

# International Corporate Rescue



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## Overseas Action by the UK's Pensions Regulator – An Update

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### Introduction

In our article<sup>1</sup> in the fourth issue of last year's *International Corporate Rescue*, we outlined the complexities faced by the Pensions Regulator ('TPR') in exercising its 'moral hazard' powers under the Pensions Act 2004, in instances where the 'target' is a non-UK resident insolvent entity.

The recent decision of TPR's Determinations Panel in relation to the Lehman Brothers Pension Scheme sheds more light on TPR's approach to imposing financial support directions ('FSDs') upon insolvent entities. In particular, the decision:

- confirms that TPR continues to adopt a wide definition of 'benefit' in the hands of an FSD target (this being a pre-requisite of the statutory test of reasonableness in issuing an FSD);
- confirms that TPR will look through complex corporate family structures and impose liability upon indirect parents and related subsidiaries of a pension plan's sponsoring employer; and
- importantly, demonstrates that TPR does not believe that insolvency of the FSD target is an impediment to the issuance of an FSD, but rather that 'insolvency is a situation where an FSD might be necessary and appropriate in order to protect the interests of members'.

Interestingly, the decision makes no reference to the decisions of the Canadian and US bankruptcy courts in the *Nortel* case which we referred to in our previous article, and it will be interesting to see how the decision is received by the US courts supervising the Lehman Chapter 11 proceedings.

### A brief recap on TPR's powers

TPR was established by the Pensions Act 2004 and invested with significant powers enabling it to pierce the corporate veil and pursue entities connected to, or associated with, defined benefit pension plan sponsoring employers. The purpose of these sections of the Pensions Act 2004, commonly referred to as the 'moral hazard' provisions, was twofold. Firstly, they were intended to ensure that corporate groups 'stood behind' pension promises given to UK employees. Secondly, they were intended to prevent pension liabilities from being 'dumped' upon the newly created Pension Protection Fund (which was itself established under the Pensions Act 2004 and given the power to assume liability (to a limited extent) for the pensions liabilities of insolvent sponsoring employers).

The key species of moral hazard power, and the one that has been utilised in the *Lehman Brothers* case, is TPR's power to issue financial support directions (FSDs) under section 43 of the Pensions Act 2004, where the sponsoring employer is either 'insufficiently resourced' or a 'service company'.

In simple terms, a sponsoring employer will be considered to be a 'service company' where its sole purpose is to employ individuals to service the human resources needs of the wider corporate group, and where the only cash flowing through it follows from transmission of salary and payroll costs to those entities within the group which are resourced by individuals employed by it. A sponsoring employer will be 'insufficiently resourced' where its assets amount to less than 50% of the pension plan's projected section 75 debt<sup>2</sup> at a time when the resources of other companies within its group (taken alone or aggregated together) amount to 50% or more of the projected section 75 debt.

FSDs may be issued against any entity which is connected with, or an associate of, the sponsoring employer.

### Notes

1 N. Greenacre and S. Owens, 'The Questionable Reach of the UK Pensions Regulator' (2010) 4 *International Corporate Rescue* 247-255.

2 Section 75 debt is the statutory debt on the employer under section 75 of the Pensions Act 1995. It is crystallised when a sponsoring employer suffers an 'insolvency event' or where the pension plan is placed into winding up. In multi-employer pension plans, a given employer's share of the overall section 75 debt is crystallised, broadly, when that entity ceases to employ individuals who are active members of the plan when at least one other participating employer continues to employ active members of the plan.

'Associated' and 'connected' for these purposes bear the same meanings as under general UK insolvency legislation and would thus include direct and indirect parent and subsidiary undertakings and other 'sibling' and 'cousin' entities within a corporate group. In order for a target to be susceptible to an FSD, TPR may determine that it would be *reasonable* to issue an FSD against that particular entity and in making the determination of reasonableness, TPR will have regard to:

- the relationship between the target(s) and the sponsoring employer;
- the involvement of the target(s) with the pension plan in question;
- the value of any benefits received by the target(s), directly or indirectly, from the sponsoring employer; and
- the financial resources of the target(s).<sup>3</sup>

In this regard, TPR has stated that it will define 'benefits' widely, stating that it will consider whether the target has 'received assets or dividends from the employer, or shared common security or cash flow arrangements or gained tax advantages'<sup>4</sup> and, in the case of *Sea Containers*, TPR considered material the fact that the target in that instance had enjoyed 'tax and other advantages of being registered in Bermuda whilst having the headquarters of its container leasing business in London.'<sup>5</sup>

