SQUIRE SANDERS

SUPREME COURT HOLDS THAT THE PENSIONS REGULATOR'S MORAL HAZARD POWERS ARE A PROVABLE DEBT IN AN INSOLVENCY

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Comment

Today's decision of the Supreme Court to hold that a financial support direction ("FSD") or a contribution notice ("CN") issued to a target after the commencement of its insolvency process is a provable debt, rather than being paid out of floating charge realisations as an administration expense in priority to the administrators' costs and preferential and unsecured creditors, is great news for lenders and Insolvency Practitioners alike. It means the FSD or CN will rank with other unsecured creditors. This decision represents closure of an issue which has been troubling lenders, Insolvency Practitioners, plan trustees and the Pensions Regulator since 2009.

Introduction

The Supreme Court was asked to determine whether, in circumstances where an FSD or CN under the Pensions Act 2004 is issued by the Pensions Regulator ("the Regulator") after a company has gone into administration or insolvent liquidation, it imposes any and if so what obligation on the company and its office-holders. It was necessary to consider the way in which Parliament intended the pensions and insolvency statutory regimes to interact.

Under the Pensions Act 2004, the Regulator has power to impose:

- a CN on the plan employer or any person (corporate or individual) connected or associated with the plan employer where either:
  - there has been a deliberate effort to prejudice the position of a plan regarding any statutory debt due or prospectively due from the employer to the plan; or
  - action is taken which is materially detrimental to the likelihood of members receiving their benefits in full from the plan. The Regulator can only issue a CN if, and to the extent, he considers it reasonable to do so in all the circumstances of the case. A CN creates a monetary debt of a specific amount due from the CN target to the plan.
- an FSD on the plan employer or any person (save in exceptional circumstances, excluding an individual) connected with the plan employer where the plan employer is a "service company" (i.e. its turnover is wholly or principally derived from the provision of the services of employees to group companies) or is otherwise "insufficiently resourced" (a complex financial test comparing the value of the debt due or potentially due from the plan employer to the plan with entity value of the plan employer and the entity value of the plan employer's group). Again, the Regulator can only issue an FSD if he considers it reasonable to do so. An FSD creates an obligation on the FSD target to provide support to the plan. The FSD stipulates neither the value nor the form of the support to be provided. Consequently, this has to be negotiated after the FSD is issued. Failure to comply with an FSD is sanctionable by CN.

Unlike a statutory debt under section 75 Pensions Act 1995 (which it is clear ranks as an unsecured creditor in insolvency proceedings), the Pensions Act 2004 is entirely silent as to the dividend ranking status of an FSD or a CN in relation to an insolvent company.

Facts

The administrators of 20 Nortel and Lehman companies made court applications for directions as to the effect of the FSD regime created by the Pensions Act 2004 upon companies in administration or insolvent liquidation. At first instance, Briggs J held that (a) the liability arising under a CN to a company in administration will rank as an administration expense, (b) the liability arising under a CN issued to a company in a liquidation following an administration will rank as a liquidation expense if the FSD preceding it was issued while the company was in liquidation, although if the FSD preceding it was issued while the company was in liquidation any liability arising under the CN will be a provable debt in the liquidation, and (c) an FSD, whether issued to a company in administration or in a subsequent liquidation, imposes an obligation on the company, to be performed by the administrator or liquidator, to comply with the FSD by putting in place reasonable financial support for the pension plan within the period specified in the direction.

We considered the implications of the case in our Pensions Review in December 2010.

Briggs J decided that Rule 13.12 of the Insolvency Rules, which sets out what is a provable debt, did not cover a FSD/CN issued to a target after the commencement of its insolvency process. Unless the FSD or CN was to be deprived of practical financial effect the only alternative available was to find that the FSD/CN was an expense of the insolvency process, which meant, amongst various unfortunate consequences, that it will be paid out of floating charge realisations in priority to the administrators' costs and preferential and unsecured creditors. The rights of fixed charge secured creditors were unaffected by this decision although the value of floating charges was potentially adversely affected.

The administrators of Nortel and Lehman also pointed out the difficulties they would face in trying to achieve their statutory objectives if faced with contingent FSD liabilities with priority of an indeterminate but potentially crippling amount; that this would in practice impede any informed judgment as to the administrators' choice between the alternative statutory objectives of administration; and would disable them from the beneficial management of the company's business and affairs.

The Court of Appeal upheld the decision of Briggs J on 14 October 2011. Insolvency Practitioners voiced grave concerns about the impact of the decision on UK corporate restructurings. The Regulator issued a statement on 26 July 2012 saying that these concerns are misconceived. Intended to provide clarity and comfort to those concerned by the case, the statement suggests the Regulator will look to achieve broad equity between the claims of pension plan trustees and the unsecured creditors of the recipient of an FSD issued after an insolvency event. The Regulator's statement also said it will not generally oppose court applications by Insolvency Practitioners to prospectively vary the statutory priority order on insolvency so that their fees and expenses are paid ahead of FSD liabilities.

Conclusion

Whilst the Supreme Court's decision clarifies the priority status of moral hazard orders, it is important to keep the issue of FSDs/CNs in context. To date, the Regulator has exercised these powers just six times (four FSDs; two CNs). Whilst this may appear low, it is important to note that four of the cases involved non-UK targets, all involved some form of corporate insolvency (albeit the target has not always been undergoing insolvency proceedings), all are/were high value (in context) and several cases have settled prior to the conclusion of regulatory action. In only one of the non-UK cases has the form and value of the support to be provided been agreed and implemented (in *Sea Containers,* where Squire Sanders acted for the plan trustees) and, so far, the Regulator has not reached the point of enforcing any of its orders (whether in the UK or elsewhere). For further discussion on this point, see

UK Pension Regulator's Overseas Reach: Storm in a tea cup? by Philip Sutton.

Notwithstanding this decision, the Regulator's moral hazard powers remain a concern to non-UK targets with an underfunded defined benefit pension plan in a UK subsidiary.

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