Nortel judgment ends super priority for pension claims in insolvency

INTRODUCTION

In the eagerly awaited Nortel decision[1], the Supreme Court has held that the costs of complying with financial support directions ("**FSDs**") issued by the Pensions Regulator ("**TPR**") against companies in administration are a provable debt, ranking equally with other unsecured, non-preferential debts. In so doing, it has reversed the decision of the Court of Appeal that found that such liabilities ranked as an expense of the administration, thereby elevating them to super-priority status. This briefing outlines the findings of the case and its implications.

BACKGROUND

The case arose following the financial collapse of the Nortel and Lehman Brothers groups. Both had final salary pension schemes that were in substantial deficit. The administrators of companies associated with the pension scheme employer (the "**targets**") within each group received notice that TPR was considering issuing FSDs to the targets, requiring them to provide financial support to the schemes. The administrators appealed against the notice, which had the effect of staying proceedings by TPR, and applied to court for a determination on whether an FSD or a contribution notice ("**CN**") issued after the target has gone into administration or liquidation (an "**insolvency event**"), imposes any obligation on the target and its office-holders and, if so, how that obligation would rank in the target's insolvency.[2]

The Court of Appeal, upholding the High Court decision, found that (on the basis of existing case authority) it was necessary for a debtor to be under an existing legal obligation at the commencement of an insolvency event in order for a debt to be provable, and that a target could not be said to be under a legal obligation prior to the issue of an FSD as it was dependent on the exercise of discretionary powers by TPR. The issue of an FSD after the commencement of an insolvency event was not therefore sufficient to trigger a contingent liability constituting a provable debt. Accordingly, a CN issued in such circumstances would also not be a provable debt. Both the Court of Appeal and the High Court reluctantly concluded that the liability was an expense of the administration that would therefore be payable in priority to claims of floating charge holders, unsecured creditors and the administrators or liquidators in respect of their remuneration. This produced a number of anomalies, including that an FSD liability arising prior to an insolvency event would be a provable debt, while one arising after the event would be an insolvency expense. Also, an FSD liability arising after an insolvency event would rank higher than a statutory ("section 75") debt, which is a provable debt in the employer company's insolvency payable under the pensions legislation to meet the shortfall in the scheme assets. The administrators appealed against the decision.

[1] Re Nortel Companies & Ors [2013] UKSC 52 (24 July 2013).

[2] The ability to issue an FSD is one of TPR's two "moral hazard" under the Pensions Act 2004. The other is the ability to issue a CN, which requires a target to pay a specified sum to a scheme. These discretionary powers exist to assist TPR in meeting its statutory objectives of protecting the benefits of scheme members and reducing the risk that the Pension Protection Fund may be obliged to pay compensation to members on the insolvency of the sponsoring employer. If financial support is not forthcoming following the issue of an FSD, TPR may seek to impose a CN.

THE SUPREME COURT'S DECISION

The four possibilities presented to the Supreme Court as to how the cost of complying with an FSD (or CN) issued after an insolvency event should rank were that:

1. it would be an expense of the administration or liquidation (i.e. the conclusion reached by the lower courts);

2. it would be an ordinary provable unsecured debt within rule 13.12 of the Insolvency Rules 1986 ("**IR 1986**"), ranking *pari passu* with other unsecured debts falling within that category;

3. it would be payable (if at all) only out of any surplus available after payment in full of all unsecured creditors (i.e. not a provable debt); or

4. if the third possibility is correct, the court could and should direct the administrators to vary the statutory ranking of liabilities in order to treat the liability more favourably.

The Supreme Court decided unanimously that the liability was a provable debt. In so doing it overruled earlier, long-standing decisions on personal insolvencies that the lower courts had felt they were bound to follow. Lord Neuberger, in the leading judgment, found that those cases, which held that a liability for costs arising from a judgment given after the commencement of the insolvency was not provable as a contingent debt, were "very short of any reasoning". He was also of the view that the more recent cases cited, with their narrow construction of the term "contingent liability", had also been wrongly decided. It was his view that the liability under an FSD would be a liability within rule 13.12(1)(b) IR 1986 as it was one to which the company may become subject after the insolvency event by reason of an obligation incurred before that event. The fact that the liability did not arise until after the insolvency event did not prevent it from being a provable debt as there was a pre-existing obligation that gave rise to it.

