Feature

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KEY POINTS

- The English High Court has recently determined that:
  - a financial support direction ('FSD') or contribution notice ('CN') issued against a company after the commencement of and during administration is not a provable debt but an administration expense;
  - an FSD issued against a company after the commencement of and during liquidation (following administration commenced prior to 6 April 2010) is a liquidation expense;
  - a CN issued against a company after the commencement of liquidation (following administration commenced prior to 6 April 2010) relating to non-compliance of an FSD issued in (i) the administration, is a provable debt in the liquidation; or (ii) the liquidation, is a liquidation expense.
- The ramifications of this decision are significant for officeholders given that their remuneration would rank to be payable as an expense only after the liability for an FSD/CN had been met, in certain of the situations set out above, unless the court ordered a variation of the statutory order of expenses. Such a prospective order could be made where the assets of the insolvent company are insufficient to meet its liabilities.

Moral hazard for officeholders? The *Lehman Brothers/Nortel Networks* decision

The English High Court was recently asked to decide whether a financial support direction ('FSD') or contribution notice ('CN') issued against a target company after it enters administration (or a subsequent liquidation) is: (i) a provable debt; (ii) an expense; or (iii) a debt which is not payable at all (referred to as falling down a 'black hole'). Mr Justice Briggs handed down his judgment on these issues following a combined directions application by the administrators of certain UK Nortel Networks and Lehman Brothers entities in administration (the 'Administrators') (*Re Nortel GmbH and other companies; Re Lehman Brothers International (Europe) (in administration) and other companies* [2010] EWHC 3010 (Ch)). An appeal to the Court of Appeal is currently pending and is expected to be heard before the court's summer vacation.

THE FRAMEWORK FOR THE MORAL HAZARD PROVISIONS

The Pensions Act 2004 ('PA') introduced the Pension Protection Fund ('PPF') and the Pension Regulator (the 'Regulator'). The Regulator is empowered under the PA in certain circumstances (including where the employer company enters into insolvency proceedings) to exercise its powers to make FSDs and CNs against employer companies and companies associated or connected with the employer (a 'Target') of a defined benefit pension scheme in deficit. These powers are intended to address the 'moral hazard' that employers and Targets might seek to avoid their pensions obligations and push these liabilities on to the PPF.

In addition to FSDs/CNs, where a defined benefit scheme is in deficit the PA specifies circumstances where part or all of that deficit can become an immediate liability of one or more employers participating in the scheme. The statutory liability arises under s 75 of the Pensions Act 1995 (the 's 75 debt') and is triggered, *inter alia*, by the insolvency of a sponsoring or participating employer. The s 75 debt is calculated by reference to the cost of securing the pension scheme's liabilities in full by the purchase of insurance company annuity contracts (the 'buyout basis'). Significantly, the legislation states that the s 75 debt does not rank as a preferential debt.

One of the first stages under the procedures in the PA to be followed prior to issuing an FSD is for the Regulator to issue a Warning Notice to directly affected parties. These parties may respond to such notice in writing and/or orally before the matter is considered by the Determinations Panel. The Determinations Panel will then decide whether or not the Regulator should issue an FSD against any or all of the relevant Targets. The Targets may appeal this decision to the Upper Tribunal (Tax and Chancery Chamber). An appeal from this tribunal lies to the Court of Appeal.

The current procedural status in *Lehman* and *Nortel*

The Determinations Panel has made determinations that an FSD should be issued against certain Nortel Network and Lehman Brothers Targets although the Regulator has not yet issued these FSDs. Both matters have been referred to the Upper Tribunal. However, these references have been stayed pending the outcome of the issues raised in the combined directions application brought by the Administrators.

Based on publicly available information the Nortel Networks pension scheme had a buyout deficit of approximately £2.1bn in January 2009 and the Lehman Brothers scheme had a buyout deficit of approximately £148m when it was last valued in January 2007.

The Regulator's power to issue an FSD

The Regulator has power to issue an FSD where the employer of the pension scheme is a service company or insufficiently resourced at the relevant time, up to two years after that relevant time. The determination to issue FSDs against certain Nortel Network and Lehman Brothers entities was made by the Regulator within the relevant period.

A 'financial support direction' is a direction which requires the person/s to whom it is issued to secure financial support for the scheme. An FSD may be issued to any scheme employer or a Target if the Regulator considers it is reasonable to impose one. 'Financial support' is an arrangement approved by the Regulator, including arrangements under which additional financial resources are provided to the scheme or the liability for its deficit is guaranteed.

