

## Note

### THE DUTIES OF ADMINISTRATORS IN SOLVENT COMPANIES

A question not frequently encountered by insolvency practitioners ('IPs') acting as administrators is how to exercise their powers, and discharge their duties, where a company is or might be solvent in the context of a contested application to remove them as office holders. In a scenario where there is likely to be a surplus after payment of creditors and expenses, and thus a likely return to members or shareholders of a company, this usually signals a reasonably happy outcome for the member who at best expects little return. Unusually, this outcome may be compromised by a lender who was willing to forebear on defaulting loans in order to assist in the realisation of assets at a higher price than what might otherwise have been obtained in a forced sale. In this instance the share of return to the lender would increase, but it would be at the expense of the members or shareholders. This 'commercial tension' or conflict between competing interests raises an important question as to what the administrators' duties to shareholders are, and to whom their duties primarily lie. This matter of interest was examined by Mr Hugh Sims KC, sitting as a deputy High Court judge, in his decision in *Nardelli v Richardson (Nardelli)*.<sup>1</sup>

The facts of *Nardelli* are worth briefly noting. Proceedings arose out of the proposed development of a new 6,000 unit 'Eco Town'. The three companies which were formed had shareholders and directors in common and had acquired land or options over land and outline planning permission. Loans were provided to these companies in the form of fixed and floating charge security. A developer had brought proceedings for breach of contract against one of the companies and obtained a judgment for £13.4 million plus interest and costs. The secured lender sent letters of demand to each of the companies in relation to its loans, which were then in default. The companies were unable to meet the demands, which led to the appointment of the administrators.

The administrators established that since the companies were balance sheet solvent the creditors would not only be paid in full, but a surplus would be available for shareholders after the companies' property were sold. Subsequently, the administrators received a higher offer for the land, requiring them to exercise an option to buy. The secured lender agreed to inject additional funds to accept this offer, which in turn significantly reduced the expected return to shareholders.

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<sup>1</sup> [2024] EWHC 2740 (Ch).

Action was taken by the applicant to seek the removal and replacement of the administrators under the Insolvency Act 1986, Sch. B1 paras 74, 88, and 95 on the ground that the administrators' conduct was in breach of their duties and favouring the secured lender had caused him unfair harm as a shareholder.

The applicant's claim as to who administration should benefit under these circumstances led the court to find, contrary to the shareholders' argument, that solvency does not change administration into a process for the benefit of the members or shareholders.<sup>2</sup> Instead, it is said that the creditors' interests are given primacy. However, this position is not without its exceptions. In the proper exercise of their statutory powers, administrators are afforded significant discretion to manage insolvency proceedings, a matter that the courts are keen to remind disgruntled creditors or trustees.<sup>3</sup> While this discretion is conceived broadly, it is not absolute,<sup>4</sup> and it is here where the critique must begin. Once the limit of that discretion is examined, this note will assess what powers are permitted of the administrators. Afterwards, what follows is an examination of the administrators' duties, before the concluding remarks.

To help pull these threads apart, the oversight the courts may exercise in relation to an administrator's discretion is also important. On the general use of discretion, two points should be noted. First, there is a distinction between decisions that an office holder can make only with the sanction of the court, where the court will consider the position afresh, and decisions that the office holder can make without sanction, where the role of the court is one of review. Secondly, there is a difference to be noted between commercial decisions where the court will not interfere, and decisions on the law, where the court may do so. In *Nardelli*, it was noted that unless there was some identifiable flaw in the administrator's reasoning, or a failure to take account of some material factors, the matter is a commercial decision and as such the courts would not ordinarily interfere.<sup>5</sup> In practice, to determine what amounts to a flaw in reasoning or a failure to consider material factors is likely to be a contentious matter. While it is clear that administrators do not have unrestricted authority to make any type of commercial decision, even if rationalised, the court's general approach often shows a reluctance to second-guess administrators' decisions.

This cautious but pragmatic approach by the courts has restricted efforts to ascertain the limits of an administrator's discretion, which was already circumscribed as the courts are only able to examine the

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<sup>2</sup> *Ibid*, [39], [145].

<sup>3</sup> See *Patley Wood Farm LLP v Kicks* [2023] EWCA Civ 901, [2023] BPIR 1483 (hereafter *Patley*).

<sup>4</sup> A. Balan, 'Patley Wood Farm LLP v Kicks and the balancing act of office holder discretion' (2024) 140 *LQR* 518.

