Julian Dobson SOLICITORS *Insolvency Lawyers*

Topics covered

- **Administration and Liquidation Expenses**
- **Rent and Rates**
- **Annulment of bankruptcy orders**
- **Trustees costs and remuneration**

Administration expenses after Nortel

Rescue culture under attack?

In the latest clash between the Pensions Regulator and the administrators of Nortel and Lehman in the Court of Appeal **[2011] EWCA Civ 1124**, the Pensions Regulator prevailed again. In both the cases of Nortel Group and Lehman Brothers, the Pensions Regulator had not issued a Financial Support Direction ("FSD") or Contribution Notice ("CN") until after the companies went into administration. Following administration, the question was, how would the claims which run into £billions be treated in the administrations. Whilst the pensions legislation had previously defined a similar liability under Section 75 of the Pensions Act 1995 as ranking as a provable debt, the position in respect of both FSD's and CN's was unspecified.

In the earlier judgment, Briggs J held that the liabilities created by such notices where they were issued after the administration had commenced would constitute a "necessary disbursement" and therefore be payable as an administration expense.

The benefit of a liability being treated as an administration expense is that it ranks ahead of unsecured creditors and is payable before floating charge holders and the remuneration of the administrators. The Pensions Regulator argued that the liabilities under FSD's and CN's were payable as an expense of the administration, thereby enhancing the prospects of the members of the pension schemes. If correct, this would limit further claims against the Pension Protection Fund to make good the deficit where the employer has insufficient assets.

A provable debt

The starting point is whether or not the liability is provable in administration and/or any subsequent liquidation. If it is provable, then the creditors' claims will rank alongside other creditors of the same category. If a debt is not provable, then it is most likely payable as an expense. If the liability is neither, then it falls into the "Black Hole" category and will never be paid.

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For further information on the topics raised in this bulletin or further details

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The Court looked at the various permutations involving the timing of any FSD or CN in relation to a company going into administration and the definition of ñdebtò

Rule 13.12 of the Insolvency Rules 1986 defines ñdebtòin relation to the winding-up of the company as either:-

(a) any debt or liability to which the company is subject at the date on which the company goes into liquidation; or
(b) any debt or liability to which the company may become subject after that date by reason of any obligation incurred before that date

Debt by reason of an obligation incurred before

In Nortel, although the notices were issued after administration, it was argued that the debt was provable because it arose out of an obligation incurred before that date. In considering that question the Court of Appeal looked at some of the earlier authorities. In **Re Smith; ex parte Edwards (1886)** a debtor entered into an arbitration agreement and following his bankruptcy the arbitrator made a costs award in favour of the creditor. In that case the Court held the costs award was a provable debt in the bankruptcy, as it had been incurred by reason of the contractual obligation undertaken in the arbitration agreement, before the bankruptcy.

Debt by reason of a contingent liability

In **Glenister v Rowe [2000] Ch 76** following litigation, a creditor filed a notice of appeal. The debtor was then made bankrupt. The creditor went on to win his appeal with costs and then sought to recover the liability by way of a statutory demand. The debtor resisted on the ground that the debt had been provable in his earlier bankruptcy and was therefore no longer enforceable against him. The matter came before the Court of Appeal and whilst the Court of Appeal did not consider whether the debt was incurred by reason of an obligation existing before the commencement, it did consider whether the liability for costs was a ñcontingent liabilityòwhich would have been a liability to which the debtor was subject at the commencement of the bankruptcy. The Court concluded that the mere fact that there is a risk of a costs order being made is not a contingent liability and for it to be a contingent liability it must arise out of an existing or underlying liability. This was followed in **Foots v Southern Cross Mine Management Pty Limited [2007] BPIR 1498** where a party had lost an action before being made bankrupt and, whilst a costs order was inevitable, it was not a provable debt because it was not a contingent liability at the time of the bankruptcy.

Debt – a prior legal obligation contingent liability

In **Haine v Day [2008] BCC 845** the Court had to consider the status of protective awards payable to employees who were dismissed without consultation before the company went into liquidation. In that case, the debts which arose by reason of the protective awards subsequent to liquidation were provable because they stemmed from a breach of a prior legal obligation and were a ñcontingent liabilityòbefore the liquidation. The Employment Tribunal had no option but to make the award.

Debt – liability created by FSD or CN

The net result is that without a pre-existing legal obligation, a liability cannot qualify as a contingent liability so as to be provable. The mere existence of the financial support direction regime does not give rise (in the absence of an FSD or CN being served before the insolvency commenced) to a legal obligation which would constitute a contingent liability or be provable by reason of an obligation incurred before the insolvency event. The liabilities created by the FSD and CNõs were not in this case provable.

