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Moral dilemma in Court of Appeal Pension case

On 14 October, the Court of Appeal decided unanimously that pension liabilities arising post insolvency as a result of the Pensions Regulator's moral hazard powers were to maintain their super priority ahead of all creditors other than those with a fixed charge. Whilst the decision comes as no surprise, it is still of great concern to those involved in these cases and other insolvencies where there is a defined benefit pension scheme with a deficit. It will cause further delay to the ongoing administration proceedings for Lehman Brothers International (Europe) and the Nortel Networks Group, including any distributions to creditors. It was recognised by the Appeal judges that the decision may have a serious impact on the rescue culture itself.

Summary

At first instance Briggs J held that if Contribution Notices (CNs) and Financial Support Directions (FSDs) were to be issued by the Pensions Regulator pursuant to its "moral hazard" powers against various entities in the Lehman Brothers Group and also the Nortel Network Group, they should be treated by the companies in administration as an administration expense, not an ordinary unsecured debt. In agreeing with the first instance judge, the Court of Appeal's decision provides a binding precedent for other cases that CNs and FSDs issued after the commencement of a formal insolvency process would rank in priority to the claims of all creditors other than those secured by a fixed charge. (By way of reminder see a full list of priority of claims in administration at the end of this briefing). As an administration expense in these cases, the liabilities would be payable before the administrators' own remuneration.

Implications

Whilst the super priority does not apply to all pension liabilities (only those arising out of the Regulator's moral hazard powers which are imposed after the insolvency proceedings have been commenced), it does mean, however, that creditors lower down in the priority ranking will only get paid if there are sufficient funds left over. In practice, this means that the creditors of group companies, which originally had no direct liability to a defined benefit pension scheme, may have their recoveries reduced or extinguished altogether in favour of the Pensions Regulator's claim.

Key issues

The main issue to be decided by the Court of Appeal was whether, in circumstances where an FSD or CN is first issued after the target company has gone into administration or liquidation, this imposes any obligation on the target company and its officeholders? The administrators for Nortel argued that it was a provable debt ranking alongside other unsecured creditors, whilst the Lehman administrators argued that it was not payable at all and fell into a "black hole". The Court of Appeal dismissed both these arguments and held that such FSDs and CNs were administration expenses. FSDs and CNs issued before the target company has gone into administration will not be. Today's decision recognised the conflict between pensions legislation (designed to protect pension funds) and insolvency legislation (which promotes *pari passu* distribution between creditors) in the context of companies subject to a formal insolvency process.

Key Issues

- **Appeal Court confirms super priority for pension claims**
- **No changes to legislation yet**
- **Further appeal to Supreme Court anticipated**

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The Court of Appeal recognised that its conclusion led to some curious consequences, for example it means that a liability under a CN would get a higher ranking in the insolvency of the target company than the main employer's statutory liability to fund the same pension scheme on its insolvency, which is an unsecured claim under the Pensions Act 1995. (It was, however, noted that Briggs J had alluded to ways of alleviating such problems, including the Court's power to vary the statutory order of payment of expenses if the assets of the insolvent company are insufficient to meet its liabilities pursuant to the Insolvency Rules 1986). It was also recognised, that insolvent companies were not immune from the moral hazard provisions, and therefore insolvency officeholders could not ignore any obligations arising from the Pensions Regulator's action.

The Court of Appeal, like the judge at first instance, clearly felt constrained by the wording of the insolvency legislation in respect of the definition of provable debts and the previous case law in relation to administration expenses. Much of the judgment is devoted to a very technical analysis of the legislation and the authorities. The Pensions Regulator, will no doubt take heart from the Court of Appeal's judgment today, especially comments regarding the effect of the decision on the Lehman and Nortel estates which essentially provided that the pensions legislation served "*a valuable and realistic purpose"* as it enables a redistribution of assets where otherwise creditors of the targets would have a greater share of assets, partly as a result of having had the benefit of services of employees, but without having to pay for those services by way of contribution to the pension schemes.

Based on the current position, companies and those associated with defined benefit schemes should continue to seek advice if they are contemplating any corporate restructurings and consider seeking clearance where appropriate. Group companies may find they have an ongoing exposure, even if they themselves are subject to insolvency proceedings. It may also mean that the current practice of seeking the common appointment of administrators in a group company context (based on the fact that they all have their centre of main interest in England) becomes less attractive, as the risk of any pensions liabilities being imposed as priority claims may make the position less beneficial than if the proceedings had taken place elsewhere. Whilst the super priority does not rank ahead of fixed charge security, those with floating charge security (including fixed charges that are recharacterised as floating) will be affected in terms of potential recoveries. Consequently, banks, in particular, need to assess the potential risks of this super priority status when they are considering lending new money to, or refinancing, groups that have defined benefit pension schemes which may have significant deficits. Furthermore, the ranking of such liabilities ahead of the remuneration of insolvency officeholders and the fact that they may arise after the commencement of the insolvency process may mean that insolvency practitioners are not prepared to run the risk of administering estates with potentially significant and unknown pension liabilities looming. With stakes so high, it is likely that the decision will go to the Supreme Court.

Priority ranking in an administration

Claims in administration rank as follows:

- Fixed charge security;
- Costs and expenses of the administration in accordance with Rule 2.67 of the Insolvency Rules 1986**;** **(Following this decision FSDs and CNs are included at this level);**
- Preferential creditors;
- Unsecured creditors up to a maximum of £600,000 if the company's net property is £10,000 or more;
- Holder of a floating charge;
- Unsecured creditors;
- Post administration interest on debts;
- Deferred creditors; and
- Shareholders (only if there is a surplus after the debts are paid).

Pensions Regulators Moral hazard powers

Under the Pensions Act 2004 (the 2004 Act), the Pensions Regulator has wide powers to extend defined benefit pensions liabilities beyond actual employing companies, to their "associates" and "connected persons". These terms include group companies, shareholders, and individuals such as directors. There are two main powers – the Regulator can issue FSDs and CNs. FSDs can be used to extend pension liabilities to entities associated with an employer, without any fault on their part. An FSD requires the person to whom it is issued to put in place financial support for the pension scheme (which could include, for example, making all members of the group jointly and severally liable for the pensions liabilities). If a person fails to comply with an FSD, the Pensions Regulator is empowered to issue a CN to that person requiring that a contribution be made to the scheme. The conditions for imposing a CN directly, are stricter (generally the recipient must have caused some harm to the pension scheme), but the consequences are more severe – a CN can be used to attach personal liability to directors and also to accelerate pension liabilities and require large one-off payments. Both powers have been exercised only rarely - the Regulator issued its first FSD in 2007 and has only issued 3 in total. However in the cases of Nortel Networks and Lehman Brothers, the Regulator has pursued this route.

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