JONES DAY

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FINANCIAL SUPPORT DIRECTIONS AND INSOLVENCY: THE PENSIONS REGULATOR'S VIEW

SUMMARY

On 26 July 2012, the Pensions Regulator (the 'Regulator') issued a statement on financial support directions (FSDs) with the intention of providing further guidance and comfort with regard to the circumstances in which it will issue an FSD after a company has been placed into administration.

As readers may recall, the current legal position following the rulings in *Lehman Brothers* and *Nortel Networks* is that if an FSD is issued before a company goes into administration, it will rank as a general unsecured debt. However, an FSD issued after a company has been placed into administration will rank as an expense of the administration. An FSD issued after administration will therefore be discharged from floating (not fixed) charge realisations and will rank above payment of the administrator's own remuneration. The priority of FSDs over floating charge holders could have a material impact on the return to secured creditors, particularly where there are few or no fixed charge assets.

The current ranking of FSDs issued after administration is of great concern to insolvency practitioners and lenders in particular and is arguably frustrating the legitimate use of administration. Understandably, insolvency practitioners are reluctant to accept appointments where there is a risk of not being paid. In some circumstances, we have seen administrators insist on fee indemnities being put in place before they are prepared to accept an appointment. Lenders are equally concerned about their potential return in an insolvency if floating charge realisations are in the first instance applied in satisfaction of any FSD issued after administration. Concern has also been expressed with regard to the important leverage the Regulator arguably has in any restructuring negotiations in view of the priority status enjoyed by FSDs issued after administration and how such leverage might be used.

In response to the above concerns, the Regulator has stated that it has no intention of deliberately delaying the issue of an FSD until a company goes into administration and thereby taking advantage

of post-insolvency priority ranking. Further, the Regulator has stated that in most circumstances it will not object to an application issued by an administrator to reorder the statutory order of priorities so that the payment of the administrator's own reasonable remuneration will rank ahead of an FSD. The Regulator has also advised that in the forthcoming appeal to the Supreme Court on this issue, it will argue that an FSD issued after administration is a provable debt which will rank as a general unsecured debt as an alternative to an administration expense. Whilst the statement is welcomed, it is unlikely to provide the certainty stakeholders are seeking and which they hope the Supreme Court will deliver in respect of the *Lehman Brothers* and *Nortel Networks* appeal.

WHAT IS AN FSD?

An FSD (issued under section 43 of the Pensions Act 2004) requires the recipient to put forward a proposal for financial support for a defined-benefit pension scheme in order to address funding deficiencies. Where a proposal for reasonable financial support is not submitted, a Contribution Notice (CN) may be issued under section 47 of the Pensions Act 2004.

A sponsoring employer has ongoing scheme funding obligations or, where the employer is insolvent or the scheme is in wind-up, it will owe a section 75 (buyout) debt to the scheme. There is normally no legal obligation for other group companies to support or be liable for that scheme. However, if the particular circumstances and history of an employer and a scheme suggest it could be reasonable for the employer's group (or part of it) to support the scheme, then the Regulator may investigate and ultimately issue an FSD to a member or members of the employer's group.

CURRENT LEGAL POSITION

In December 2010, Mr Justice Briggs ruled in the cases of *Lehman Brothers* and *Nortel Networks* that the liability imposed by an FSD issued during administration ranked as an expense of the administration. In law, an administration expense must be paid before any distribution to preferred creditors, holders of floating charges, and unsecured creditors (including the remuneration of the administrators themselves), but not before holders of fixed charges.

In October 2011, the Court of Appeal confirmed the ruling of Mr Justice Briggs. That judgment is being appealed to the Supreme Court but is not scheduled to be heard until 14 May 2013.

THE REGULATOR'S POSITION

The Regulator points out that FSDs have been issued in only four cases since the power came into force in April 2005.

Whilst the Regulator cannot change the order of the priority ranking of liabilities under the FSD, it has expressly acknowledged that the ruling in *Lehman Brothers* and *Nortel Networks* does not override its duty to act reasonably, nor prevent it from considering various relevant factors when assessing whether the amount and the form of financial support proposed are reasonable. The Regulator has stated, however, that it has no intention of deliberately delaying the issue of an FSD until a company goes into administration to take advantage of post-insolvency priority ranking.

The Regulator states that where an insolvent FSD recipient has submitted proposals for financial support, it is highly unlikely to be reasonable for the Regulator to insist upon a level of support which would leave administrators out of pocket and unsecured creditors without any return. Further, the FSD is unlikely to result in a contribution amounting to the scheme's entire section 75 debt unless the recipient agrees to this.

Where administrators are concerned about their own fees, they may apply to court for a prospective order to vary the order of priority that ranks FSD liabilities against other administration expenses, including administrators' remuneration. The Regulator has stated that with sufficient information and in consultation with the trustees and the PPF, it would not in most circumstances seek to object to a reordering that subordinates FSD liabilities to the administrator's reasonable remuneration and that it would consider any proposals to reorder other categories of administration expense above FSD liabilities.

In any case, it will still be possible for insolvency practitioners to gauge before accepting an appointment whether the factual tests for an FSD are likely to be met by the scheme and to consider taking appropriate steps (e.g., clearance) as a result. Clearance is the procedure in section 46 of the Pensions Act 2004 which can provide certainty to insolvency practitioners (and lenders) that specified events will not result in the Regulator's issuance of an FSD.

With regard to the appeal which is currently pending in the Supreme Court, the Regulator has advised that it intends to argue that FSD liabilities incurred after administration are provable debts which rank as general unsecured debts as an alternative to administration expenses.

JONES DAY VIEW

Whilst the statement issued by the Regulator is clearly welcomed, it is unlikely to provide to lenders the level of certainty they will typically require in order to be satisfied with and to properly assess the potential risks for them in administration. Whilst clearance remains an option, for practical reasons this is not always possible.

For insolvency practitioners, the Regulator's comment that it will not (in most circumstances) object to an application by an insolvency practitioner to reorder the statutory order of priorities is helpful and will undoubtedly provide a level of comfort to insolvency practitioners that their fees will be paid. However, the risk of nonpayment has not been removed, and we envisage that in the short term, insolvency practitioners may still require fee indemnities to be provided to them pending final resolution of this issue in the Supreme Court.

LAWYER CONTACTS

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