An expense in the administration

If it is not a provable debt, then is the liability created by an FSD or CN issued during administration an expense. The Court considered the decision in **Re Toshoku Finance UK plc [2002] 1 W.L.R. 671** where a liability arose under tax legislation which provided that the liability in respect of a period after the commencement of the liquidation was one which the liquidator was obliged to pay and as such it was a ñnecessary disbursementò and constituted an expense.

The Court examined specific examples in both the cases of rent and rates and the Liquidation Expenses Principle in order to determine whether or not they constitute a provable debt or an expense.

Rent as an expense and the Liquidation Expenses Principle

Where a company has entered into a lease before an insolvency process arises, then the rent arrears up to the date of the insolvency will be treated as a provable debt. In a liquidation where a liquidator retains the benefit of the premises or uses them during the course of the liquidation then, following the ñLiquidation Expenses Principleò (also known as the Salvage or Lundy Granite Principle), the rent and other liabilities under the lease post liquidation will rank as a liquidation expense.

In **Re Oak Pits Colliery (1882)** Lindley LJ commented on the situation where a liquidator retains property for the purpose of advantageously disposing of it and continues to use it. In such circumstances he considered the rent post-liquidation ought to be paid in full, like any other debt or expense. The position was further clarified by Lord Hoffman in **Re Toshoku Finance [2002] 1 W.L.R 671** in which he commented that it was not sufficient that the liquidator retained possession for the benefit of the estate if it was also for the benefit of the landlord. ñNot offering to surrender or simply doing nothing was not regarded as retaining possession for the benefit of the estateò

In **Goldacre Offices v Nortel [2010] BCC 299** the Court held that where premises are occupied wholly or partly by a company in administration, the rent falling due after commencement will constitute an administration expense or a necessary disbursement.

The effect of the decision has been graphically illustrated in the recent case of **Game Group** where the appointment of administrators was delayed until after the march quarter day thereby avoiding a rent liability of £21 million becoming an expense in the administration.

It was argued that in order to determine whether or not the liability should be treated as an expense, it must also satisfy the additional test of the Liquidation Expenses Principle i.e. that it is retained for the benefit of the estate in liquidation.

There may be liabilities which the liquidator is obliged to pay in any event such as fees payable to the Insolvency Service but they are not subject to the additional test in the Liquidation Expenses Principle. The position with rent due under a lease is that it is payable and provable before liquidation as a prior legal obligation. Following liquidation, it will be payable as an expense but only if its use is retained for the benefit of the estate so that the Liquidation Expenses Principle applies.

Rates as an expense

The Court also noted an important distinction between the position with regard to rent and rates. In the case of rates, in **Exeter City Council v Bairstow [2007] BCC 326** it was held that rates due post-administration would be payable as an expense, irrespective of whether or not the premises were occupied or there was any benefit to the estate as is required in the case of rent. There was no requirement to show that the Liquidation Expenses Principle applied. The position now is that where the premises are unoccupied, both the liquidator and administrator are relieved of any liability for rates post-insolvency.

The Liquidation Expenses Principle will only apply to a pre-liquidation debt which is, up to the point of insolvency, provable and following administration/liquidation the office holder retains the use or benefit. It is the application of the Liquidation Expenses Principle in those circumstances that may elevate a provable debt arising out of a pre liquidation obligation to an expense. The approach that should be adopted is to first consider whether the liability is provable. If it is not then look to see if the expense falls within the expense categories contained in the relevant rules. If it does then there is no need to consider further the Liquidation Expenses Principle and it will be payable as an expense.

FSD and CN as an Expense

The Court of Appeal concluded after consideration of the various authorities that the FSD or CN does not give rise to a provable debt if served after commencement. Parliament has imposed a financial liability on a company, which constitutes a necessary disbursement within the **Toshuko** principle and is therefore payable as an expense, without the need to consider the Liquidation Expenses Principle.

The significance of the Nortel decision and whether the liabilities described rank as an expense in an administration will have an impact on any decision to place the company into administration and the eventual outcome. Leave to appeal has been granted and the matter will be considered further by the Supreme Court. There also remains the possibility of a change in legislation to ensure that administrations remain a viable option in such circumstances.

Annulment of bankruptcy orders

The firm recently presented a seminar on the annulment of bankruptcy orders. Of particular interest to matrimonial lawyers is the analysis of cases where bankruptcy petitions have been presented in order to thwart matrimonial proceedings. Areas of

particular interest include the role of the Trustee when required to report to Court and the question of costs both in relation to annulment applications and the procedure allowing for the challenge of the Trusteeôs remuneration and costs on the grounds that they are excessive.

The seminar covered recent cases on annulment including the decision in **Mekarska v Ruiz and Boyden [2011] EWHC 913 (Fam)**. That case highlighted the unhappy relationship between matrimonial proceedings and bankruptcy. In particular the case considers the damaging impact of delay in making any application to annul the bankruptcy order and the effect of the increasing costs and expenses incurred in the bankruptcy.

Copies of the seminar hand-out are available on request to info@juliandobson.com.