



JONES DAY  
COMMENTARY

## TO RANK OR NOT TO RANK: THE UK SUPREME COURT DECISION IN *LEHMAN/NORTEL*

In a much-awaited judgment, the UK Supreme Court has decided that the liability of a company in administration or liquidation to contribute to an under-funded pension fund following a Financial Support Direction or a Contribution Notice is a provable debt ranking equally with other unsecured creditors. Crucially, it is not an expense of the administration or liquidation which would cause it to rank ahead of all creditors (except fixed charge holders) and even the administrator's or liquidator's own remuneration.

This is a very helpful decision for all stakeholders in an insolvency process (e.g. debtors, creditors and insolvency practitioners) as it brings certainty after several unsettled years over the treatment of these pension liabilities which, because of their size, fundamentally alter the centre of gravity of any administration or liquidation.

As well as overturning the first instance and Court of Appeal judgments, the Supreme Court also decided that various other cases were wrongly decided and has readjusted common law back to an earlier view of

what constitutes a "provable debt" (i.e. a debt which can be claimed in an English insolvency process).

### THE ISSUES

The names Lehman and Nortel are now synonymous with vast corporate failures which have been litigated over repeatedly. The Pensions Regulator had issued Financial Support Directions ("FSD") to support under-funded employee pension schemes *after* the groups' administrations in respect of pension deficits which arose before the administrations. The question for the Court to deal with here related to how these FSDs should be categorised and ranked within the administration.

**Pensions.** The Pensions Regulator has the power to require certain members in the same group as an employer under a defined benefit pension scheme to provide financial support for any defined benefit pension scheme which appears to be, and to have been for some time, in substantial deficit. There is a lengthy process set out in statute detailing how the

Pensions Regulator should go about this but, in summary, after due investigation, the Pensions Regulator may issue an FSD which obliges other group companies to provide reasonable financial support to the pension scheme and, if such support is not forthcoming, to issue a Contribution Notice (“CN”) for a set amount to be paid. The length of the process and nature of the Pensions Regulator means that FSDs and CNs are often not issued until after the company is in administration or liquidation. Despite this, neither the pensions nor the insolvency legislation defines how these liabilities are to be categorised in an insolvency.

**Insolvency.** The statutory order of priority for payments out of the company’s assets is:

1. Fixed charge creditors;
2. Expenses of the insolvency procedure (including officeholder’s fees);
3. Preferential creditors;
4. Prescribed part creditors (ordinary unsecured creditors claiming against a maximum pot of £600,000);
5. Floating charge creditors;
6. Unsecured provable debts;
7. Statutory interest;
8. Nonprovable liabilities; and
9. Shareholders.

The pension liabilities could be considered to be one of three options. First, they could be unsecured provable debts; second, an expense of the insolvency; or third, nonprovable liabilities. If the third, there was a further argument that the Court had discretion to order the administrator to treat them as either provable debts or an expense.

A further issue was that debts were provable only if they existed at the time of the company entering administration or liquidation. Where an FSD was issued before administration, it was common ground that that liability would be a provable debt. However, as noted above, the Pensions Regulator often issued an FSD or CN only after entry into a formal insolvency procedure, so not being clearly provable.

## FIRST INSTANCE AND COURT OF APPEAL

The first instance Court and Court of Appeal found that the liabilities were expenses in the administration. However, it seems that they felt constrained by prior case law to rule out treating the liabilities as provable debts as the liabilities under the FSD arose after the companies had entered administration. Then, left to decide between being unprovable debts or expenses, the courts opted to categorise the liabilities as expenses.

The practical impact of those decisions was that the sums in question were so large as to wipe out totally any return to the unsecured creditors (other than possibly through the prescribed part) and would rank ahead even of the officeholder’s fees. This would have had a huge effect on the viability of administration for companies with pension deficits.

## SUPREME COURT

The Supreme Court held unanimously that the “fair and sensible answer” was that a liability under an FSD or CN issued after formal insolvency should be treated as a provable debt. The Court provided various supporting arguments, but the crux of it boiled down to equality between creditors and equality of treatment before and after insolvency. Reasons for the Court’s decision included:

- The pension trustees were entitled to receive the sum by law, but that did not provide any greater or lesser priority than other unsecured creditors.
- An FSD or CN issued before insolvency would be a provable debt as would a debt to a pension scheme (a “s75 debt” as it is commonly known) where no FSD or CN had been issued. It would be “arbitrary” for the characterisation of the debt to turn on when or whether an FSD or CN were issued, especially as the decision to issue would be based on the state of affairs before an insolvency event.
- If the liability were an expense, the Pensions Regulator might wait until after an insolvency event to issue an FSD or CN because it would give a greater return as an expense rather than a provable debt.

- It seemed unlikely that Parliament intended the liabilities to rank behind provable debts. The length of the process to issue an FSD and CN meant that they would almost always be issued in respect of insolvent companies. If they were unprovable debts ranking behind the unsecured creditors, then very few FSDs and CNs would ever be satisfied.

