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BRIEFING

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Pension debts – priority of claims

EMPLOYMENT, PENSIONS AND BENEFITS BRIEFING 220

Employers (and others) will owe various liabilities to fund defined benefit pension schemes. It can be important to know how that liability ranks as a matter of priority compared with other claims on the employer. This can be important in insolvency but also when trustees look at the 'strength of employer covenant'. This briefing looks at the general position of priority of pension claims.

Pension liabilities

The general rule is that employers are liable (under statute or the terms of the pension scheme itself) to fund defined benefit occupational pension schemes. This obligation can either be on an ongoing basis or as a termination debt on a relevant trigger, such as the scheme winding up if the employer enters insolvency.

The funding obligations under the trust deed and rules of the scheme are underpinned by the following statutory obligations.

- For an ongoing scheme, the scheme specific funding provisions in part 3 of the Pensions Act 2004. See our briefing No. 217: *Pensions: scheme specific funding requirements*.
- On a termination, the debt on the employer provisions under section 75 of the Pensions Act 1995. See our briefing No. 213: *Debt on the employer – an overview of section 75 of the Pensions Act 1995*.

Priority of claims

It is clear that, in general, obligations on employers to fund pension schemes are unsecured and non-preferential. This means they rank alongside an employer's other unsecured creditors. For example, when an employer goes into liquidation available assets are used to meet outstanding claims – but secured claims (fixed or floating charge) and preferential claims are generally met ahead of unsecured non-preferential claims.

The general rule is that pension claims are unsecured and non-preferential. However, the following are exceptions to this.

- Some outstanding pension obligations are preferential debts under the Insolvency Act 1986. The amount of these is, however, relatively small – see below.
- Pension debts will have an increased priority if specific security is given by the employer. For example, a fixed or floating charge over assets. These have become more common in recent years – there can be a saving from the levy charged by the Pension Protection Fund (PPF).
- Some priority may apply to pension obligations that arise after a formal insolvency process (eg liquidation or administration) starts. Some obligations can get an increased priority as being 'adopted' employee claims or as being expenses of the insolvency. This is a complex area; it is discussed further below.

Claims against third parties

Third parties (ie entities that are not the employer) can also have liabilities to fund pension schemes. In practice, this is most likely to arise in the circumstances below.

- If the third party has given a direct guarantee or security to the pension scheme – this can be used to re-inforce the employer 'covenant' and can help in discussions about funding with trustees and with the PPF levy.
- If liabilities are imposed on the third party by the Pensions Regulator using its 'moral hazard' powers

The scheme is usually an unsecured creditor of the employer. The priority of an unsecured creditor when the assets of a company are realised in an insolvency and compared with other creditors is broadly summarised as:
- creditors with fixed charges;
- insolvency expenses (within the Insolvency Rules 1986);
- preferential creditors;
- creditors with floating charges;
- unsecured creditors (usually including the pension creditor);
- subordinated creditors; and
- equity/share capital.

Source: adapted from the Pension Regulator's guidance, 'Monitoring employer support'. See www.thepensionsregulator.gov.uk.

under the Pensions Act 2004. See our briefing No. 199: *Extracting pension scheme funding from third parties: overview*.
- If the third party has given a funding commitment to the employer (eg as part of service arrangements for employees to use). This would tend to be an obligation on the third party to pay an amount to the employer (and not to the trustees etc).

Broadly, the level of commitment on the third party as a question of priority for its debts will depend on the nature of the claim. A simple guarantee or moral hazard order from the Pensions Regulator will rank as an unsecured claim. However, priority for what would otherwise be an unsecured debt may arise if the third party itself grants security (eg a mortgage or charge over assets) or if the claim arises after the start of insolvency and becomes an expense of the insolvency – see below.

Structural subordination

When dealing with groups of companies, the general rule is each member of the group is liable for its own debts. If the companies are (as is common) limited liability entities, there is no general liability of (say) a holding company for the debts or obligations of its subsidiary. A liability can arise in extreme circumstances, but this is difficult and unusual without an express guarantee from the parent.

This means that it can be important to know which entity has relevant assets and which entity has the relevant claims against it. A claim (say) against a parent company may be of lower value than the same claim against a subsidiary (with assets) if the parent company's only assets are shares in subsidiaries and all the real assets are in the subsidiaries. This would mean that:
- a claim against a subsidiary would rank for a dividend against the assets in that subsidiary; but
- a claim against a parent would only rank against the assets of the parent. In practice, if the parent's only assets are shares in the subsidiary a dividend will only be payable to the parent's creditors if there is a flow of assets from the subsidiary to the parent – eg the subsidiary is solvent and pays a dividend to the parent.