### Lehman Brothers: the background

The sole sponsoring employer of the Lehman Brothers Pension Scheme was Lehman Brothers Limited ('LBL'). LBL was a wholly-owned subsidiary of Lehman Brothers Holdings plc, which was itself a wholly-owned subsidiary of Lehman Brothers Holdings Limited, which was itself an indirectly held subsidiary of Lehman Brothers Holdings Inc., the ultimate parent company within the Lehman Brothers Group.<sup>6</sup> As a whole, the Lehman Group was a complex web comprising what was estimated to be somewhere between 4,000 and 7,000 separate legal entities, with the London group itself consisting of some 200 separate legal entities.<sup>7</sup>

Whilst accepting that there was no allegation that the Lehman group acted in any way improperly in relation to the plan, the Determinations Panel noted that cash contributions to the plan would, in practice, have been made by Lehman Brothers Holdings Inc., since all 'spare cash' in subsidiary entities was 'swept back' to New York at the end of each working day.<sup>8</sup> Lehman Brothers Holdings Inc. had, shortly before its Chapter 11 filing, entered into a guarantee of LBL's liabilities with the trustees of the plan.<sup>9</sup>

### The concept of 'benefit' and test of reasonableness in issuing an FSD

Of key importance in the determination was the fact that three key target entities – Lehman Brothers International (Europe), Lehman Brothers Europe Limited, and Lehman Brothers Asset Management (Europe) Limited – which were the group's key operating entities in London, were staffed substantially by employees seconded from LBL. The respective operating companies reimbursed LBL for most staff so seconded 'with no uplift or profit element for LBL',<sup>10</sup> though a 10% uplift was levied on the costs of employees seconded to the operating companies to perform various 'back office' functions.<sup>11</sup>

Since none of the FSD targets had challenged the assertion that LBL was a 'service company' as defined under the Pensions Act 2004, or that they were associated/connected entities, the determination as to whether or not to issue an FSD against those entities accordingly fell to the issue of reasonableness. The secondment of staff to the targets, along with other findings as to the operation of the group's finances, and the provision of real estate by LBL to the operating entities, formed the core of the Determination Panel's finding that it would be reasonable to issue an FSD against these targets, as well as against Lehman Brothers Holdings Inc., as the ultimate parent company of the group.

The Determinations Panel noted that:

'There was a benefit to the operating companies in not having to hire their own staff, and run their own

### Notes

3 Pensions Act 2004, section 43(7).

4 See <[www.thepensionsregulator.gov.uk/guidance/guidance-clearance](http://www.thepensionsregulator.gov.uk/guidance/guidance-clearance)> (The Pensions Regulator, 'Regulatory Guidance: Clearance', June 2009) at para. 106.

5 See <[www.thepensionsregulator.gov.uk/docs/DNseaContainers.pdf](http://www.thepensionsregulator.gov.uk/docs/DNseaContainers.pdf)> at paras. 5 and 26(2)(b).

6 <[www.thepensionsregulator.gov.uk/docs/DN1784039.pdf](http://www.thepensionsregulator.gov.uk/docs/DN1784039.pdf)>. Reasons of the Determinations Panel of the Pensions Regulator in relation to the Determination Notice issued in 13 September 2010 in relation to the Lehman Brothers Pension Scheme, at para. 13.

7 See <[www.thepensionsregulator.gov.uk/docs/DN1784039.pdf](http://www.thepensionsregulator.gov.uk/docs/DN1784039.pdf)> at paras. 11 and 12.

8 See <[www.thepensionsregulator.gov.uk/docs/DN1784039.pdf](http://www.thepensionsregulator.gov.uk/docs/DN1784039.pdf)> at paras. 17 and 18.

9 See <[www.thepensionsregulator.gov.uk/docs/DN1784039.pdf](http://www.thepensionsregulator.gov.uk/docs/DN1784039.pdf)> at para. 21.

10 See <[www.thepensionsregulator.gov.uk/docs/DN1784039.pdf](http://www.thepensionsregulator.gov.uk/docs/DN1784039.pdf)> at para. 30.

11 See <[www.thepensionsregulator.gov.uk/docs/DN1784039.pdf](http://www.thepensionsregulator.gov.uk/docs/DN1784039.pdf)> at para. 32.