The Regulator's power to issue a CN

If a Target fails to comply with an FSD the Regulator has power to issue a CN (ie a notice providing that the Target is liable to pay the scheme trustees a specified sum amounting to some or all of the pension deficit), if the Regulator considers that it is reasonable to impose a CN. The CN is a debt due from the person to whom it is issued owed to the scheme trustees.

FSD/CN AS A PROVABLE DEBT

The first substantive issue before the High Court was whether an FSD/CN could be a provable debt in the administrations of the relevant Targets. It was followed by a subsidiary issue as to whether a CN issued in a subsequent liquidation, if the Target moves from administration to liquidation, is a provable debt.

The Insolvency Rules 1986 ('IR') impose a cut-off date by which point the relevant liabilities must have arisen in order to be considered provable. Where an administrator has been permitted by the court to make a distribution to creditors the rules on proving debts which apply in liquidation also apply in administration.

In the ordinary course, the cut-off date is the date on which the company *first* enters into insolvency proceedings. The court held that an exception applies for companies entering administration prior to 6 April 2010, which subsequently enter into liquidation (and the relevant UK Nortel Networks and Lehman Brothers administrations commenced prior to 6 April 2010). In this situation the relevant cut-off date for proving debts in the administration is the date of commencement of the administration and the cut-off date for proving debts in a subsequent liquidation is the date of commencement of that subsequent liquidation.

IR 13.12 provides that a 'debt' in relation to administration or liquidation of a company includes:

- any debt or liability to which the company is subject at the date on which the company went into liquidation or administration; and
- any debt or liability to which the company may become subject after that date by reason of any obligation incurred before that date.

There are a limited number of debts that are not provable under the IR either for public policy reasons or because they are not provable under various statutes. The liabilities under an FSD/CN are not so expressly referred to under these rules or any statutory provision.

When did the relevant obligation arise?

The Regulator and the trustees of the Lehman Brothers and Nortel Networks UK pension schemes (the 'Trustees') argued that the Targets incurred the relevant obligations in relation to the FSD before the cut-off date (ie before they entered administration), and therefore an FSD issued during the administration would be a provable debt under IR 13.12(1)(b). The argument against this was, in essence, that the FSD regime does not impose a legal obligation on a Target as the imposition of a financial obligation under an FSD depends on the exercise of discretion by the Regulator.

After reviewing the relevant case law Briggs J noted that the effect of *Glenister v Rowe* [2000] Ch 76 and *R (Steele) v Birmingham City Council* [2005] EWCA Civ 1824 was that if there is no legal obligation under IR 13.12(1)(b) then there cannot be a contingent liability under IR 13.12(1)(a). The obligation under IR 13.12(1)(b) must be a legal obligation (ie either contractual or statutory); one which gives rise to a liability; and one which is owed by the insolvent person. Briggs J distinguished the cases of *Glenister* and *Steele* from *Re Smith; ex parte Edwards* (1886) 3 Morrell 179; although all of these cases relate to the exercise of discretion. In *Glenister* and *Steele* it was the exercise of discretion which created the legal obligation (therefore preventing a provable debt arising even when the relevant acts occurred prior to the cut-off date), whereas in *ex parte Edwards*, the relevant obligation arose under a contract entered into prior to the cut-off date.

Briggs J concluded that, pending the issue of an FSD/CN, a relevant legal obligation had not arisen prior to the cut-off date. At this stage, the only obligations owed to the employee beneficiaries of the scheme or the scheme trustees were owed by the employer. At most, Briggs J thought that there was a moral obligation on the Targets to provide proper support to the employer in connection with the pension scheme.

Briggs J did not consider that this situation fell within the ambit of the principles in *Haine v Day* [2008] EWCA Civ 626 (see box) and *Unite (the Union) v Nortel Networks UK Limited* [2010] EWHC 826 (Ch) given that the discretionary process of the FSD regime was not one where the Regulator could be said to have no real discretion whether or not to issue an FSD/CN.

Haine v Day

In *Haine v Day*, the Court of Appeal held that protective award claims made against a company for failure to consult with its employees before the company entered administration (which was followed by liquidation) were provable in the liquidation. The awards were made by the employment tribunal after the date the company entered insolvency proceedings. Although the Court of Appeal recognised that the tribunal retained discretion under the relevant statute not to make the award, it felt that an award for the maximum period permitted under the statute was inevitable because of the company's complete breach of the statute. As a result the Court of Appeal held that the tribunal had no real discretion to exercise in relation to the employees' claim to refuse an award; the discretion could only be exercised in one way.

