Lehman / Nortel Pensions

The Supreme Court today handed down judgment in the *Lehman* and *Nortel* pensions appeals [2013] UKSC 52, reversing the decisions of Briggs J and the Court of Appeal and, in the process, sweeping aside numerous other well-known and long-established decisions.

The Supreme Court unanimously upheld the appeals (Lords Neuberger (President), Mance, Clarke, Sumption and Toulson), and held that:-

1. The liability of a target company to provide financial support pursuant to a financial support direction ("FSD"), or to pay the debt required to be paid under a contribution notice ("CN"), is provable in that company's administration even where the relevant FSD was not issued until after the commencement of the administration.

2. Had that liability not been provable, it would not have been payable as an expense of the administration. Where: (i) a statutory liability is one which could have been imposed before or after an insolvency event; (ii) the liability does not give rise to a provable debt; and (iii) the statute is completely silent as to how the liability should be treated if it is imposed after an insolvency event, the liability can only be an expense if the nature of the liability is such that it must reasonably have been intended by the legislature that it should rank ahead of provable debts.

Gabriel Moss QC, **Richard Sheldon QC**, **Mark Phillips QC**, **Robin Dicker QC**, **William Trower QC**, **Barry Isaacs QC**, **Felicity Toube QC**, **David Allison**, **Daniel Bayfield**, **Tom Smith** and **Stephen Robins** all appeared before the Supreme Court.

Wider relevance

Insolvency

The decision is one which is bound to be welcomed by insolvency practitioners and others working in the insolvency industry.

Legally, its relevance is in explaining: (i) how one identifies whether a contingent liability is provable in an administration or liquidation; and (ii) when a statutory liability will be payable as an expense in an administration or liquidation.

Commercially, the decision is bound to be seen as promoting the rescue culture. Substantial expense claims hinder the ability of an administrator or liquidator to achieve an advantageous result for creditors.

The decision also avoids the risk of liquidity drying up more generally – in circumstances where those lending to companies against the security of a floating charge were at risk of making no recovery at all where the borrower was the recipient of an FSD after having gone into administration. Prior to the decision of the Supreme Court, in that scenario, the FSD liability was payable as an expense and, therefore, in priority to the floating chargeholder.

In light of the judgment, insolvency practitioners will have to take great care to ensure that the financial support they offer reflects the fact that any CN liability will only be provable. By agreeing to provide financial support, the administrator will cause the company to incur an expense liability and its quantum should reflect the fact that the trustees would only be entitled to a dividend on their CN claim.

More generally, the judgment leaves significant scope for future argument as to when and whether, for the purposes of rule 13.12(1)(b), an obligation has been "incurred" under particular statutory provisions.

There will also be room for debate as to whether the legislature must reasonably have intended that a particular statutory liability should rank ahead of provable debts.

Pensions

The Pensions Regulator will need to take care in calculating what level of financial support is appropriate to require in circumstances where the CN debt is now much less likely to be worth 100p in the £. In doing this, the Regulator should take into account that the administrator or liquidator is unlikely to be acting in the best interests of the creditors by offering financial support which is more generous than that which the company would pay out if a CN were to be issued.

Pension scheme trustees should also take note of the judgment and assess their prospects of recovery in light of it. This will require them to consider closely the financial positions of group companies trading as going concerns and, post-insolvency, the progress of administrations and liquidations and the prospects for the unsecured creditors generally.

The Facts

Numerous UK registered members of the Lehman Brothers group of companies and of the Nortel group of companies have gone into administration.

The Lehman group included a company which entered into service contracts with, and ran a pension scheme for the benefit of, employees who worked for other group members.

The Nortel group included a company which had a pension scheme and which was insufficiently resourced to fund that scheme.

The pension scheme in each case was a final salary scheme which is in substantial deficit.

The Pensions Regulator subsequently initiated machinery under the Pensions Act 2004 to require certain other group members to provide financial support for the relevant scheme.

That machinery has been held up so it can be decided whether the liability under such a requirement would rank: (a) as an expense of the targets' administration; (b) *pari passu* with the targets' other unsecured creditors; or (c) as neither.

Under option (a) the liability would rank ahead of the unsecured creditors, and may well be paid in full; under option (b) it would rank equally with those creditors; under option (c) it would rank behind them, and would probably be worthless.

The FSD regime

The FSD regime was introduced to address the risks of moral hazard, namely to prevent groups of companies from avoiding their pension obligations by using company structures and business transactions and leaving such obligations to be borne by the Pension Protection Fund, and to act as a deterrent against such behaviour.

Although it is the FSD regime under the Pensions Act 2004 which was of central importance, section 75 of the Pensions Act 1995 Act is highly relevant in that it provides that, upon the happening of an "insolvency event" (which term includes administration and liquidation), an amount equivalent to any shortfall in the assets of an occupational pension scheme as against its liabilities, which exists immediately prior to the relevant event, is to be a debt, known as a "section 75 debt", due from the employer to the trustees of the scheme.