HR departments and the like, in the secondment arrangements’

and that:

‘the relationship between the operating companies and the seconded employees had more to it in substance than it might appear in strict legal form – i.e. – they were treated as and acted as their employers for all practical purposes’.<sup>12</sup>

This approach is consistent with the wide definition of ‘benefits’ which TPR has already expressed and which we have summarised above, particularly in relation to impose an FSD on the ultimate parent, Lehman Brothers Holdings Inc., where the Determinations Panel stated that:

‘Everything that the subsidiaries benefited from ultimately benefited LBHI, albeit the benefit might be indirect and diluted. However, we consider that the benefits received by LBHI from LBL were considerable’.<sup>13</sup>

The approach also demonstrates TPR’s (and the Determinations Panel’s) willingness to look behind complex intra-group structures to the commercial reality of relationships between entities within corporate groups, with the bottom line in the Lehman case appearing to be the Determinations Panel’s view that:

‘employers who take the benefit of employees should ultimately take the burden of their pension promises’.<sup>14</sup>

### The Determinations Panel’s ‘three stage’ concept of FSDs

In its decision in *Lehman Brothers*, the Determinations Panel has stated that the issuance of an FSD is a three-stage approach:

- firstly, there is imposition of an FSD under section 43 of the Pensions Act 2004, which gives rise to the obligation to put financial support in place;
- secondly, under section 45 of the Pensions Act 2004, the financial support put in place must be an arrangement complying with that section and approved by TPR; and
- thirdly, in the event of non-compliance, there can be enforcement under section 47 of the Pensions Act 2004 (which, as noted in our previous article,

would take the shape of a contribution notice imposing a specified amount of financial liability on the part of the target, and enforceable as a debt against that target).

Importantly, the Determinations Panel noted that the first stage, i.e. issuance of the FSD, does not require that the specific amount of support to be put in place by the given target entity be quantified at that stage. For instance where, as in *Lehman Brothers*, there is more than one target, the proportions of the targets’ respective financial support obligations can be determined at a later stage.

In particular, the Determinations Panel stated that:

‘The crux of the matter is that imposing an FSD on a target does *not* impose a liability on them. Rather, it puts them in the field of play when the issue of how to achieve financial support is determined and ultimately *thereafter* whether or not to impose liability’.<sup>15</sup>

We consider that in emphasising that the issue of an FSD does not of itself generate a financial liability on the part of the target, the Determinations Panel goes some way towards accepting the position of the US and Canadian bankruptcy courts in the *Nortel* case. It will be recalled that in its decision in that case, the US Bankruptcy Court (District of Delaware) considered that an FSD amounted to:

‘[a] post-petition [attempt] to assess, impose and/or liquidate a debt against a Chapter 11 debtor outside of the bankruptcy court [goes] to the essence of the Chapter 11 claims process, and [is one of the reasons] why there is an automatic stay [upon further debt being imposed upon the Chapter 11 debtor]’.<sup>16</sup>

Whilst it is true, in the strict sense, that an FSD does not impose a debt in its own right, as we noted previously, the issue of the FSD generates a *contingent* claim in the hands of TPR which is entirely separate from any pre-existing section 75 claim in the hands of the pension plan’s trustees. It is therefore difficult to understand what TPR believes it can achieve by the issue of an FSD. On the one hand, if it enforces against a non-compliant FSD target by means of a section 47 contribution notice, then it crystallises that contingent claim into a new debt against the insolvent entity, in breach of any automatic stay in force. On the other hand, an unenforced FSD achieves very little, and is neither ‘necessary’ nor ‘appropriate’ in order to protect the interests of plan members, as the Determinations Panel

### Notes

12 See <[www.thepensionsregulator.gov.uk/docs/DN1784039.pdf](http://www.thepensionsregulator.gov.uk/docs/DN1784039.pdf)> at paras. 104-109.

13 See <[www.thepensionsregulator.gov.uk/docs/DN1784039.pdf](http://www.thepensionsregulator.gov.uk/docs/DN1784039.pdf)> at para. 119.

14 See <[www.thepensionsregulator.gov.uk/docs/DN1784039.pdf](http://www.thepensionsregulator.gov.uk/docs/DN1784039.pdf)> at para. 125(iii).

15 See <[www.thepensionsregulator.gov.uk/docs/DN1784039.pdf](http://www.thepensionsregulator.gov.uk/docs/DN1784039.pdf)> at para. 96.

16 See <[www.deb.uscourts.gov/Opinions/2010/kg031810\\_0910138ord.pdf](http://www.deb.uscourts.gov/Opinions/2010/kg031810_0910138ord.pdf)> at p. 11.



appears to believe,<sup>17</sup> particularly where the section 75 debt in the hands of the trustees has been filed as a claim against an insolvent sponsoring employer, and as here, the ultimate parent has entered into a direct guarantee (with the plan trustees) of the sponsoring employer's financial obligations to the plan.