As for why the liability under the FSD and CN should be treated as a debt arising before insolvency, and therefore provable, the Court held that the obligation for the liability occurred before the date of insolvency. The Court noted that it was “dangerous” to try to suggest a “universally applicable formula” to test whether a pre-insolvency obligation was sufficient to create a post-insolvency liability. Nonetheless, it expressed the view that for an obligation incurred pre-insolvency to rank as a provable debt, a company must have taken or been subject to one or more steps which (i) had some legal effect and (ii) resulted in it being vulnerable to the specific liability, with a real prospect that the liability would be incurred. If both of those tests were met, the Court should then consider whether it would be consistent with the regime which imposed the liability that the steps would give rise to the obligation. If the answer is yes, the obligation ranks as a provable debt.

Applying that test to *Lehman/Nortel*, for the first limb, the Supreme Court found that all the relevant companies had been members of the group for at least two years before the commencement date of the administration (the look-back period for the Pensions Act), creating a legal relationship. As for the second limb, at the commencement date of the administration, the groups both had under-funded pension schemes, which had been in deficit for more than two years and so were exactly the type of companies which would be the targets of an FSD. Having satisfied itself as to those parts of the test, the Court referred back to its earlier arguments (above) as to why it was consistent with the pensions regime to impose a liability ranking as a provable debt.

**Earlier Authorities.** The Court dismissed various of the earlier authorities, reverting to the 19th century approach endorsed by the report which led to the Insolvency Act that, where possible, all debts and liabilities should be incorporated into the formal insolvency and discharged. The judge noted that those liabilities should include all “contracts, liabilities, engagements and contingencies of

every kind” and cited various further amendments of the insolvency legislation which widened the class of creditors.

## OTHER COMMENTS

Despite deciding that a claim in an administration or liquidation could only be a provable debt or an expense, not both, the Court took the opportunity to consider what constituted expenses and whether it had a residual discretion to impose a ranking on a claim since it had heard full argument on both points.

**Expenses.** Again, with caveats about creating a general rule, the Court suggested that a disbursement would be an expense if it arose out of something done in the administration (normally by the administrator) or imposed by statute on the administrator as part of the administration. The Court emphasised that any such liability would be one which was incurred *as part of* the administration rather than merely incurred during the period of the administration. Additionally, there would either be a clear or reasonably assumed statutory intention that such a liability should rank ahead of provable debts.

**The Residual Discretion of the Court.** The third limb of the question was: If the Court had found that the pension liabilities were neither provable debts nor expenses, could the Court order that they be treated as such? This idea was firmly quashed by the Court as being “wrong in principle” and “highly problematic in practice”. It would be wrong for the Court to overrule statute and problematic because of the confusion to officeholders that it might cause and court applications by disgruntled creditors seeking a higher ranking. Further, the Court held that it could not sanction a course which was outside an administrator’s statutory power, such as varying creditors’ rankings.

## THE FUTURE

Not only does this decision bring certainty after two and half years of court proceedings, it also brings clarity as to where pension liabilities will rank in an insolvency. Additionally it settles that pension liabilities are provable debts whether or not an FSD or CN are issued and whether or not they are issued after insolvency proceedings. This will help creditors

and debtors in insolvency contingency planning and bring certainty to consensual restructurings. More broadly, it provides a useful test for establishing what is a provable debt and overrules a diverging line of judgments.

**How Will the Pensions Regulator React to Being an Unsecured Creditor?** As the Pensions Regulator had stated publicly that it would not use its powers to issue FSDs and CNs arbitrarily despite the first instance and Court of Appeal decisions, we do not think that the Supreme Court decision will have a material impact on the Pensions Regulator's negotiating position in consensual restructurings. This is not to say the Pensions Regulator will be sitting on the sidelines in other aspects of insolvencies, such as pre-packaged administration asset sales.

There has been disquiet that in some pre-pack administrations, the administrators accept a sale price which is enough to cover the secured creditors and their fees, but do not appear to push harder for the unsecured creditors. The Secretary of State for Business has recently commissioned a report to investigate pre-pack administrations, specifically their transparency and the returns delivered for creditors. It is possible in light of this decision, and the findings or recommendations of the report on pre-pack administrations, that the Pensions Regulator will play a more active part in challenging sales where the unsecured creditors get only a token return. This may be especially true where the potential targets of an FSD or CN are also insolvent, so contributions from them will be minimal. Should the Pensions Regulator adopt a more robust attitude, administrators and purchasers may have to pay more attention to the outcome for unsecured creditors or risk challenges to administration sales.

## LAWYER CONTACTS

For further information, please contact your principal Firm representative or the lawyers listed below. General email messages may be sent using our "Contact Us" form, which can be found at [www.jonesday.com](http://www.jonesday.com).

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