<sup>5</sup> *Re Lehman Brothers International (Europe) Ltd* [2008] EWHC 2869 (Ch), [2009] BCC 632, [45]; *Re Longmeade Ltd* [2016] EWHC 356 (Ch), at [66].

issues that arise in litigation.<sup>6</sup> If the matters do fall within the issues raised in litigation, one of the matters addressed in *Nardelli* was whether the administrators had considered all the relevant factors. The respondents had argued that the applicant had no standing to request independent office holders to investigate the conduct of the administrators to determine if any breaches had occurred so that claims could be advanced against them.<sup>7</sup> This position was countered by the applicant who argued that even if the allegations of breach of duty were not clear it was sufficient to show that there was a serious issue for consideration.<sup>8</sup> In these circumstances, what is a relevant factor will ultimately be led by the facts of the case, but it was noted that this posed its own issues.

The deputy judge noted the difficulties associated with conduct where a conflict of interests such as this may call into question the independence of the administrators. The judge however did reiterate the importance of specifics and concluded that ‘whatever generic category a case may be said to fall within, or outside, this is no substitute for a sharp focus on the detailed facts’.<sup>9</sup> It is the focus on detailed facts that provide an administrator with direction on how to deal with the issues at hand. Yet, even within specific facts, there is often some flexibility on how to address specific issues, and this is where the use of an administrators’ discretion can be used to justify outcomes, even if at first sight the available options appeared quite limited.

This may give the impression that it is difficult to challenge the decisions of an administrator, but while in some instances there will simply be insufficient evidence to show a breach of duty to consider the members, the jurisdiction to remove an administrator could still be engaged where there was a good reason why matters should be investigated.<sup>10</sup> Here, the court recognised that on the approach to be taken there is no ‘one-size’ fits all, with the court required to consider the circumstances and features of administration in each case as to whether shareholders’ interests should form part of the considerations.<sup>11</sup> Yet, even if consideration is given to all relevant factors, the decision may still not provide a conclusive good reason; at least in the eyes of certain creditors. Instead, the best approach is to determine whether the decision reached is within the scope of what can be decided by the administrators. On this basis, it is now necessary to review the powers and duties permitted to the administrators.

Broadly conceived, the afforded powers permit administrators to make all the necessary decisions in order to achieve the purpose of administration. This may require administrators to proceed with an

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<sup>6</sup> *Al-Medenni v Mars UK Ltd* [2005] EWCA Civ 1041, at [21].

<sup>7</sup> *Nardelli*, at [55].

<sup>8</sup> *Nardelli*, at, [57].

<sup>9</sup> *Nardelli*, at [58].

<sup>10</sup> *Nardelli*, at [59].

<sup>11</sup> *Nardelli*, at [60].

objective without consulting all relevant parties. It is often this lack of transparency that leads to much of the distrust that may be felt by members or shareholders, despite evidence that shows to the contrary, their interests were considered alongside that of the creditors.<sup>12</sup> It is suspected in *Nardelli*, and cases like it, that the litigation is not necessarily concerned with the administrators' decisions, which may be commercially justified and have been made in accordance with the powers afforded to them, but rather the real issue is with the 'unfair' outcome that has harmed their interests, and a result that is often beyond the administrators' control. Understandably, this may attract criticism, but it is not in breach of their powers.

On the duties of the administrators', attention should be drawn to paragraph 3 of Schedule B1 to the Insolvency Act 1986, which provides the objectives that the administrators' should aim to achieve. It provides:

- (1) The administrator of a company must perform his functions with the objective of—
  - (a) rescuing the company as a going concern, or (b) achieving a better result for the company's creditors as a whole than would be likely if the company were wound up (without first being in administration), or (c) realising property in order to make a distribution to one or more secured or preferential creditors.
- (2) Subject to sub-paragraph (4), the administrator of a company must perform his functions in the interests of the company's creditors as a whole.
- (3) The administrator must perform his functions with the objective specified in sub-paragraph (1)(a) unless he thinks either— (a) that it is not reasonably practicable to achieve that objective, or (b) that the objective specified in sub-paragraph (1)(b) would achieve a better result for the company's creditors as a whole.
- (4) The administrator may perform his functions with the objective specified in sub-paragraph (1)(c) only if— (a) he thinks that it is not reasonably practicable to achieve either of the objectives specified in sub-paragraph (1)(a) and (b), and (b) he does not unnecessarily harm the interests of the creditors of the company as a whole.