It is particularly interesting that the Determinations Panel's decision makes no reference to the decisions of the US and Canadian courts in the *Nortel* case. At best, the imposition of the FSDs in the Lehman case will be a pyrrhic victory for TPR and plan members if the decision is met with the same unenthusiastic response in the US bankruptcy courts as was faced in the *Nortel* case.

Some industry experts have speculated that TPR may seek to argue that any liability imposed upon an insolvent entity on enforcement of an FSD would amount to an 'expense of the administration', thus taking precedence over all other debts, secured and unsecured alike.<sup>18</sup> For the reasons we noted in our previous article and, in particular, because of the prejudicial nature that such a finding would have upon creditors in the 'home' jurisdiction of the court being asked to make such a declaration (whether in the US or elsewhere), we consider that such a determination is highly unlikely.

## Issues of procedural justice

A large part of the Determinations Panel's decision is devoted to consideration of various preliminary applications launched by several of the FSD targets arguing a lack of natural justice in TPR's conduct of the matter. In very broad outline, it had been argued that respondents had a lack of time in which to prepare responses to the 'warning notices' issued by TPR, and that TPR refused to supply respondents with certain documentary evidence upon which it later sought to rely. On these bases, the respondents argued that they had been substantively deprived of their 'opportunity to make representations' under section 96 of the Pensions Act 2004.

Whilst the Determinations Panel found against the respondents on these preliminary applications, there was some criticism by the Determinations Panel of TPR's conduct of the matter. In particular, the Determinations Panel rejected the arguments advanced by counsel for TPR that the respondents were 'immersed' in the issues (and thus did not need an extension of

time or additional disclosures). In view of the 'unparalleled complexity' of the Lehman insolvency,<sup>19</sup> the Determinations Panel considered that the presumption should in fact be that the targets had 'relatively little information and understanding', and also noted that:

'TPR is under a heightened obligation [in complex cases] to ensure that the targets are given every reasonable opportunity to respond to the case being put against them'.<sup>20</sup>

The issue of procedural propriety in TPR's conduct of FSD proceedings is of key relevance where the target is an overseas entity since, for reasons we have noted in our previous article, enforceability in a foreign court may well be hindered where there are arguments that the respondent/defendant has not been afforded 'natural justice' or the 'due process of law' or other similar rights to a fair hearing.

Whilst the Determinations Panel ultimately rejected the targets' arguments that they were deprived of their right to a fair hearing (amongst other reasons, on the basis that their lawyers had managed to submit substantive responses, notwithstanding the lack of time allowed for such responses<sup>21</sup>), a foreign court may not be as easily persuaded as the Determination Panel was that the targets had been given a fair chance to respond to arguments levelled against them.

## Conclusions

Whilst the Determinations Panel's decision demonstrates the continued willingness of TPR to engage in battle with non-UK resident insolvent entities, the doubts as to enforceability in overseas courts remain. We consider it unlikely, for manifest reasons of public policy, that courts in other jurisdictions will afford TPR's claims the sort of priority TPR seems to consider UK pension claims merit.

The key point is that, notwithstanding the Determinations Panel's characterisation of an FSD as a multi-stage process (with the initial issue of an FSD imposing no liability as such on the given target), an FSD is the first step in a series of steps which culminates in the imposition of a new debt upon the target entity which would be in breach of any automatic stay. The Determinations Panel's *laissez-faire* approach to issues of procedural justice is also unlikely to find favour with foreign courts that are asked to enforce such debts, even in cases where the target remains solvent.

## Notes

17 See <[www.thepensionsregulator.gov.uk/docs/DN1784039.pdf](http://www.thepensionsregulator.gov.uk/docs/DN1784039.pdf)> at para. 122.

18 See <[www.professionalpensions.com/professional-pensions/news/1734675/tpr-power-enforce-lehman-bros-fsd](http://www.professionalpensions.com/professional-pensions/news/1734675/tpr-power-enforce-lehman-bros-fsd)>.

19 See <[www.thepensionsregulator.gov.uk/docs/DN1784039.pdf](http://www.thepensionsregulator.gov.uk/docs/DN1784039.pdf)> at para. 75.

20 See <[www.thepensionsregulator.gov.uk/docs/DN1784039.pdf](http://www.thepensionsregulator.gov.uk/docs/DN1784039.pdf)> at para. 76.

21 See <[www.thepensionsregulator.gov.uk/docs/DN1784039.pdf](http://www.thepensionsregulator.gov.uk/docs/DN1784039.pdf)> at para. 71(i).

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