Supreme Court Rules Against Super Priority Status of Pension Regulator's Claims in Insolvency

The Supreme Court has boosted the rescue culture by ruling that Financial Support Directions (FSDs) issued by the UK Pensions Regulator after commencement of insolvency proceedings are not an expense of the administration and, instead, rank on a par with unsecured claims. This decision in the Nortel and Lehman administrations will be reassuring to creditors and insolvency and restructuring practitioners.

Key Points

- Liabilities under an FSD and subsequent Contribution Notice (CN) issued against an insolvent company were not an expense of the administration but would rank as a provable debt.
- The liabilities under an FSD are provable in a formal insolvency proceeding, but will not be paid ahead of distributions to unsecured creditors, floating charge holders, the administrators' own fees, unpaid wages and holiday pay. Even if the court had found that FSD liabilities were not provable, they would not have been an expense of the administration.
- In administration, the order of priority for payment of FSDs and CNs out of the company's assets is now, in summary terms, as follows:

  First: Fixed Charge Creditors
  Second: Expenses of the Administration
  Third: Preferential Creditors
  Fourth: Unsecured Creditors (up to a maximum of £600,000)
  Fifth: Floating Charge Creditors
  Sixth: Unsecured Provable Debts (including liabilities under FSDs and CNs)
  Seventh: Statutory Interest on Debts
  Eighth: Deferred Creditors
  Ninth: Shareholders

The case has raised important legal and practical questions about the manner in which corporate insolvency provisions relating to the priority ranking of debts apply to the FSD regime. Not only has the Supreme Court judgment provided welcome guidance on the treatment of pension scheme claims in insolvency, but it has also analysed in detail how statutory demands made to a company in administration or liquidation rank in the process, and, generally, when and how a contingent liability will be provable in an administration or liquidation.

The decision has real practical relevance. By clarifying that liabilities arising pursuant to an FSD do not enjoy priority ranking as an expense of the administration, lenders benefiting from fixed and floating charge security no longer have the worry of floating charge realisations being wiped out by a sizeable pension claim which ranks ahead of them. Furthermore, concerns around the use of administration as a corporate or business rescue tool, which had been posed by the earlier decisions, have been alleviated by this judgment. From the perspective of the Pensions Regulator, the decision means that they will need to take into account the fact that the debt is unlikely to be paid out at par when they are seeking financial support from target companies in the group.

Background

The FSD Regime

The backdrop to the case was the FSD Regime which exists to protect pension scheme members. In particular, in cases where employees are working on behalf of companies within a group but are actually employed by a "service company" with limited assets, there could be a pension scheme shortfall if that company were to fall into financial difficulty. In order to stop the "moral hazard" of companies structuring their business in order to avoid pension payments, the Pensions Act 2004 introduced an FSD regime. Pursuant to this regime and to the Pensions Act 1995, the Pensions Regulator has the power to impose (by the issue of an FSD) an obligation on certain companies associated with the employer to financially support the under-funded scheme and to deal with non-compliance by imposing a monetary liability payable to the trustees of the scheme.

The Details of the Case

The now familiar case concerned final salary pension schemes of companies in the Lehman Brothers group and the Nortel group which were in substantial deficit. A number of UK registered entities of both groups went into administration proceedings and the Pensions Regulator subsequently issued FSDs to other companies within the group, requiring them to provide financial support to the pension schemes. The administrators sought directions of the Court to determine whether the liabilities under the FSDs were provable claims (which would rank equally with other unsecured creditors); administration expenses (which must be paid before distributions to unsecured creditors, floating charge holders and preferred creditors); or neither. The Court of Appeal upheld the 2010 decision that the liabilities were expenses of the administration because there was no option open to them to rank the liabilities as provable claims due to binding precedent. The issue then went before the Supreme Court.

The Issues

The Supreme Court provided an in-depth step-by-step legal analysis of certain statutory provisions, related case law and their application in the context of the ranking of pension claims and other statutory liabilities, which can be summarised as follows:

1. *What constitutes a provable debt?*

The Supreme Court considered Rule 13.12 (1) of the Insolvency Rules 1986, and held that a provable debt in administration must either be: (a) a liability to which the company is subject at the date of the insolvency event, or (b) a liability arising by reason of any obligation incurred before the insolvency event but to which the company becomes subject after that date. A provable debt can never be both.

2. *Does a statutory liability (such as under an FSD) issued after an administration therefore fall under (a)?*

That depends on whether the liability has arisen "by reason of any obligation incurred before" the insolvency event.

3. *In this context, what does the word "obligation" mean?*

The Supreme Court noted that an "obligation" can arise under a contract. However, where the liability does not arise under a contract but arises, for example, under a statutory provision, the position is not so straightforward. Referring to existing case law, the Court held that in order for a company to have incurred a relevant "obligation" the following three requirements must "normally" (but not always) apply:

> *"it must have taken, or been subjected to, some step or combination of steps which (a) had some legal effect (such as putting it under some legal duty or into some legal relationship), and which (b) resulted in it being vulnerable to the specific liability in question, such that there would be a real prospect of that liability being incurred. If these two requirements are satisfied, it is also, I think, relevant to consider (c) whether it would be consistent with the regime under which the liability is imposed to conclude that the step or combination of steps gave rise to an obligation."*

The Supreme Court relied on *Re Sutherland* [1963] AC 235 and other cases that were concerned with the meaning of "contingent liabilities". The court reasoned that the two concepts are closely related: a company committing itself to a contingent liability is "*much the same thing as having incurred an obligation from which a contingent liability may arise"* for the purpose of constituting a provable debt.

The Decision

In the circumstances, the three requirements for the relevant Nortel and Lehman Brothers companies to have incurred a relevant "obligation" had been satisfied. Firstly, in the circumstances, the target companies had become a member of a group of companies and thereby had put themselves into some legal relationship. Secondly, by the date they went into administration they were "vulnerable to the specific liability" of the FSD regime because they either included amongst them a service company with a pension scheme or an insufficiently resourced company with a pension scheme. Thirdly, the Court held that it is consistent with the FSD regime that the potential FSD liabilities derived from obligations incurred before the insolvency event.

The Court of Appeal had felt bound by earlier authorities involving personal bankruptcy and orders for costs. It had held that where an order for costs was made against a person after an insolvency process had been instituted against him, his liability for costs did not arise from an obligation which had arisen before the issue of bankruptcy proceedings. The Supreme Court swept these earlier decisions aside and, on the basis of the same reasoning outlined above, concluded that an order for costs made against a company in liquidation or administration, made in proceedings begun before it went into liquidation or administration, would be a provable debt.

The Supreme Court also provided guidance as to when a liability would constitute an administration expense even though it was "strictly unnecessary to consider this question" having decided that the FSD liability was a provable debt. The Court disagreed with the Court of Appeal's reasoning with respect to the House of Lords' judgment in the case *In re Toshoku Finance UK plc* [2002] 1 WLR 671. The Court did not accept that a financial liability imposed by statute, which is not a provable debt, should become an expense of the administration (or liquidation). In the Court's opinion, a liability would only be an administration expense "*if it arises out of something done in the administration (normally by the administrator or on the administrator's behalf), or if it is imposed by a statute whose terms render it clear that the liability to make the disbursement falls on an administrator as part of the administration – either because of the nature of the liability or because of the terms of the statute*."

If you would like to learn more about the issues in this alert, please contact your usual Ropes & Gray attorney, or any of the attorneys listed below.

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