Original Article

An inconvenient truth: Pensions in the UK have priority ranking

Received (in revised form): 22nd December 2011

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ABSTRACT Defined benefit pension schemes in deficit have long been a matter of concern. The outcome in October 2011 of linked appeals by the administrators of the groups of both Nortel and Lehman Brothers were a notable triumph for the UK Pensions Regulator and scheme trustees. However, the adverse consequences of these cases on lenders and insolvency practitioners, created by the 'oddities, anomalies and inconveniences' of a 'legislative mess' are also likely to generate important knock-on effects for corporates and scheme trustees.

Pensions (2012) 17, 4–7. doi:10.1057/pm.2012.1

Keywords: pensions regulator; moral hazard; Section 75 debts; priorities; insolvency; administration expenses

THE PROBLEM WITH PENSIONS

Unfortunately, as we live longer and the markets are in turmoil, the UK's private sector defined benefit (DB) schemes will remain, stubbornly, in aggregate deficit. GBP158 billion and counting.

Meaningful state regulation of the pensions problem in the private sector only began with the Pensions Act 1995, which arrived in the wake of the death of Robert Maxwell. In the context of the recent Nortel/Lehman cases, most notable of the surviving aspects of that regime is the triggering of a debt, which the employer of a DB scheme is liable to pay in the event of its insolvency. This is calculated on the basis of the employer's responsibility to meet the buy-out cost of the scheme (that is, the cost of securing members' benefits by purchasing annuities from an insurance company). It has come to be known as a Section 75 debt.

Parliament passed the Pensions Act 2004 in order to address the deficiencies of the 1995 regime. In so doing, it dramatically ramped up protections for DB scheme members. The 2004 Act (as amended in 2008) created the PPF; a 'lifeboat' scheme that guarantees a minimum level of pension for members of DB schemes whose employer has gone bust; and which is funded, controversially, by a levy on other UK DB scheme employers. The Act also created the office of the Pensions Regulator, with a remit actively to police compliance of employers' obligations to fund their schemes. Recognising the 'moral hazard' of giving unscrupulous employers a way out by dumping their DB schemes on the PPF, Parliament gave the Pensions Regulator powers to impose either:

- *Financial support directions (FSD)* – a requirement to provide financial support to an under-funded DB scheme (which might be anything from cash to a parent company guarantee) in circumstances where the employer is either a 'service company'

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for other companies in its group or if it has insufficient net assets to meet at least 50 per cent of its obligation to pay a Section 75 debt; or

- *Contribution notices (CN)* – a requirement to pay immediately anything up to the full amount of the employer’s Section 75 debt obligations where there has been an act or a failure to act: (i) which has been ‘materially detrimental’ to the likelihood of accrued scheme benefits being received; or (ii) where one of its main purposes was to reduce the amount of any Section 75 debt (or prevent it from becoming due). A CN can also be issued for non-compliance with a FSD.

Of critical importance for lenders to corporate groups is the fact that these powers can be exercised not only against defaulting employers, but also against entire corporate groups and others, simply by virtue of their connection or association with the employer.

THE LEHMAN AND NORTEL ADMINISTRATIONS

Lehman collapsed in September 2008. Its UK arm entered administration. Among those companies was the principal employer in the Lehman Brothers Pensions Scheme. The administration triggered both a £140m Section 75 debt on the scheme’s employer and an assessment period for the scheme’s entry into the PPF. The Regulator began to investigate and identified that the employer was a service company, providing employees on secondment for most of the group’s European activities. Eventually, its Determinations Panel confirmed in September 2010 that an FSD should be issued against several group companies.

Nortel, a Canadian-owned telecoms giant, went bust in early January 2009. At that time, Nortel’s principal operating company in the United Kingdom was placed into administration, along with its UK subsidiaries and various European entities (on the basis that their centre of main interest (COMI) was in England). That company was also the principal employer in the group’s DB scheme for UK employees. The scheme had 42000 members and a buy-out

deficit of GBP2.1 billion. The Regulator began to investigate around the time of the group’s collapse and matters followed a similar course to the Lehman case, culminating in a determination issued in June 2010 that an FSD should be issued against various companies, including the European entities in administration.

