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# The Treatment Of Pension Claims In UK Insolvency Process

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When the Lehman Brothers group imploded in September 2008, the impact of events on the Lehman Brothers U.K. pension scheme was not seen as a key concern for anyone other than the members themselves. Yet as time progressed, the scheme featured heavily in resolving the administration of many U.K. Lehman Brothers group entities and in the process, important legal principles relating to defined benefit pension schemes were decided. Many ancillary points were decided during the litigation (some of which are discussed below), but the most important issue, that of the priority of debts on a winding up, is of great significance.

Defined benefit schemes are a type of occupational pension scheme set up by employers for the benefit of their employees. There are generally two types of occupational pension scheme:

- defined benefit schemes (where a defined level of benefit, usually calculated by reference to a member's final salary, is promised on retirement); and

- defined contribution schemes (where benefits payable on retirement are calculated by reference to contributions paid and returns on investment).

This article focuses on the operation of anti-avoidance pension legislation in relation to U.K. defined benefit pension schemes. In particular, we discuss the litigation over the imposition of pension liabilities on certain Lehman group companies and attempts of those companies to clarify the nature and extent of their obligations.

The outcome of the U.K. Supreme Court hearing on the priority issue overruled previous judgments, which would have transformed the prospects of recovery for many unsecured creditors by giving pension liabilities "superpriority." The facts of the matter also reinforce the principle that, thanks to anti-avoidance legislation, pension liabilities are quite transferable within corporate groups at the behest of the U.K. Pensions Regulator — something that should be borne in mind by unsecured creditors, even when the company they are lending to does not have a pension scheme.

**Factual and Regulatory Background**

In the U.K., when an employer with an occupational pension scheme suffers an insolvency event, a debt becomes due from the employer to the trustees of its pension scheme, which is equal to the shortfall (if any) in the assets of the scheme to its liabilities. Named after the relevant section in the Pensions Act 1995, this debt is known as "Section 75 debt."

If the employer does not have sufficient assets to cover its Section 75 debt, a pension protection fund exists to protect employees who are members of defined benefit pension schemes. The fund is financed by levies upon all benefiting pension schemes. However, in order to guard against an employer transferring the burden of funding its pension scheme to the fund (for example by structuring its activities using a "service company"[1]), an anti-avoidance regime was created, known as the Financial Support Direction (FSD) scheme.

If certain circumstances are met, the regulator can issue an FSD to entities connected or associated with an employer. The recipient of an FSD, is, as the name suggests, required by law to financially support the relevant pension scheme. An FSD does not stipulate how much each recipient must contribute; it merely requires that a "financial support arrangement" is established to the satisfaction of the regulator. If a recipient does not comply with the terms of an FSD, the regulator may issue a contribution notice, therein creating a specific monetary liability payable by the company to the scheme trustees. A contribution notice will be calculated to make up the deficit in the relevant pension scheme, an amount based on the amount of Section 75 debt.

**Regulator Investigation**

The main sponsoring employer for the scheme was Lehman Brothers Ltd. LBL provided substantially all of the staff and infrastructure for the Lehman group's operations in the U.K. — making it a service company under the act — until Sept. 15, 2008, when it entered into administration with the scheme in deficit and with no ongoing support from other group companies.

Shortly afterward, the regulator commenced an investigation into the scheme, which at that time was underfunded and without a solvent supporting entity. It subsequently issued certain group entities (which include Lehman Brothers Holdings Inc. and Lehman Brothers International (Europe)) with FSDs (the "targets").

**Ancillary Issues**

The regulator's decision to issue FSDs to the targets was referred to the Upper Tribunal (Tax and Chancery) by the six FSD recipients, who argued that no such obligation should be placed upon them, and also by the scheme trustees, who wanted FSDs to be issued to up to 38 other Lehman group entities. These proceedings were stayed to allow for additional legal contests to be resolved.

On its slow journey to the Supreme Court, various judges and panels considered many different aspects of pensions and insolvency law, and the following rulings were made:

- FSDs can be issued against insolvent companies;

- FSD obligations can exceed, in aggregate, the Section 75 debt owed to a pension scheme;

- Pension scheme trustees are "directly affected persons" for the purposes of the Pensions Act 2004, giving them the right to make appeals about the decisions of the regulator;[2] and

- The two-year time limit for the regulator to issue an FSD does not apply to directions that the Upper Tribunal may give regarding an FSD, or any subsequent order or appeal made on those directions.

Although noteworthy, the above decisions mostly affect legal procedure and will be of limited interest to professionals working outside of those areas. In contrast, professionals in many different areas, especially those involved in structuring deals in corporate groups with defined benefit pension schemes, need to be aware of the main ruling of the Supreme Court in the Lehman pension litigation because it cuts to the heart of the English restructuring and insolvency system: the statutory ranking of debts on a winding up.

**Supreme Court — "Superpriority" and FSDs**

After deciding to whom FSD/contribution notice liabilities (support liabilities) should apply, and given that most of the targets had gone into insolvent administration, the next issue for the courts to decide naturally related to where support liabilities rank in the priority of liabilities set out in U.K. insolvency law when the FSD/contribution notice is issued after the target has entered administration.[3]

U.K. insolvency law[4] dictates that when a company is liquidated, the order of priority for payment out of the company's assets is as follows:

1. Fixed-charge creditors;
2. Expenses of the insolvency/administration;
3. Preferential creditors and prescribed part;[5]
4. Floating-charge creditors;
5. Unsecured provable debts;
6. Statutory interest;
7. Nonprovable liabilities; and
8. Shareholders.

