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feature

DEALING WITH THE CLAIMS OF CONTINGENT CREDITORS IN INSOLVENCY ADMINISTRATIONS

Keith Bennetts provides a considered analysis of the rights of contingent creditors under the Corporations Act.

During the course of corporate insolvency administrations it is not uncommon to encounter persons asserting rights against a company on the basis that, although a presently due debt does not exist, a claim against the company, relating to pre-administration events, may arise at some future time.

Such persons are contingent creditors with rights that may significantly impact on the outcome of an insolvency administration. For this reason their position under the *Corporations Act 2001* (Cth) warrants close analysis.

In a number of insolvency provisions the Corporations Act employs the term 'contingent creditor' or 'contingent claim'. For example, the Corporations Act provides that:

A contingent creditor may apply for an order to wind up a company on grounds of insolvency (s 459P).

In winding up a contingent claim is admissible to proof against the company (s 553).

At a creditors' meeting a person may be entitled to vote in respect of a contingent claim (Corporations Regulations 5.6.23(2)).

In not providing a statutory definition of 'contingent creditor' or 'contingent claim', the Corporations Act has left it to the courts to provide insights into the nature and meaning of this claim. The following is a typical judicial description:

Contingent liabilities must, therefore, be something different from future liabilities which are binding on the company, but are not payable until a future date. I should define a contingency as an event which may or may not occur and a contingent liability as a liability which depends on its existence upon an event which may or may not happen.¹

The following are examples of contingent liabilities within the above description:

- Potential tax liabilities.
- A possible damages liability arising in tort, such as negligence or defamation.
- Warranty claims that may arise during the agreed warranty period.
- Possible statutory claims for misleading and deceptive conduct.

- Possible damages claim arising from a breach of contract eg. a lessor's claim in respect of future rent and for the performance of the lessee's covenants.
- A personal guarantee that gives rise to a contingent claim of the guarantor against the insolvent debtor. (Note: The rule against double proof ensures that the guarantor cannot prove its claim until the amount guaranteed is paid in full at which time the amount of the claim will have crystallised.)
- A possible claim against a holding company in liquidation in respect of insolvent trading by its insolvent subsidiary.

WHY ALLOW CONTINGENT CLAIMS TO FEATURE IN INSOLVENCY ADMINISTRATIONS?

The answer to this question has its genesis in bankruptcy law. Since the mid-19th century English bankruptcy law has recognised that the purpose of bankruptcy is to permit all creditors to share in the distribution of the assets of the bankrupt, and to leave the bankrupt thereafter free from the liability of previous obligations (with limited exceptions).

¹ *In re Sutherland, dec'd* (1963) AC 235 at 262.

Essentially, recognition of contingent claims ensures claims against the bankrupt should be as wide as possible, so that the financial affairs of the bankrupt may be dealt with comprehensively. As one court observed, 'the bankrupt is to be a freed man – freed not only from debts, but from contracts, liabilities, engagements and contingencies of every kind'.²

The English provisions recognising claims of contingent creditors were adopted in Australian bankruptcy laws, and in due course the statutes which regulated the winding up of companies adopted the bankruptcy practice.

At this stage it will be useful to review ways in which a contingent creditor may impact on insolvency processes.

THE CONTINGENT CREDITOR AS WINDING UP APPLICANT

Under s 459P(1) of the Corporations Act a contingent creditor is given standing to apply to the court for a company to be wound up in insolvency. However, in view of the unique nature of a contingent claim, an application by a contingent creditor may only be made with prior leave of the court, and for such leave to be granted the court must be satisfied by clear evidence before it that there is a prima facie case that the company is insolvent (see s 459P(2), (3)).

The standing of a contingent creditor to apply for a winding up order was reviewed by the High Court in *Community Development Pty Ltd v Engwirda Construction Co.*³ In circumstances where a dispute existed between a builder and the building owner as to the final payment under their building contract, the builder applied for the winding up of the building owner on grounds of insolvency. The final payment was not presently due and payable under their contract because the payment

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was conditional upon the issue of an architect's certificate or an arbitrator's award, neither of which had been obtained by the builder.

In resolving the narrow question as to whether the builder had standing to present the winding up application on grounds of the building owner's insolvency, the Court accepted that the builder was 'a contingent creditor for the amount of the payment whatever the amount may turn out to be',⁴ and as such under the corporations legislation was entitled to present the winding up application.

ENTITLEMENT OF CONTINGENT CREDITOR TO VOTE AT CREDITORS' MEETING

When reviewing the issue of a contingent creditor voting at a creditors' meeting it is necessary to refer to the Corporations Regulations. Specifically with respect to a contingent claim, Corporations Regulation 5.6.23(2) imposes a prohibition on a claimant voting on such a claim 'unless a just estimate of its value has been made'.

