BRI Ferrier

TECHNICAL INSIGHTS

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Court orders limiting the personal liability of administrators for debts arising in the course of administration

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Introduction

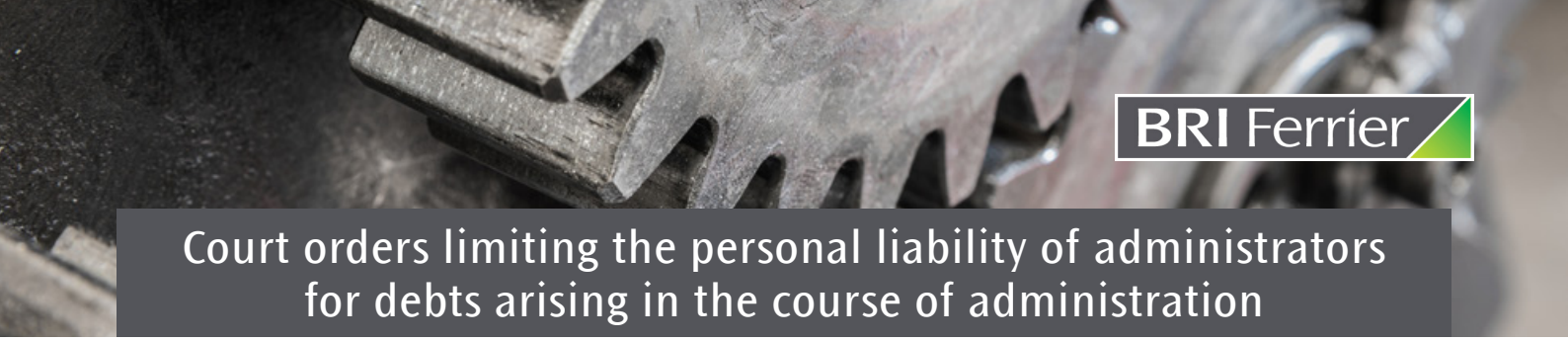
By virtue of the operation of sections 443A(1) and (2), Corporations Act the administrator of a company under administration is personally liable for debts incurred in the exercise of powers as administrator for (amongst other things) services rendered or goods bought or moneys borrowed on behalf of the company during the course of the administration. Usually such debts incurred will be paid from the available assets of the company pursuant to the administrator's statutory right of indemnity under section 443D, Corporations Act. However, if there are insufficient company funds available the administrator will be obliged to personally meet the shortfall.

There are significant policy reasons why personal liability has been imposed on administrators in these circumstances. First, it is intended to provide protection to parties who at the request of the administrator continue to deal with the company during the post-administration period. Next, the personal liability of the administrator coupled with a right of indemnity will assist in achieving the statutory objectives of the administration. In particular, the company in appropriate cases will be in a position to continue trading through the administration period as a result of suppliers and other creditors willing to deal with the company on the understanding that the administrator will carry personal liability.

Consequences arising from administrator's exposure to personal liability

On occasions the administrator may recognise that the best outcome for the company and its creditors will be dependent upon incurring substantial future debt or liabilities for which the administrator will be personally liable. For example, the administrator may identify the need to meet the substantial cost of repairs and maintenance of necessary plant and equipment. In other cases, the administrator may recognise that meeting the company's ongoing operating costs, such as employee's wages, will be necessary to continue trading the company's business with a view to selling its assets on a going concern basis.

In such cases the company is most often not in a



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financial position to meet such ongoing expenditure. One option commonly pursued by administrators in these circumstances is to seek external funding, usually from the company's existing lender, to meet post-administration debts and liabilities. Once again, however, the administrator will be exposed to personal liability under section 443A(1) in the event that a shortfall is experienced by the lender under the funding arrangement.

It is apparent that administrators cannot be expected to accept personal liability in cases where the incurring of substantial future debt is solely for the benefit of the company and its creditors and the assets of the company are insufficient to indemnify the administrator. Clearly if such proposals for the incurring of future debt are to proceed there will need to be legal means available to ensure that the administrator's personal liability will be limited, notwithstanding the operation of section 443A(1), Corporations Act.

Legal framework under which the courts may limit the personal liability of administrators

Under section 447A, Corporations Act the court has been given broad power to modify the operation of Part 5.3A, Corporations Act as it thinks appropriate in relation to a particular company under administration.

It is well established that the judicial power contained in section 447A enables a court to make orders that limit the personal liability of administrators under section 443A(1), Corporations Act. The principles governing the granting of orders under section 447A for this purpose have been usefully summarised in Re Mentha (2010) FCA 1469, as follows:

- the proposed arrangements are in the interests of the company's creditors and consistent with the objectives of Part 5.3A, Corporations Act
- typically the arrangements proposed are to enable the company's business to continue to trade for the benefit of the company's creditors
- the creditors of the company are not prejudiced or disadvantaged by the types of orders sought and stand to benefit from the administrator entering into the arrangement
- notice has been given to those affected by the order

Most of the cases where the courts have exercised its powers under section 447A to vary the administrator's personal liability under section 443A(1) have involved administrators seeking to borrow funds during the period of the administration. The orders typically sought have the effect of limiting recourse of the lender to the administrator personally only to the extent to which the administrator is able to meet the lender's debt from the assets of the company.