The lower courts both held that support liabilities constituted expenses of an administration (position no. 2 on the above list), thereby giving them a status known as "superpriority," ranking above not only unsecured creditors and floating-charge holders but also preferential creditors. It was reasoned (somewhat reluctantly as the courts considered themselves bound by precedent) that support liabilities could not be provable debts, as most practitioners had assumed they were, because they were not legal obligations existing at the commencement of an insolvency event.

Although on one analysis, support liabilities could be seen as contingent liabilities formed before an insolvency event, the courts rejected this because such liabilities depend entirely on the discretionary powers of the regulator to issue an FSD. Significantly, under U.K. insolvency law, the administrators' remuneration ranks after the expenses of the administration.[6]

On appeal, the Supreme Court considered the following three options as to how support liabilities should be treated:

- expenses of the administration;
- provable unsecured debts (ranking equally with other unsecured liabilities of targets); or
- neither provable debts nor expenses (ranking behind even the unsecured liabilities of targets).

The Supreme Court held that Support Liabilities were provable unsecured debts, overruling the lower courts by a unanimous decision. Free from the restrictions of contrary precedent, the Supreme Court made its decision seemingly based largely on what was reasonable; the lower court's ruling had created a number of anomalies, not least the fact that support liabilities would now rank higher than the original Section 75 debt that they were designed to guarantee.

Following a detailed examination of the Insolvency Rules 1986, Lord David Neuberger, who gave the leading judgment, argued that even when issued after an insolvency event, support liabilities could be deemed to have been incurred before that event (and so constitute provable debts) because the relevant company will have taken a number of steps prior to insolvency, which (a) "put it under some legal duty or into some legal relationship"; and (b) "resulted in it being vulnerable to the specific liability," such that there was a "real prospect" of that liability being incurred.

By analyzing support liabilities in this way, the Supreme Court found that they were contingent liabilities, where the obligations had been incurred before the insolvency event took place. Presumably in the case of Lehman, this occurred when the LBL service company structure was put in place.

**Conclusion and Outlook**

Following the decision of the Supreme Court, the parties negotiated a settlement deed, which was signed on Aug. 14, 2014. Under the terms of settlement, six Lehman companies to whom FSDs were issued will pay the scheme trustees an amount that is expected to satisfy in full the scheme's liabilities to its members, an amount estimated at £184 million. Proceedings at the Upper Tribunal have been indefinitely stayed and the scheme is expected to be fully funded.

In the Lehman case, support liabilities relating to the scheme were fairly small, especially when compared to the size of the Lehman group estate. Nevertheless, pension scheme liabilities are often overlooked, even though they can be huge. Amongst FTSE 100 companies, the combined pension deficit as of June 2014 was £37 billion.[7] Such figures, which for many large institutions run individually into the billions,[8] will have a large impact on payouts to creditors on a winding up.

On the face of it, the end result of the Lehman pension litigation was not unsurprising, and most commentators, including the regulator, consider that a fair outcome was achieved. Nevertheless, the ready imposition of support liabilities by the regulator should serve as a reminder of the potential liabilities to those dealing with companies with defined benefit occupational pension schemes, especially if those schemes are in deficit.

This issue of banks and pension liabilities under English law came back into focus recently with the publication of the Financial Services and Markets Act 2000 (Banking Reform) (Pensions) Regulations 2015. The draft regulations, which are currently under consideration by the Parliament, complement the new ring fencing regulations,[9] which have the purpose of ring-fencing banks' retail and small- and medium-enterprise deposits in separate financial independent legal entities. Only applicable to banks that accept such deposits,[10] the new pension rules seek to further protect those depositors by ensuring that ring-fenced banks are not, and cannot become, liable for another entity's pension liabilities, unless those liabilities arise from other ring-fenced banks in the group, or wholly owned subsidiaries of other ring-fenced banks in the group.

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[1] I.e., a company in a group of companies whose turnover is solely or principally derived from amounts charged for providing the services of its employees to other group companies.

[2] At first instance, such appeals (technically known as "references") are made to the Upper Tribunal.

[3] It was common ground that liabilities arising under an FSD or contribution notice issued before the target entered into administration would be provable debts.

[4] In particular, the Insolvency Act 1986 and its accompanying statutory instrument, the Insolvency Rules 1986 (SI 1986/1925).

[5] The prescribed part is a portion of the proceeds of a realization of assets covered by a floating charge that must be set aside and applied in satisfaction of unsecured debts up to a maximum of £600,000.

[6] Paragraph 99, Schedule B1, Insolvency Act 1986

[7] Accounting for Pensions 2014, Lane Clark & Peacock LLP

[8] The Supreme Court decision discussed above was actually a joined case with that of stricken telecommunications giant Nortel, where the UK pension debt was £2.1 billion.

[9] Enacted by the Financial Services (Banking Reform) Act 2013. The regime is expected to come into force in 2019.

[10] Certain other criteria, such as the size (in absolute terms and relative to the size of the bank in question) of the deposit business apply.