THE PRIORITY RANKING OF ‘MORAL HAZARD’ CLAIMS

The administrators in both cases were faced with the question of how a FSD (and any subsequent CN) should be treated in the waterfall of distributions from the administration. They applied to the High Court for directions on the point. The Regulator, the PPF and the scheme trustees were respondents. In broad terms, the options put to the court were that the FSDs should be treated as follows:

- *Administration expenses* – a special category of super-priority claim, ranking ahead of any floating charge, preferential debts and (within the expenses category) ahead even of the administrators’ remuneration. Such claims only rank behind debts secured by fixed charges;
- *Provable unsecured debts* – a low priority debt category, ranking behind any secured claims, save to the extent of any ring-fenced Prescribed Part fund set aside from floating charge realisations; or
- *Non-provable claims* – a rather nebulous ‘black hole’ category of claim, ranking for payment only out of any (very unlikely) surplus after payment of provable debts.

The administrators contended that the FSDs were non-provable claims. The respondents argued that the claims were administration expenses, with a fallback that they were provable debts.

With evident reluctance, Briggs J, in a judgment delivered in December 2010, held that, on the facts of these cases, the FSDs were administration expenses. In essence, the issue was a matter of timing. He noted that the FSDs (and CNs) were statutory liabilities and were imposed after the administrations had commenced. In such a case, he held that he was bound to

follow the principle, laid down by the House of Lords *In Re Toshuko Finance UK plc [2002] 1 WLR 671*, that such liabilities were administration expenses. He went on to note that, had the FSDs been issued before the commencement of the administrations, they would have ranked as provable unsecured debts.

Briggs J went on to criticise what he described as a *legislative mess* created by the conflicting regimes under pensions and insolvency legislation. One particularly curious consequence of the ruling was that, through a mere accident of timing, Section 75 claims which would rank only as provable unsecured debts in an employer's administration, would effectively have super-priority as an FSD or CN in a connected-party insolvency if they arose after the administration had been commenced.

Unsurprisingly, the administrators appealed to the Court of Appeal on essentially the same issues. On 14 October 2011, the Court of Appeal unanimously upheld the decision of the High Court (despite the *oddities, anomalies and inconveniences to which this gives rise*) and, in large part, the judge's reasons, although without the same degree of reservation.

The Court of Appeal has now granted to the administrators permission to appeal the matter to the Supreme Court. In so doing, it recognised the implications of this case and the fact that the Supreme Court would not be bound by the *Toshuko* principle in the same manner as the junior courts.

IMPLICATIONS FOR LENDERS AND INSOLVENCY PRACTITIONERS

While welcoming the *clarity* of the result, the UK Pensions Regulator has been at pains to play down the consequences. Despite the Regulator's good intentions, pending a reversal on appeal, the outcome is of serious concern to lenders and advisers when dealing with cases involving a DB scheme in deficit, for the following reasons:

- *Lenders with inadequate fixed charge security risk a shortfall in recoveries on insolvency* – Section 75 debts, and therefore Regulator claims, are

potentially large enough to wipe out any value in the floating charge.

- *In practice many (if not most) FSDs and CNs are likely to be issued after the commencement of an insolvency process* – The Regulator has the duty and power to use these powers, but has limited resources to do so. In practice, insolvency is the most likely trigger for an investigation by the Regulator and the process is time-consuming.
- *Protections for lenders in facility documentation offer little assistance and might in fact crystallise the problem* – The ability for lenders to intervene quickly is often vital. The difficulty is that, the very act of enforcement could be the catalyst, which 'flips' the priority of putative Regulator claims from unsecured to super-priority.
- *Lenders will need to factor insolvency practitioners' concerns into any insolvency strategy* – Before accepting a formal appointment in respect of a group which is at risk of claims from the Regulator, insolvency practitioners will require comfort that they can make distributions to creditors and draw payment from available asset realisations.
- *There might be clarity but there is no certainty* – The appeal process is likely to take at least a year with little comfort that the Supreme Court will reach a different conclusion. Alternatively, Parliament might reverse the effect of these rulings through amendments to primary or secondary legislation but politicians will be reluctant to be portrayed as choosing banks ahead of pensioners.