The FSD regime permits the Pensions Regulator to seek financial support from associates of the employer to seek to recover the section 75 debt.

Key aspects of the decision

The appeals raised a point of real significance for English insolvency law, namely how statutory liabilities imposed on companies in administration or liquidation are to rank for payment.

Provable debts

For a debt to be provable in an administration or liquidation, it must fall within rule 13.12(1) of the Insolvency Rules 1986. The Supreme Court confirmed that paragraph (a) of that rule is concerned with liabilities to which the company "is subject" at the date of the insolvency event, whereas paragraph (b) is directed to those liabilities to which it "may become subject" subsequent to that date, and that there is no overlap between these two categories.

The Court held that the liability was provable because it fell within rule 13.12(1)(b), i.e. it is a liability which arises by reason of an obligation incurred before the insolvency date.

Borrowing heavily from *Re Sutherland* [1963] AC 235, the Supreme Court held that, normally, in order for a company to have incurred a relevant "obligation" under rule 13.12(1)(b), 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 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 under rule 13.12(1)(b).

In addressing this test, the Court held that:

As to the first requirement, on the date they went into administration, each of these companies had become a member of a group of companies. Membership of a group of companies is undoubtedly a significant relationship in terms of law: it carries with it many legal rights and obligations in revenue, company and common law.

As to the second requirement, by the date they went into administration, the group concerned included either a service company with a pension scheme, or an insufficiently resourced company with a pension scheme. Accordingly, the target companies were precisely the type of entities who were intended to be rendered liable under the FSD regime.

So far as the third requirement is concerned, the unanimous view of all of the Judges who had considered the point was that the sensible and fair answer would appear to be that the potential liability of a target company under an FSD issued after an insolvent event, and in particular the liability under a CN issued thereafter, should be treated as a provable debt.

Applying the Supreme Court's analysis to costs cases, where an order for costs is made after the company has gone into administration or liquidation, it will be provable. By becoming a party to legal proceedings in this jurisdiction, a person is brought within a system governed by rules of court, which carry with them the potential for being rendered legally liable for costs, subject of course to the discretion of the court. An order for costs made against a company in administration or liquidation, made in proceedings begun before it went into that process, is therefore provable as a contingent liability under rule 13.12(1)(b), as the liability for those costs will have arisen by reason of the obligation which the company incurred when it became party to the proceedings. Cases such as *Glenister v Rowe* [2000] Ch 76 were held to have been wrongly decided.

Expenses

The Supreme Court need not have concerned itself with the scope of administration and liquidation expenses having decided that the FSD / CN liabilities would be provable. However, it did and has given helpful guidance in this regard, reaching the conclusion that Briggs J and the Court of Appeal had misunderstood and misapplied the guidance of the House of Lords in *Re Toshoku Finance UK plc* [2002] 1 WLR 671.

The Supreme Court rejected there being a general rule that where by statute Parliament imposes a financial liability which is not a provable debt on a company in an insolvency process then, unless it constitutes an expense under any other sub-paragraph in the twin expenses regimes for liquidation and administration, it will constitute a necessary disbursement of the liquidator or administrator.

Unless the statute states, expressly or impliedly, how the liability is to rank, the liability can only be an expense if the nature of the liability is such that it must reasonably have been intended by the legislature that it should rank ahead of provable debts.

Comment

The decision of the Supreme Court is to be welcomed. The trustees of a pension scheme take their rightful place in the insolvency waterfall, alongside the target company's unsecured, general creditors, whether or not the FSD is served prior to the company going into administration or afterwards.

The anomalies thrown up by the decisions of the lower courts have been avoided. For example, the section 75 debt is merely provable and non-preferential in respect of the employer. There is no obvious reason why the secondary liability represented by a CN should rank as an expense. Another oddity arises from that fact that section 43(6)(a) of the 2004 Act makes it clear that an FSD and a CN may be issued to an insolvent employer. The effect of this is that, by issuing an FSD and CN against an employer, the Regulator could (if the lower courts were correct) elevate the merely provable and non-preferential section 75 debt against the employer into an expense of the employer. A further peculiarity is that, if an FSD and CN gave rise to the super-priority inherent in expense liabilities but only where no FSD had been issued prior to the commencement of the insolvency event, is that it would produce an entirely different result depending on the timing of the issue of the FSD.

Insolvency practitioners can now continue to focus their energies on achieving the statutory purpose for which they are appointed, free from the risk of having insufficient assets available to them even to discharge the expenses of the process.

Please contact the **Practice Managers** if you require any further information.

South Square will shortly be holding inside track seminars on the implications of this decision. Watch your inbox for an invitation in the very near future.