Briggs J held that an FSD issued after the commencement of administration is not a provable debt in the administration. However, once issued, the FSD converts the moral obligation into a legal obligation under IR 13.12(1)(b) upon the Target to secure financial support for the scheme by reasonable arrangements. Further, a CN (which is issued after the Regulator uses its discretion, but only after non-compliance with an FSD) would be a provable debt in a subsequent liquidation of these Targets. In this situation, IR 13.12(1)(b) would be satisfied given that the CN would be the remedy for non-compliance of a pre-existing legal obligation (ie the FSD).

FSD/CN AS AN EXPENSE

Having concluded that an FSD/CN could not, in these circumstances, be a provable debt in the administrations, the court also heard arguments whether or not the FSD/CN would constitute an expense in the administration or a subsequent liquidation of the Targets.

The rules for the priority of payment of expenses in administration are substantially similar to those for liquidation and are set out in IR 2.67 (see box), which was introduced when changes were made to the insolvency legislation, enabling an administrator in some circumstances to make distributions. Note that under these rules, expenses that are necessary disbursements rank to be paid in priority to administrator's remuneration.

The court has power to vary the statutory order of payment of expenses if the assets of the insolvent company are insufficient to meet its liabilities (IR 2.67(2) and (3)), although the writer is not aware of any such orders having been made to date in practice.

Issues at the hearing on expenses

The primary argument made by the Regulator and the Trustees was that any financial liabilities under an FSD/CN issued after the cut-off date are expenses in accordance with the principles established in *Re Toshoku Finance plc (in liquidation)* [2002] 1 WLR 67, a House of Lords decision concerning liquidation expenses. In *Re Toshoku* under the then applicable Income and Corporation Taxes Act 1988 a company was chargeable to corporation tax on profits (which were deemed by statute to have arisen but had not in fact done so) arising in the winding up. These payments were held to be a necessary disbursement of the liquidator pursuant to IR 4.218 (which IR 2.67 substantially follows) because the obligation to pay them arose after the cut-off date for proving debts. This liability to pay tax on notional profits was therefore payable ahead of the liquidator's remuneration. Amendments were subsequently made to the then Finance Act 1996 to mitigate the consequences of the decision.

Priority of payments of expenses in administration

The order in which administration expenses are met under IR 2.67 is as follows:

- Expenses properly incurred by the administrator in performing his functions as administrator;
- The cost of any security provided by the administrator;
- The costs of the party who appointed the administrator, incurred in connection with the appointment;
- Any allowance made, by order of the Court, towards costs of an application for release from the obligation to submit a statement of affairs;
- The fees of any person employed to assist in the preparation of the statement of affairs;
- Any necessary disbursements by the administrator in the course of the administration;
- The remuneration of anyone employed by the administrator to perform any services for the company;
- The administrator's remuneration; and
- Any corporation tax on chargeable gains accruing on the realisation of any asset of the company.

The Regulator argued that the *Re Toshoku* decision was binding and meant that where a statute creates a monetary liability applicable either expressly to a company in insolvency proceedings or to a company regardless of whether or not it is in insolvency proceedings, then if the obligation is not a provable debt it is an expense. Parliament intended that the liabilities under an FSD/CN should be paid by both insolvent and solvent Targets given that there is no distinction in the FSD regime between these Targets. The Administrators argued that the FSD regime is aimed at solvent, rather than insolvent companies and that Parliament could not have intended that the priority of an FSD/CN against a Target rank higher than the s 75 debt of the employer itself in an insolvency scenario. Briggs J agreed with the Regulator and Trustees and thought that it would be a strange result if the FSD regime is ineffective against Targets in insolvency before the Regulator has had a chance to implement its procedures.

The Administrators also argued that *Re Toshoku* does not stand for the proposition that every non-provable debt should be an expense. A liability is only an expense if Parliament intended that the debt was a liability of a company in an insolvency process and a necessary disbursement, that is, a liability which is payable by the company in that insolvency process and therefore the officeholder is obliged to discharge. They argued that Parliament could not have intended an FSD to have super-priority, therefore it should only be payable after all provable debts are paid in full.

Briggs J held that *Re Toshoku* establishes, as a general rule, where Parliament imposes a financial liability by statute which is not a provable debt on a company in an insolvency process, then, unless it is an expense under another paragraph of IR 4.218 (or IR 2.67), it is a necessary disbursement of the liquidator/administrator. It does not matter whether the statute expressly refers to companies in insolvency or whether the statute achieves the same result through insolvency neutral language. It is only relevant that the statute defines who is chargeable for the relevant liability.

Briggs J considered that the *Re Toshoku* principle was equally applicable to administrations as it is to liquidations (agreeing on this point with David Richards J in *Exeter City Council v Bairstow* [2007] BCC 236).