The process of just estimation for the purposes of this regulation was usefully summarised by the Court in *Selim v McGrath*.⁵

... it seems to me regulation 5.6.23 in requiring a just estimate of value to be made does not contemplate that the chairperson or administrator will undertake any detailed enquiry. He or she will do the best that can be done

by reference to the factual material the claimant furnishes, viewed in the total context with which the decision-maker is dealing.

If that material provides reasonable grounds, within that context, for ascribing a particular figure to the particular claim, the chairperson or administrator is no doubt expected to accept that position. If, on the other hand, there is little or no material from which a conclusion as to value can be drawn, a just estimate may be zero or perhaps the nominal amount of \$1.00, assuming that admission is warranted at all.

Implicit in this consideration of voting rights of contingent creditors is the important distinction between proof for distribution purposes and proof for voting purposes. The latter process is one in which extensive debate and deliberation is not envisaged. By way of contrast, adjudication of proofs of debt for distribution purposes requires that the true liability enforceable against the company must be arrived at through comprehensive reflection and analysis by the insolvency administrator.

ADJUDICATION ON PROOFS LODGED BY CONTINGENT CREDITORS FOR DISTRIBUTION PURPOSES

It is convenient to start with s 553 of the Corporations Act which provides that all claims against the company 'present or future, certain or

² *Ex parte Llynvi Coal and Iron Co, In re Hide* (1871) 7 LR Ch App 28, 31-32. ³ [1969] 120 CLR 455, 10/10/1969. ⁴ At p460. ⁵ [2003] NSWSC 927 at para 103.

contingent, ascertained or sounding only in damages ... are admissible to proof against the company'. From there detailed provisions governing the valuation of contingent claims are to be found in s 554A.

Under that section the liquidator is directed to make an estimate of the value of the claim or refer the question of value to the court (s 554A(3)). If the liquidator refers the question of valuation to the court, the court must value the claim or determine a method to be applied by the liquidator to arrive at a valuation of the claim (s 554A(4)). With respect to the liquidator's valuation a person aggrieved by the valuation may, within 21 days of becoming aware of the valuation, appeal to the court for a review of the liquidator's estimate.

The above provisions proceed on the basis that any contingent claim

In this regard the liquidator may rely on his or her own expertise; however, it is often necessary to obtain the input of expert advisors as the process of valuation is worked through.

It should be noted that at any time during the course of liquidation the valuation of a contingent claim remains open to variation in light of subsequent events, although prior distributions cannot be disturbed in the event that the variation results in an increased claim. On the other hand if the claim is reduced the creditor is obliged to repay to the liquidator the amount received as dividend that exceeds the actual entitlement (Corporations Regulation 5.6.55).

Finally, although the above discussion has concentrated on dealing with contingent claims for liquidation purposes, the same

agreement previously concluded by the company in the capacity of guarantor were caught by the DOCA.

The Court recognised that as the execution of the guarantee occurred before the DOCA was entered into, the DOCA released the guarantor company from all debts or claims arising under the guarantee, whether existing, future or contingent. Moreover it was irrelevant that such claims under the pre-DOCA guarantee agreement arose before, during the course of the DOCA, or after the release of the company from the DOCA. In turn, those debts or claims were provable under the DOCA to be dealt with by the administrator in the manner described above in the context of liquidation.

SPECIAL RULES

Although the Corporations Act does not provide a statutory definition of 'creditor', the courts have consistently referred to the words of s 533 in determining who is a creditor for the purposes of insolvency proceedings under the Act. Since the enactment of that section the ambit of creditors' claims has extended to 'claims against the company (present or future, certain or contingent, ascertained or sounding only in damages)'.

In view of the unique nature of a contingent claim, with its existence dependent on an event that may or may not happen, special rules have been developed, particularly with respect to the right of a contingent claimant to apply for a company's winding up on grounds of insolvency, voting at creditors' meetings, and being admissible to proof for distribution purposes.

The above discussion has highlighted these situations and the rules that have emerged giving effect to the unique position of a contingent creditor. ▲

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is capable of valuation. As a general rule, where the liquidator embarks on the task of valuation, with or without the directions of the court, the following steps will need to be taken:

- Formulate a view as to the likely chances of the contingency occurring; this may result in categories such as 'probable', 'reasonably possible' and 'remote'.
- Estimate the likely amount of the claim taking into account the likelihood of the future event happening.

approach has been adopted with respect to contingent claims encountered by an administrator for the purposes of a deed of company arrangement (DOCA) (see *Easey v Grosvenor Constructions (NSW) Pty Ltd*).⁶

The recent decision in *Australian Gypsum Industries Pty Ltd v Dalesun Holdings Pty Ltd*⁷ well illustrates the position. With respect to a company entering into a DOCA the Court was required to determine whether future or contingent claims against the company arising under a guarantee

⁶ [2005] NSWSC 878. ⁷ [2014] WASC 89.