seldom adapted to the realities of secured noteholders in an Australian insolvency procedure. Further, the noteholders themselves are not involved in negotiating the documents, only the issuer's underwriter and the prospective note trustee play a material role in public note documentation.

Documentary Solutions

The most proactive solution to many of the problems described above is to include in the indenture and the security documents (i.e., the security trust deed) provisions that (1) require the security trust deed to appoint a receiver as soon as practicable without noteholder direction and, in any event, prior to the expiration of the thirteen business day statutory period, (2) provide an adequate contractual indemnity from each holder to the indenture and security trustees in the event of such appointment—and a back-to-back indemnity in favor of any receiver appointed. While such an indemnity might not be unlimited, it should be included in the finance documents if possible so that the risk is distributed evenly amongst the holders, regardless of trading in the securities. To the extent that negotiating an indemnity is too cumbersome, consider providing adequate covenant cushions to help ensure that there will always be sufficient value in the underlying charged assets to indemnify the trustees and any receiver from the assets alone.

Practical Workarounds

Of course, avoiding administration and receivership altogether, where possible, is almost always a better solution in terms of preserving value. Moreover, issuing secured public notes may not be the best means for Australian corporates to access US capital markets. However, this very situation occurred recently and may be unavoidable at times. In addition to work-out strategies that are universally favorable (early and open borrower/lender communication, early formation of an organized lender group, etc.), here are a few additional solutions for dealing with an appointment by public noteholders: (1) avoid an indemnity and provide receivership funding by having willing noteholders fund a trust (or some other special purpose entity) and appoint an escrow agent to hold funds for a brief period if appointment is imminent (such an arrangement allows the receivers to borrow funds from willing noteholders without disparate treatment of the notes themselves and without a noteholder group losing control of the process by allowing the receivers to seek financing from third parties); (2) if an indemnity is inevitable, and if certain noteholders are able to provide it, consider coercive mechanisms that are either expressly permitted or not prohibited under the indenture, in particular to give an economic incentive solely to those holders bearing the burden of such risk such as an "indemnity fee"; (3) although time consuming and expensive, consider appointment of a receiver in conjunction with a support agreement executed by the holders of at least 75% of an issuance to implement a scheme of arrangement proposed by the receiver to drag along any unwilling participants and to amend the indenture and security documents as needed, to provide additional protection for the trustees and receiver, whether through additional funding, indemnity or both; (4) find a receiver who is willing to accept an appointment with an indemnity from the assets alone (and/or with additional agreed funding)—without an indemnity from the lender (this is not as difficult as it sounds depending on the quantum, value and liquidity of the security involved, especially in a quiet insolvency market where appointments are highly sought after); (5) apply pressure on the relevant trustees to appoint a receiver with limited indemnification in light of a trustee's post-default duties under the typical indenture.

Legislative Solutions

While more dramatic (and more difficult), additional legislative changes to the Australian Corporations Act might alleviate some of the difficulties in a downside scenario, particularly where secured creditors are noteholders or other non-bank lenders. This is not an impossible scenario, as exactly this objective was accomplished—a legislative reversal of a court decision under pressure from local and US industry participants—to the *Sons of Gwalia* shareholder problem. Limiting the liability for receivers appointed in good faith to debts incurred in bad faith, as a result of fraud or for gross mismanagement of the charged assets would likely grease the wheels of appointment with little or no practical downside. Such amendments could even reallocate the risk almost entirely to the secured creditors appointing a receiver but allow such creditors to bring claims against receivers for fraud, gross mismanagement, etc. Moreover, the Corporations Act could provide for greater, more certain protections against wrongful appointments, even if narrowly tailored to appointments by secured lenders who have sought the advice of counsel and where appointment occurs only after the borrower has appointed an administrator.

Conclusion

As Australian borrowers access new debt markets and as Australian loans and notes are increasingly sold to secondary and distressed debt investors, the non-local lenders and investors may not have fully taken into consideration the procedures and details of the applicable insolvency regimes. And the laws and customary practices of a borrower's jurisdiction may not be designed to accommodate the idiosyncrasies of non-traditional lenders. As outlined briefly above, where US investors are or become the holders of Australian secured loans and notes, the traditional documentary, legislative and professional landscapes may not provide the flexibility required for a less nimble group of investors to adequately and timely respond to the borrower's insolvency. Nonetheless, educating the relevant players about the difficulties and finding creative solutions in ever-evolving markets are hallmarks of good advisors, in the US, Australia and beyond.