Nortel/Lehman: A balancing act

The Supreme Court handed down its decision yesterday on the combined appeals of Nortel GmbH (In Administration) ("**Nortel**") and Lehman Brothers International (Europe) (In Administration) ("**Lehman Brothers**") (together, the "**Appellants**") against the Pensions Regulator ("**tPR**"). The Appellants asked the Supreme Court to reverse the decision of the Court of Appeal from October 2011, which held that the costs of complying with a financial support direction (**"FSD"**) or contribution notice (**"CN"**) issued by tPR were payable as an expense of administration.

Much to the relief of employers, creditors, lenders, and insolvency practitioners, the Supreme Court has found in favour of the Appellants holding that a company's liability arising pursuant to an FSD issued after the company has gone into administration, ranks as a provable debt of the company, and not as an expense of the administration.

This article provides a brief summary of the issues in the case and discusses the impact of the Supreme Court decision on companies, lenders and the restructuring community.

Background

The financial support direction regime under the Pensions Act 2004

Under the Pensions Act 2004, tPR has power to issue an FSD requiring the recipient to put in place arrangements for the financial support of an underfunded defined benefit pension scheme. FSDs can be issued to scheme employers and to any parties connected or associated with an employer (provided certain conditions are met). The terms of an FSD can be broad and often include ensuring cash, guarantees or other security arrangements are put in place.

If a target company fails to comply with an FSD, tPR can issue a non-compliance CN requiring the recipient to pay specified sums of money into the pension scheme.

Treatment of pensions deficit on insolvency

The ordinary treatment of pension scheme deficits on insolvency of the employer company is dealt with by section 75 of the Pensions Act 1995, which stipulates that the deficit in the scheme is to be treated as a debt owed by the employer to the trustees and that the debt is to be treated as arising immediately before the onset of insolvency. The deficit for these purposes is calculated on the "*buy-out*" basis. As such, the debt is an ordinary unsecured debt. The only situation where such debt could potentially rank higher would be where specific contributions have been promised but remain unpaid at the date of insolvency.

The Appellants

When the Appellants went into administration they left behind UK pension schemes with deficits of £2.1bn and £130m respectively. In 2009 tPR initiated action against them in an attempt to protect scheme member benefits and to limit calls on the Pension Protection Fund (**"PPF"**). TPR's Determinations Panel decided that it would be reasonable to issue FSDs against numerous companies in their respective groups.

Administrators for the Appellants sought directions from the High Court on whether the liability under the FSD was:

a) a provable debt, that ranked as ordinary unsecured debt;

b) an expense of administration, with "*super priority*" ranking; or

c) of no effect whatsoever on insolvency, falling into a so-called "*black hole*".

High Court & Court of Appeal decisions

The High Court held that an FSD or CN issued following the commencement of administration proceedings was (b) above: an expense of the administration, having "*super priority*" over all unsecured creditor and floating charge holder claims, and ranking alongside other expenses of the administration.

The previous Court of Appeal cases of *Glenister v Rowe (Costs) [2000] Ch. 76* and *R (Steele) v Birmingham City Council [2005] EWCA Civ 1824* were followed, which held that, without a pre-existing legal obligation, a liability cannot be a contingent liability and therefore could not be a provable debt. The Court also felt particularly bound by the House of Lords decision in *Re Toshoku Finance UK Plc (In Liquidation) Re [2002] UKHL 6*, which established a general principle that where statute imposes financial liability which is not a provable debt, it will constitute a necessary disbursement of the administrator and rank as an expense.

Mr Justice Briggs was constrained by the governing legislation and case law, but made it clear that he believed the outcome was not what Parliament could have intended.

The Court of Appeal unanimously upheld the High Court's decision, whilst acknowledging the *"oddities, anomalies and inconveniences"* of it.

Supreme Court Decision: Not shackled by a consistent line of authority

The Supreme Court ruled that the liability under an FSD after the commencement of its administration or liquidation fell within Rule 13.12.(1)(b) of the Insolvency Rules 1986 as it was a liability under an enactment which arose by reason of an obligation incurred before the insolvency event. Therefore it is a provable debt of the company. In doing so it said that giving the liability under an FSD a status higher than that available to a section 75 debt (which is a provable debt) would be "*somewhat surprising*" but at the same time, it found it unlikely that legislation could have intended that such a liability rank behind provable debts, falling in the so-called "*black hole*".

The Court also provided some helpful guidance in this area. Lord Neuberger commented that *"[t]he mere fact that an event occurs during the administration of a company which a statute provides gives rise to a debt on the part of the company cannot, of itself, be enough to render payment of the debt an expense of the administration"*. He added that where such a statutory liability does not fall in the provable debt category and the statute is silent as to how such a liability should rank, the liability can only be an expense of the liquidation or administration if the nature of the liability is such that it must reasonably have been the intention of the legislation for it to rank ahead of provable debts.

Comments and implications

The Supreme Court reversing the decision of the Court of Appeal allows restructuring professionals to breathe a sigh of relief, as they no longer need to fear the repercussions of having to take into account potentially large pension deficits when assessing the prospects of rescuing the business of companies on the verge of insolvency nor rely on the promises of tPR made in a statement of July 2012 that it would act "*reasonably*" when exercising its anti-avoidance powers. The decision will also be appreciated by employer companies, that would have found it harder to borrow funds, as lenders would have demanded more favourable terms or even refused funding, had the FSDs retained the "*super priority*" status. For that reason, there is also an upside for pension scheme trustees in the Supreme Court's decision since a reduced ability on the part of employers to secure financing and/or achieve beneficial restructurings could prejudice the employers' ability to fund their schemes in the long-term.

Last words

The insolvency profession, companies and lenders will welcome the Supreme Court decision as the balance is restored between ensuring companies satisfy their pension liabilities and meeting obligations to their creditors, without the need for Parliament to intervene. It is a return to the norm and bolsters the corporate rescue culture that modern insolvency law seeks to encourage, and that is arguably key to the turnaround of UK plc at this time.

Also much to be welcomed is the broad approach to the definition of contingent liabilities, which constitute provable debts that can be compromised through insolvency processes. There should now be more scope to rescue companies with latent statutory liabilities, such as environmental and health and safety liabilities. Restructuring professionals advising companies in these sectors with financial difficulties will be looking closely at the decision to see whether such liabilities will no longer be at risk of having "*super priority*" status.

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