This means that a comparison between a claim against the parent and a claim against the subsidiary is that the parent claim will rank against the subsidiary assets behind the subsidiary claim. This is sometimes called 'structural subordination' and needs to be kept in mind when looking at claims in a group of companies.

Preferential debts

The Insolvency Act 1986 provides for some classes of claims against an insolvent company to be preferential debts. These are payable ahead of unsecured claims and claims that are secured by a floating charge (they rank behind a fixed charge). They can also have a special status in other proceedings (eg voluntary arrangements).

Various claims by the Crown for tax used to be preferential debts, but this preference was abolished in 2003. The main remaining category of preferential debt is some employee claims (but generally these are limited to £800) and some pension claims.

The pension claims that are given preferential status are (broadly):
- *employee contributions* – contributions deducted by the employer from the employee's pay but not yet paid to an occupational pension scheme. This is limited to the four months before the insolvency date; and
- *employer contributions* – contributions due from the employer to an occupational pension scheme in the 12 months preceding the insolvency date. But this is limited so that it only applies to amounts due to a contracted-out scheme and then to a specific percentage of earnings within a band. This means that in practice the obligation is limited.

Claims on an employer arising under the statutory schedule of contributions are classified as a debt (section 228(3) of the Pensions Act 2004). Claims arising under the employer debt provisions in section 75 of the Pensions Act 1995 are also a debt, but are clearly stated *not* to be preferential debts for Insolvency Act purposes (section 75(8) of the Pensions Act 1995).

The preferential debts are therefore broadly limited to unpaid contributions during the period before the insolvency.

Employee contributions: for unpaid employee contributions, there is no limit on the amount that can be preferential. But, in practice, amounts may be fairly limited. For relevant tax-registered schemes there are relatively tight rules under the pensions legislation that give time limits for the employer to pay employee contributions to the pension scheme. Contributions deducted during a particular month from a member's pay must be paid to the scheme before the 19th of the following month – see our briefing No. 189: *Failures to pay pension contributions by employers*.

Employer contributions: unpaid employer contributions are only a preferential debt if they are due to a contracted-out occupational pension scheme. The amount of the preference is limited to a percentage of the band earnings applicable for national insurance purposes (3 per cent or 4.8 per cent, depending on whether or not the members pay contributions).

This means that for the tax year 2011-12 the maximum amount of preferential debt is about £1,667 per member. This maximum only applies for a scheme:

- that is contracted out;
- that does not require employee contributions; or
- in which the member earns over the 'upper accrual point' (UAP) for national insurance purposes of £40,040.

The maximum amount per contracted-out member is 4.8 per cent of the annual UAP of £40,040, less the lower earnings limit of £5,304 – ie 4.8 per cent of £34,736.

For a contracted-out money purchase scheme, the preferential debt is equal to the minimum payments payable by the employer as part of the contracting-out rebate in the 12 months before the relevant insolvency date.

Insolvency expenses

When a company enters insolvency proceedings (eg liquidation or administration), the insolvency rules provide for the expenses of the insolvency to be payable from the assets of the company ahead of unsecured creditors (and ahead of claims secured by a floating charge).

In addition, the Insolvency Act 1986 gives a super-priority to some employment claims when the contracts of employment of the relevant employees are 'adopted' by an administrator.

The adoption priority only applies to claims arising under a contract of employment (not statutory claims) and that relate to liabilities arising after the date of the insolvency (paragraph 99, schedule B1 to the Insolvency Act 1986). In practice these limits, combined with the freezing of benefits and contributions under the Pensions Act 2004 when a scheme enters a PPF assessment period following insolvency of an employer, mean that pension liabilities are unlikely to fall into the adoption super-priority.

Given the specific provisions for preferential debts and adoption expenses, it is unlikely that pension contributions (particularly deficit contributions for periods before an insolvency) will be eligible to be insolvency expenses, even if the debt only arises after the insolvency starts.

But the position of moral hazard orders made by the Pensions Regulator against a company in administration (or liquidation) is more difficult. In *Re Nortel GMBH*, Briggs J held in December 2010 that such orders may rank as insolvency expenses (even if the order relates to the position of the company before it entered insolvency proceedings). An appeal is due to be heard by the Court of Appeal this summer. For further analysis see our briefing No. 210: *Moral hazard powers of the Pensions Regulator: how do they apply against a company in insolvency?*

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