Briggs J noted that there are some liabilities that may (or may have) fallen down

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a black hole, such as common law liability in tort. However, there is no case law authority which holds that a statutory liability imposed on a company in insolvency falls down the black hole because it is neither provable nor an expense. Nor has there been any authority which has held that this type of liability would be payable after a company emerges from insolvency.

The Administrators also argued that if an FSD/CN were held to be an expense then this would have an adverse effect on the rescue culture. Briggs J was not persuaded by this argument; holding that it was a matter for Parliament to balance the policy objectives of the pension and insolvency regimes if there is a conflict, rather than the court. Briggs J considered that Parliament could not have intended that the FSD regime be ineffective except in the situation where all unsecured creditors had been paid in full.

BEFORE FALLING DOWN THE 'BLACK HOLE'

An argument raised by Lehman Brothers Holdings Inc ('LBHI') was that if an FSD/CN was found by the court to be neither an expense nor a provable debt in the administrations but were provable in the subsequent liquidations of the Targets, the pension liabilities should be treated *as if* they were provable in the current administrations; in particular by relying upon the principles established by *Re Condon, ex parte James* (1874) 9 Ch App 609. If these liabilities were also found not to be provable in a subsequent liquidation, before these types of liabilities fall down a black hole, given that the government has described them as debts they should be treated the same way as other debts. LBHI argued that administrators are officers of the court and the assets of the estate would be enriched if the pension liabilities remained unpaid, therefore pursuant to *ex parte James*, these liabilities should be treated as if they are provable debts as a matter of natural justice.

JUSTICE BRIGG'S DECISION

Briggs J held that an FSD does not create an immediate financial obligation; it imposes a legal obligation on the Target to secure that reasonable financial support for the scheme is put in place within the relevant period.

Briggs J further held that:

(a) If an FSD is issued after the commencement of and during administration:
- if the Administrators propose to make a payment of money pursuant to the FSD, then the financial consequences of the FSD would not be a provable debt but an administration expense (ie a necessary disbursement); or
- if the Administrators propose to enter into a contract with the Trustees to provide support, then the sums payable in respect of the debts or liabilities arising under that contract would be chargeable upon the property which the Administrators have custody of immediately before vacating office pursuant to para 99(4) of Sch B1 to the Insolvency Act 1986 ('IA'); or
- the Administrators may consider that reasonable financial support would be to transfer the right to certain property to the Trustees; which would not give rise to a financial obligation although the costs of such transfer might.

(b) If an FSD is issued against a Target after the commencement of and during liquidation (following administration), the financial consequences of the FSD would be a liquidation expense.

(c) If a CN is issued against a Target after the commencement of and during administration, then the cost of complying with the CN would be an administration expense.

(d) If a CN is issued against a Target after the commencement of liquidation (following administration) relating to non-compliance of an FSD:
- issued during the administration, the CN would be a provable debt in the liquidation.
- issued in the liquidation proceedings, the CN would be a liquidation expense.

Note that (b) and (d) only applies to companies which entered administration prior to 6 April 2010.

Briggs J did not feel that it was necessary to address the arguments raised by LBHI relating to *ex parte James* given the results of his decision.

Briggs J referred to IR 2.67(2) and (3) which provide the court with power to vary the statutory order of payment of expenses if the assets of the insolvent company are insufficient to meet its liabilities. He considered that a prospective order could be made by the court under this rule, if the payment of the relevant FSD liability would undermine the administration. His view was that this would minimise any threat to the rescue culture.

Briggs J considered that he was bound to reach these conclusions on the basis of existing case law, but considered that the issues raised in the above cases referred to at the hearing might not be followed by a higher court and he envisaged that Parliament might wish to review the relevant statutory provisions.

Briggs J also considered that the Regulator should take into account the interests of the Targets' creditors thereby balancing those interests with the interests of the scheme trustees/members when exercising its discretion and that the level of support under the FSD should also reflect this balancing exercise so as to minimise any unfairness created by this decision.

The impact of this decision on the current administrations of Lehman Brothers and particularly Nortel Networks (given the size of the pension deficit) as well as other administrations currently ongoing or any future administrations, absent any legislative reform or a higher court's decision, is significant. The potential for an FSD/CN to rank ahead of an officeholder's remuneration may be a disincentive for officeholders to take on the position in the first place, in situations involving a defined benefit scheme, leaving these insolvent companies in limbo, with no-one willing to take on an appointment.

Insolvency and pension professionals as well as the market in general will be keeping a close eye on the outcome of the Court of Appeal hearing as well as any government responses to this decision. ■