Insights and Commentary from Dentons

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A tale of two insolvencies: Lehman Brothers and Nortel

Financial Support Directions: High Court decides they have "super-priority" in insolvency and rank ahead of other creditors

Background

The Pensions Regulator (TPR) issued financial support directions (FSDs) against several Nortel and Lehman Brothers companies that are in administration earlier this year, requiring them to provide financial support for their underfunded UK pension schemes. The deficit in the Nortel pension scheme is £2.1 billion and the deficit in the Lehman Brothers scheme is £140 million. The administrators sought directions from the High Court on their obligations in relation to an FSD. The central issue was where an FSD sits in the order of priority for payment of creditors in administration.

There were three main options that might apply to an FSD:

1 It is an expense of the administration and ranks ahead of other creditors.

2 It is a provable debt within the administration and an unsecured claim.

3 It is a non-provable claim payable only after all other unsecured creditors are paid in full.

Decision

Briggs J concluded that an FSD was not a provable debt if it is issued by TPR after a company goes into administration, as had happened in both the Nortel and Lehman Brothers administrations. As a general rule a debt is only provable if it exists, whether as an actual or contingent liability, at the date the company enters into administration. He pointed out that FSDs were created to impose a pension liability on a company where it had no contractual or statutory obligation and only, at best, a moral obligation in respect of them. Thus, it arose in these cases after the administration began.

Having concluded that an FSD was not a provable debt, Briggs J then considered whether it could be treated as an expense of the administration, which ranked above the claims of existing creditors and equally with the costs of the administration. In *Re Toshoku* in 2002 the House of Lords ruled that where Parliament imposed a financial liability which is not a provable debt in a company's insolvency then, in the absence of provision for it under the insolvency regime, it is an expense of the administration. He observed that the Pensions Act 2004 completely failed to make any reference to the status of an FSD (or contribution notice) where it was imposed on a company that was already insolvent. He felt that this omission in the Pensions Act 2004 led to the conclusion that the FSD liability was an administration expense under the *Re Toshoku* decision.

Comment

- Briggs J reached his decision reluctantly and it was one that was forced on him by the complete failure of the Pensions Act 2004 to address the status of an FSD where it is imposed on an insolvent company as well as weaknesses in the insolvency legislation.
- The decision will almost certainly be appealed. It is likely that the appeal will eventually end up in the Supreme Court, as Briggs J observed: "I hope that a higher court may find a way through or around existing authorities."
- At first glance it is a spectacular result for the Nortel and Lehman pension schemes. It means they will take priority over other creditors on the FSDs. However, it is a result that Trustees should treat with caution and as a temporary position. It causes immense difficulties where there is a final salary pension scheme within a group of companies in administration. There is a two-year time limit for TPR to issue an FSD. Until this time limit expires an administrator would not know what dividend, if any, other creditors might receive or

even whether he could discharge the administration expenses in full. He might not be able to trade a business in the administration so that a viable business is closed. That state of affairs needs to be resolved.

- The decision leads to a number of illogical and unfair results. A Section 75 debt is by law an unsecured claim in an insolvency whilst, according to this case, an FSD is an administration expense. Thus, if A, B and C are a group of companies in administration and A has a pension scheme, the Section 75 debt is only an unsecured claim in its insolvency. If an FSD is imposed on B and C to support A's pension obligations, that secondary liability is elevated to the status of an administration expense above B and C's other creditors. These creditors would include employees as well as trade creditors. If, in the above example, B was only placed in administration after the FSD was imposed on it, then the FSD is a provable debt in B's administration and ranks as an unsecured claim. Yet, in C's case, it still ranks as an administration expense.
- Banks may be reluctant to lend to group companies within which there is a final salary scheme because of the concern that in an insolvency the FSD liability would take precedence. It is not practical to seek clearance from TPR on these issues. The additional risk may, at the very least, significantly increase borrowing costs for these companies.
- The judge suggested there were powerful considerations indicating that Parliament did not intend this result and what was "currently a legislative mess" may need to be dealt with by a suitable amendment to the insolvency rules or the Pensions Act 2004. It seems improbable that the decision will remain unchanged so that the effect may be short lived.

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