In *Nardelli* at [37], the judge drew attention to two points when considering this cornerstone provision. With reference to *Davey v Money*,<sup>13</sup> Snowden J, as he then was, made it clear that the interests of creditors as a whole was relevant whichever objective in para 3 was pursued. Arguably, secured

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<sup>12</sup> *Nardelli*, at [152].

<sup>13</sup> [2018] EWHC 766 (Ch), [2018] Bus 22 LR 1903, at [323], hereafter *Davey*.

creditors are the focus in objective three (1(a)(c)), but this could not be pursued if it would unnecessarily harm the interests of creditors as a whole. The nature of this harm and who it is directed towards is important since the presence of harm is not in itself enough. Creditors are harmed regularly, what matters is if the harm was unnecessary.<sup>14</sup> The concept of unfair harm in relation to paragraph 74 of Sch. B1, provides insight into how members or shareholders' interests should be considered when they are engaged by reason of there being a likely return to shareholders.

The scope of para 74 provides members with relief against unfair harm, the outcome of which is determined based on the administrator's actions. This can include acts, proposals to act, or circumstances where the administrator has not performed his functions as quickly or as efficiently as is reasonably practicable (para 74(1)(a) -(b), (2)). In that respect, unfairness is not restricted to instances where an act may lead to unjustifiable discrimination between members of a class. Discrimination may be permitted, where it can be justified. This is a crucial point to note. The outcome of an unfair harm case may depend on whether there is commercial justification for a decision that causes harm to a class of creditors or members as a whole, with a lack of a justification likely to satisfy unfairness within paragraph 74.<sup>15</sup> However, even in instances where commercial justification is provided, if it was contrary to 'logical analysis', then the court may intervene.<sup>16</sup> In practice, whether a commercial decision is considered logical will depend on the specific circumstances. Decisions by an administrator that led to a failure to acquire the best price reasonably obtainable, or if the administrator relied upon advice that was wrong,<sup>17</sup> and this caused harm to the creditors, then this could fall within the 'illogical' classification. However, there may be then a defence available to the administrator if he or she can demonstrate that they have exercised reasonable skill and care as expected of ordinarily competent IPs.<sup>18</sup> Applied to *Nardelli*, if the interests of the members were considered, but a logical argument was made to pursue the course of action that was taken, then it would appear that the members' interest can be justifiably diminished. If rationalised on commercial grounds, the decision(s) will be classified as logical and mainly left undisturbed.<sup>19</sup> Even in instances where decisions may be reviewed, the circumstances in which they are reviewed are limited and they must not be reviewed in hindsight; only may the decisions be examined with the knowledge that was available at the time.<sup>20</sup>

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<sup>14</sup> *Nardelli*, at [157].

<sup>15</sup> *Nardelli*, at [48].

<sup>16</sup> *Loveridge v Povey* [2024] EWHC 329, at [50].

<sup>17</sup> *Davey*, at [447], [450]-[451].

<sup>18</sup> *Re Charnley Davies Ltd (No2)* [1990] BCC 605, at 618D-E.

<sup>19</sup> J Wood, 'Insolvency office-holder discretion and judicial control' (2020) 6 J.B.L. 451.

<sup>20</sup> *AMP Music Box Enterprises Ltd v Hoffman* [2002] EWHC 1899 (Ch); [2002] BCC 996, 1001-2, hereafter *AMP Music*.

In *Nardelli*, since the allegation of unfair harm also formed the basis of the application to remove under para 88 of Sch. B1 to the IA 1986, and no other relief was sought other than removal, para 74 was said not to add much to this case.<sup>21</sup> This is not however strictly true since there is a broader level of judicial discretion that has to be applied to para 88, given that ‘the court may by order remove an administrator from office’. While para 77 may look to challenge an administrator’s conduct through the presence of unfair harm, para 88 provides the courts with ‘unfettered’ discretion to remove on the basis of due cause or good reason.<sup>22</sup> Within this provision, a good reason may include instances where an alternative administrator would have taken a different approach, particularly if it had an adverse impact on the petitioner.<sup>23</sup> Yet the mere existence of an alternative approach does not prove bias, bad faith, or a lack of commercial justification. By itself, a different approach would not provide a good reason for removing the administrators.<sup>24</sup> If there was a different opinion on the working of Sch. B1, which could have led to a different outcome for creditors, but the decisions were based on rational commercial grounds, then the court would not exercise its discretion to intervene.

