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ARTICLE

Regulator Imposed Support for Pension Schemes: A New Category of Super Priority Insolvency Expense

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A new category of super priority insolvency expense has been established by the High Court which will have wide ranging implications for the restructuring world. Mr Justice Briggs held that the costs of complying with Financial Support Directions ('FSDs') issued by The Pensions Regulator ('TPR') qualify as administration expenses, payable in priority to unsecured creditors, floating charge holders and the administrator's own remuneration and expenses.[1]

The FSD regime

The FSD regime was established by the Pensions Act 2004 to provide TPR with a means to ensure that companies connected to UK entities that are sponsoring employers of defined benefit pension schemes contribute towards the schemes' deficit. An FSD directs the target companies to put forward arrangements for the provision of reasonable financial support sufficient to enable the continuation of the scheme and reduction of the scheme's deficit. The form of the support (e.g. a guarantee) is to be approved by TPR in advance. Failure to comply with an FSD may result in the issuing by TPR of a Contribution Notice ('CN'), which requires the target to make a specified payment to the pension trustees.

TPR has used its FSD powers sparingly. The first occasion was in relation to the Sea Containers group, headed by a Bermudan parent company in Chapter 11 bankruptcy proceedings in the US. The FSDs imposed on two group companies led to an agreed arrangement with the pension trustees which was approved by TPR and by an order of a Delaware court.

The next time TPR sought to impose FSDs was against certain companies respectively in the Nortel and Lehman groups. There has already been litigation in the US and Canadian bankruptcy courts concerning TPR's actions against the companies in insolvency processes in those jurisdictions, which has yet to be fully worked through. Many of the relevant target companies were in administration in England, including certain non-UK registered companies. Their administrators brought the application before Mr Justice Briggs in this case.

The question to be determined was how any costs of compliance with an FSD issued after the target company has entered into administration or liquidation, as well as the amount required to be paid pursuant to any subsequent CN, rank in an administration or liquidation.

The Court's decision

The Court held that where an FSD or CN has been issued before the 'cut-off date' for an insolvency, the associated costs and/or debt will rank as an unsecured debt. However, where an FSD or CN is issued after the cut-off date, it will rank as an expense of the administration or liquidation. There is one quirk in relation to CNs arising as a result of the (non-retrospective) change to the Insolvency Rules in April 2010, which applies where the target company has gone into administration before 5 April 2010 and an FSD is made while it is in administration but TPR issues a CN for non-compliance *after* the target company has gone into liquidation. Here the amount payable pursuant to the CN will be an unsecured claim, provable in the liquidation. This is because the relevant cut-off date will be the date of the liquidation (as opposed to the date of the preceding administration, which is the case for administrations commenced after that date). At the date when the liquidation commences, the non-compliance CN is considered to be a pre-liquidation liability contingent on failure to comply with the FSD.

Why an expense?

Mr Justice Briggs conducted a detailed review of both the relevant pensions and insolvency legislation, and

Notes

1 *Re Nortel GMBH and others* [2010] EWHC 3010 Ch.

found that the question of how FSDs and CNs are to be to treated post insolvency is not specifically provided for in either. He first ruled that there is no restriction on TPR issuing FSDs and CNs against companies in an insolvency process. In considering the nature of an FSD, he found that until an FSD has been issued, TPR has a *discretion* whether or not to exercise its power to do so. Following certain authorities on this area, he held that the fact that an FSD might be issued is not sufficient for this to trigger a contingent liability constituting a provable debt, where TPR has not exercised its powers prior to the commencement of the administration or liquidation.

However, Mr Justice Briggs was of the view that Parliament could not have intended for such claims to fall down a 'black hole' and effectively be irrecoverable on a company's insolvency. Following the approach in *Toshoku*,[2] he considered that all statutory liabilities that are not provable debts should be regarded as falling within the 'necessary disbursements' category of administration or liquidation expenses,[3] including FSDs and CNs. He conceded, though, that it was nonsensical for the moral hazard powers of TPR to have super priority status, given that the statutory debt triggered on insolvency which is payable by the employers with primary liability is itself only an unsecured debt (pursuant to the relevant pensions legislation).

Impact on restructurings and insolvencies

The most immediate impact will be felt by creditors of the companies directly affected by this ruling who do not have the benefit of fixed charges. However, the potential impact is much broader and more indiscriminate. The extent to which many defined benefit pension schemes in the UK are in deficit is well publicised. A figure in excess of GBP 2 billion is referred to in the case of *Nortel* – there are not many insolvent estates that can pay expenses, preferential debts and floating chargeholders and return a dividend to unsecured creditors, with amounts of this order having to be paid in priority as well. Administration may not even be an option if there is no certainty that the key expenses and remuneration of the insolvency practitioner can be paid – one of the blows to the rescue culture this ruling delivers. Mr Justice Briggs suggested that concerns of this nature can be addressed by an application for a prospective order to alter the priority of expenses.[4] At the very least, this will add delay and cost, with out of court administration appointments, a key reform introduced by the Enterprise Act 2002, now less likely where the company falls within the reach of TPR's powers. The further time alone required to due diligence the risks, communicate with TPR and the trustees and prepare court applications may rule out a rescue option for some companies. Such a court order will also not address the impact on creditors other than fixed chargeholders.

The concerns from the perspective of the insolvency profession were voiced in evidence considered by the Court. These additionally included that a massive potential liability with super priority status may make it impossible to assess whether administration will achieve a better result for creditors or whether the business can be traded for a period, as well as that it may make England less attractive as a centre for restructurings of companies falling within the EU Regulation on Insolvency Proceedings, especially for groups using a uniform insolvency process led from the UK. Mr Justice Briggs considered the negative impact of his decision is mitigated by the requirement for TPR to act reasonably, including when deciding whether to exercise its powers to issue an FSD and when assessing a target company's proposal for financial support. He referred to the obligation of the target as being to 'provide reasonable financial support, having regard to the circumstances, including its financial condition' and 'having regard to the interests of the insolvent target's creditors'. However, it is difficult to see how much comfort can be drawn from this, when it is also clear that TPR's role is to ensure that pension schemes are properly funded and prevent schemes falling into the statutory fund that provides a backstop for schemes with insolvent employers (the Pension Protection Fund).

In any event, in those situations where groups in financial difficulties are considering restructuring their debt, with or without a formal insolvency process, there is no doubt that there is significant uncertainty with which all stakeholders have to contend, where there is a defined benefit pension scheme in the mix. From a lender's perspective, recoveries from floating charge realisations may be imperilled if administration or liquidation is not avoided – initiating such proceedings may not now be the best way of cramming down subordinate creditors. Pension trustees will have a greater role and more leverage. Whilst much of this points to trying to restructure consensually, not only may the shifting balance of power of those involved make this more challenging, but raising fresh finance, even just to have some breathing space, may be all that more difficult now.

Notes

2 *Re Toshoku Finance UK plc, Khan and another v Inland Revenue Commissioners* [2000] All ER (D) 378.
3 See Rule 2.67(1)(f) (for administration) and Rule 4.218(1)(m) (for liquidations), Insolvency Rules 1986.
4 Pursuant to Rule 2.67(3) Insolvency Rules 1986.

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What next?

The Court, commenting that it was dealing with a 'legislative mess', expressed hope that a higher Court or Parliament would review the position and cure the anomalies created by the inability of legislation relating to pensions and insolvency to meld adequately in these circumstances. Permission to appeal has been granted and an appeal seems inevitable, unless Parliament steps in first.

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