At this stage it will be useful to consider a recent case in which these principles have been applied.

Preston, in the matter of Hughes Drilling Ltd (Administrators Appointed) (2016) FCA 1175, 26/9/2016

Following their appointment as administrators of Hughes Drilling Ltd and its subsidiary companies which together made up the HDL Group, the administrators formed the view that there were advantages in the companies continuing to trade on a going concern basis so as to enable the administrators to explore either a sale or rehabilitation of the HDL Group.

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However, the HDL Group had insufficient liquidity to meet wage payments and the administrator's costs and fees as and when those payments would fall due. Consequently the administrators were concerned that employees would cease to complete profitable service contracts which would in turn trigger events of default leading to the likely termination of those contracts by the HDL Group's clients.

So as to avoid this risk and to maintain day-to-day trading the administrators negotiated a funding arrangement with Westpac (the existing secured creditor of the HDL Group) borrowing approximately $4 million to enable the HDL Group to meet its payments to employees and suppliers.

On the application of the administrators the court ordered that pursuant to section 447A if the property of the HDL Group was insufficient to satisfy the debts and liabilities incurred by the administrators under the funding agreement the administrators would not be personally liable to repay such debts and liabilities to the extent of the insufficiency. In making its order the court observed:

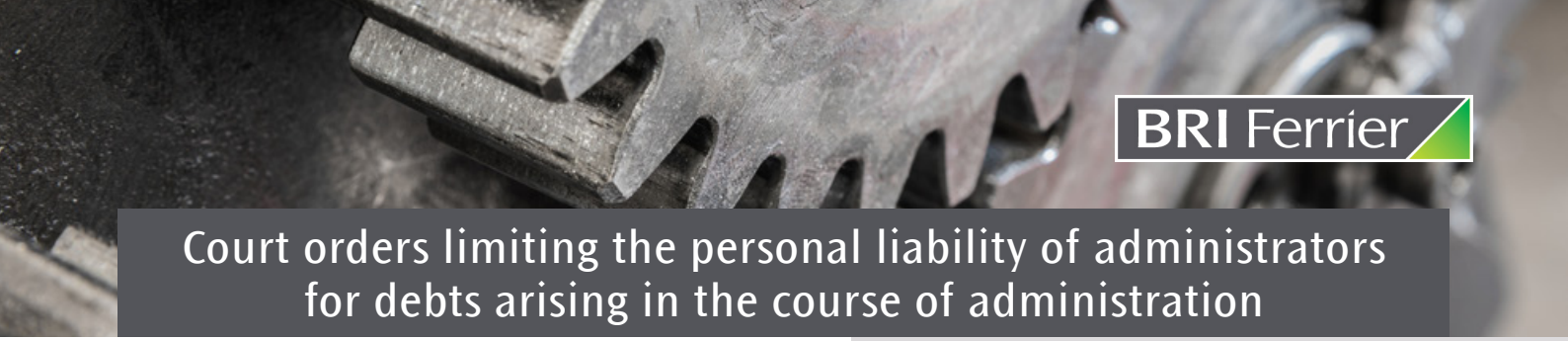
"The funding arrangement is plainly in the interests of creditors and consistent with the objectives of Pt 5.3A of the Act. The simple fact is that the provision of funding under the arrangement will only proceed if the relief sought is granted. It is not to be expected that the (administrators) should be expected to expose themselves to substantial personal liabilities in circumstances such as the present…Westpac will, of course, retain its security for the money borrowed under the funding arrangement. So far as the unsecured creditors are concerned, the evidence before me is that they are likely to be better off by the group business continuing to operate so as to preserve its value." (para 18).

Concluding comments

There are sound policy reasons why section 443A(1) imposes personal liability on administrators for post-appointment debts incurred, while providing the administrator with a statutory right of indemnity against assets of the company. On occasions, however, the financial position of the company will be such that any right of indemnity against its assets will be illusory. As one court has observed "the problem here is not the availability of the indemnity but the utility of it."

Our discussion has revealed cases arising where administrators recognise that the incurring of future debts and liabilities would be in the best interest of the company and its creditors. However, understandably, the administrators have been unwilling to commit to personal liability for such debts or liabilities arising solely from their efforts to promote the interests of the company and its creditors.

As a result, the courts, acknowledging the untenable position of administrators, have in such cases demonstrated a willingness to modify the operation of section 443A pursuant to judicial powers granted by section 447A. However, such modification of personal liability of administrators has not been lightly undertaken by the courts. Administrators seeking orders in these circumstances will need to satisfy the court that no disadvantage to creditors will be experienced, while also demonstrating to the court that the statutory objectives of the administration



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process (see section 436 Corporations Act) are being advanced by the proposals before the court.

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BRI Ferrier is a unique affiliation of expert business recovery, insolvency, forensic accounting and advisory firms. We provide practical, innovative services that help financially distressed businesses to recover or at least minimise the negative impacts of insolvency.

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We also work with financiers, solicitors, accountants and creditors to address the needs of all stakeholders when businesses face financial challenges.

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