Continuing with the administrators’ duties, on the application of good reason in para 88, it has a surprisingly broad scope. It does not require anything that amounts to misconduct, personal unfitness, or a breach of duty. Instead, it is to be measured in accordance with the interests of the insolvency process and for the purpose for which the administrators are acting.<sup>25</sup> Within these relevant interests, it was noted above that an administrator owes a general duty to the body of creditors as a whole, particularly if the second objective of administration is pursued. This may include consideration of the interests of shareholders, but it does not change the purpose of administration, nor are shareholders given priority over creditors’ interests.<sup>26</sup> Accordingly, while shareholders have the lowest ranking priority, if the company was solvent, as it was here, then the administrators would have to consider their interests when deciding on the appropriate course of action.<sup>27</sup>

The courts when making an assessment will consider but are not bound by the wishes of the majority interests, whether that be the shareholders as it was in *Nardelli*, or any other group of stakeholders.<sup>28</sup> Consideration should also extend to the impact of removal on ‘professional standing and reputation’, but the extent of this consideration appears to be uncertain.<sup>29</sup> What is clear is that the courts are

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<sup>21</sup> At [48].

<sup>22</sup> *Sisu Capital Fund Ltd v Tucker* [2005] EWHC 2170 (Ch).

<sup>23</sup> *Nardelli*, at [101].

<sup>24</sup> *Finnerty v Clark* [2011] EWCA Civ 858, [2012] 1 BCLC 286, at [37].

<sup>25</sup> *Re Buildlead Ltd (In Liquidation) (No 2)* [2006] 1 BCLC 9; [2005] BCC 138, at [168]-[169].

<sup>26</sup> See Lord Neuberger PSC in *Re Nortel GmbH (in administration)* [2013] UKSC 52, at [39].

<sup>27</sup> *Hat*, at [204].

<sup>28</sup> *Sisu Capital*, at [86].

<sup>29</sup> *Nardelli*, at [51].

prepared to remove administrators if their independence and professionalism fall short of expected standards.<sup>30</sup> In *Nardelli*, the applicant argued that the administrators' decisions had favoured the secured lender's interests to the unfair detriment of other creditors and shareholders. Not only were these allegations not substantiated, but the court did not consider the issue serious enough so as to require further investigation, nor did it amount to what would be perceived as good grounds for removal.<sup>31</sup>

All considered, the question remains who does the administrator give preference to if there are competing interests? The answer is it depends on the specifics. While the administrators are bound to act 'in the interests of the company's creditors as a whole [and this may] involve the balancing of competing sectional interests, to avoid acting so as unfairly to harm the interests of any particular creditor or group of creditors...',<sup>32</sup> the balance between the sectional interests alone cannot be considered in isolation to other relevant factors. While the solvency of the company may make shareholders' interests relevant, an administrator is within their discretion to consider the wider implications of insolvency, such as the cost and complexity of any potential litigation, and whether there are funds available for this. The presence of the secured lender in *Nardelli* led the administrators to believe that this proposal would be in the best interests of the creditors, and given the higher priority afforded to these creditors they were entitled to pursue this objective even if it did have a harmful impact on the shareholders.

This brings us to the concluding remarks. Hypothetically, if the creditors in *Nardelli* were unaffected, and an alternative decision provided 'no material difference between them [creditors] in either achieving or failing to achieve the first statutory objective (para 3(1)(a)), then [the] administrators should adopt the course of action that is most likely in the interests of the members as a whole'.<sup>33</sup> But this approach would only be possible in circumstances where the creditors' interests were not unduly harmed, or the shareholders' interests were not in conflict with that of the creditors (see para 3(4)). This was not the case in *Nardelli*. The decision not only confirms that administrators are not required to act in the creditors' interests 'at all costs',<sup>34</sup> but solvency is not a specific factor that alters administration into a process for the benefit of members. Nevertheless, in future should administrators adopt the approach taken in *Nardelli*, they are unlikely to avoid criticism or relief being

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<sup>30</sup> *AMP Music*, at 1001H.

<sup>31</sup> *Nardelli*, at [59], [151].

<sup>32</sup> *Green v SCL Group Ltd & Others* [2019] EWHC 954 (Ch), at [27].

<sup>33</sup> *Hat*, at [240].

<sup>34</sup> see, *Patley*, at [73].

sought under paras 74 and 88 since the administrators' discretion to consider shareholders' interests remains significant if the facts permit.