WIDER IMPLICATIONS

Unless and until the position is reversed, the consequences highlighted above will inevitably drive lender behaviours with a knock-on effect for corporates and trustees dealing with UK DB schemes in deficit.

- *Due diligence* – Prevention being better than cure, the outcome of this case highlights the importance to lenders of robust due diligence on DB schemes, both before and after a commitment to lend is made. Corporates can expect lenders to look harder than ever at the risks posed by this issue before committing funds.

- *Documentation* – It is only human nature that, despite the ‘trigger problems’ highlighted above, credit committees will demand more stringent terms to ensure that early intervention (where sensible) is possible.
- *Pricing* – Where lenders are unhappy with the risk and the available solutions, the outcome in these cases is likely to push up the cost of finance for corporates associated with DB schemes in deficit – and in the worst cases, corporates will struggle to find finance on acceptable terms.
- *Fixed charges* – Realisations made under valid fixed charge security rank ahead of administration expenses. The pressure on lenders to procure effective fixed charge security from corporates over a wider range of assets will no doubt increase. Trustees and the Regulator may have concerns over such activity, to the extent that this impacts on the strength of the employer covenant and their outcomes in insolvency.
- *Asset based lending* – Assets validly assigned to lenders outright are not security and therefore are not subject to deduction of administration or liquidation expenses. The decision is likely to stimulate a push from lenders for these forms of funding.
- *Assets overseas* – Questions remain (particularly in Nortel) over the enforceability of the Regulator’s powers outside of the United Kingdom, but the outcome in other cases might be quite different where the COMI is outside of the United Kingdom. One consequence of these cases might be to promote ‘forum shopping’ among corporates to satisfy lenders that the risks to them are remote.
- *Receiverships* – Where available, administrative receiverships might be a preferred alternative because of the lack of an equivalent expenses regime under that process. Lenders will need to be careful, however; an FSD or CN issued pursuant to a liquidation of the same entities (running concurrently with or subsequent to the receivership) would still give rise to the same issue and could prevent (or even result in clawback of) floating charge distributions made by the receivers.
- *Clearance* – It is highly likely that this case will reinvigorate the process of engagement between corporates, their lenders, the Regulator and trustees before completion of any round of financing or a disposal, particularly in the context of a restructuring. Such discussions are likely to represent an opportunity for trustees and the Regulator to demand improved terms for the scheme (in effect the provision by the corporate of the sort of support which might otherwise be required under an FSD). Given the strategic importance of timing, it is likely that the parties will seek to use this to their advantage in any engagement pre-insolvency.
- *Application to court* – As pointed out by the Regulator and the courts, administrators (but, curiously, not liquidators) have the right to apply to court to vary the order of priority of payment of expenses out of the available assets. This will certainly not convince a wary lender to commit funds, but it is foreseeable that the court appointment route might become the mode of choice for administrators seeking an appointment conditional on the court’s approval of a variation of the priorities.

The options available to parties will vary significantly from one case to the next and the risk can be driven as much by the timing of events as any other factor. Regrettably, we are in the hands of the Supreme Court and, potentially, Parliament. In truth, clarity and certainty are unlikely to be achieved any time soon.

In the matter of Nortel GmbH (In administration) & Others, sub nom Bloom & Others v The Pensions Regulator & Others and In the matter of Lehman Brothers International (Europe) (In Administration) & Others, sub nom Lomas & Others v The Pensions Regulator & Others [2011] EWHC 3010 (14 October 2011).