Lord Neuberger was anxious to avoid proposing a "universally applicable formula" to determine whether a company had incurred a relevant "obligation" under rule 13.12(1)(b) IR 1986, given the many different statutory and other liabilities and obligations which could exist. He nonetheless went on to suggest that the company must have taken, or been subjected to, a step or combination of steps which (a) had some legal effect (such as putting it under some legal duty or into some legal relationship) and that (b) resulted in it being vulnerable to the specific liability in question, such that there would be a real prospect of that liability being incurred. If these two requirements were satisfied, it is then also relevant to consider (c) whether it would be consistent with the regime under which the liability is imposed to conclude that the step or combination of steps gave rise to an obligation under rule 13.12(1)(b) IR 1986. In applying this test, he found that: (i) as to the first requirement, on entering administration, each target had been a member of the relevant group of companies and fell within the ambit of the FSD regime (which was undoubtedly a significant relationship having legal effect); (ii) as to the second requirement, on the facts, the companies were precisely the type of entities that were intended to be rendered liable under the FSD regime; and (iii) as to the third requirement, it was consistent with the FSD regime to conclude that an obligation under rule 13.12(1)(b) IR 1986 had arisen and that the liability should be treated as a provable debt.

Although not strictly necessary, having concluded that the liability was a provable debt, Lord Neuberger also addressed the question of whether, if the potential liability under the FSD regime did not give rise to a provable debt where the FSD is issued after the relevant insolvency event, it would be within the expression "charges and other expenses incurred in the course of the… administration" within rule 12.2 IR 1986 and, more particularly, within the expression "any necessary disbursements by the administrator in the course of the administration" under rule 2.67(1)(f) IR 1986. In his view, it would only be a "necessary disbursement" (and therefore an administration

expense) if it arose out of something done in the administration (normally by the administrator or on the administrator's behalf) or was imposed by a statute whose terms render it clear that the liability to make the disbursement falls on an administrator as part of the administration – either because of the nature of the liability or because of the terms of the statute. As a result, he disagreed with the conclusion reached by the High Court, and endorsed by the Court of Appeal, that the House of Lords had, in an earlier case, established a "general rule" that where a statutory liability is imposed on a company in administration or liquidation that is not provable, it will be a necessary disbursement of the insolvency and rank as an expense.

The third possibility, that the potential liability was a non-provable debt that would rank for payment from any surplus available after paying all other creditors, and the fourth possibility, that if the potential liability was not a provable debt then the court had a residual discretion to direct the administrator to accord it a higher ranking than would be given under the insolvency legislation, were both rejected. As regards according a higher ranking priority than that afforded by legislation, Lord Neuberger described the proposal as wrong in principle. It was his view that there could never have been an intention to give the court "a roving commission to vary the clear statutory ranking of liabilities".

IMPLICATIONS

The conclusion of the Supreme Court that the potential liability of a target under an FSD or a CN issued after an insolvency event should be treated as a provable debt was described by Lord Neuberger as "sensible and fair" and was swiftly endorsed by TPR.[3] As such, it provides welcome clarification on the categorisation and treatment of potential FSD liabilities on insolvency.

The finding that an FSD liability is an obligation giving rise to a contingent liability that ranks as a provable debt significantly widens the ambit of rule 13.12(1)(b) IR 1986. This may have implications outside the sphere of pensions legislation and raises the question of how, in practice, the three-stage test to determine whether the relevant obligation under rule 13.12(1)(b) has arisen will be applied.

In addition, the Supreme Court's confirmation that a "necessary disbursement" under rule 2.67(1)(f) IR 1986 will only be an administration expense if it arises out of something done in an administration or is imposed by a statute whose terms make it clear that the liability to make the disbursement falls on an administrator as part of the administration, is to be welcomed. It may also have wider implications as to how insolvency expenses are treated, for example on the issue of when rent is payable as an administration expense, which is currently under judicial scrutiny in proceedings relating to the administration of companies in the Game group.

Inevitably, some uncertainty remains and the decision opens the way to future debate on whether an obligation has been incurred for the purposes of rule 13.12(1)(b) IR 1986, how the liability that may result from it should be measured and whether, based on the language used in the judgment, it extends beyond liabilities created by statute.

[3] See 'Nortel-Lehman' Supreme Court judgment - regulator statement (Ref: PN 13-27, 24 July 2013).

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