BENEFIT PROTECTION: PRIORITY CREDITOR RIGHTS FOR PENSION FUNDS

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January 2007
ABSTRACT/RÉSUMÉ

Benefit Protection: Priority Creditor Rights for Pension Funds

Underfunded pension funds are in the same position as other creditors when their sponsoring firm becomes insolvent, having to join the queue claiming the remaining assets of the firm. Arguments for granting pension fund priority rights over other creditors are the same as for introducing pension benefit guarantee schemes – i.e. market failure and diversification. Arguments against such a priority position focus around the impact on other creditors and potential disruptions to capital markets.

The OECD’s report on priority pension claims within bankruptcy found that pension claims (unlike wages) rarely receive priority over other creditors. More concerning, it can be difficult for pension fund creditors (being a diverse group without strong financing) to get their voice heard properly within insolvency procedures. Difficulties with providing such priority status to pension creditors stem from problems with changing bankruptcy laws and the strength of other financial creditors. The OECD’s report concludes that priority rights should be given to unpaid and due contributions from the plan sponsor and that care should be taken that pension beneficiaries be treated at least as well as other creditors in any bankruptcy or restructuring process (e.g. ensuring their representation on creditor committees).

JEL codes: G23, J32
Keywords: underfunded, pension funds, contributions, creditors, bankruptcy, restructuring, priority rights, insolvent, pension creditors

Reconnaître aux membres des fonds de pension la qualité de créanciers privilégiés

Les fonds de pension sous-capitalisés se trouvent dans la même situation que les autres créanciers ordinaires lorsque l’entreprise promoteur du plan devient insolvable, espérant recevoir une partie des sommes recouvrées sur les actifs liquidés. Les arguments qui militent pour que l’on reconnaisse la qualité de créanciers privilégiés aux membres des fonds de pension par rapport à d’autres créanciers sont les mêmes que ceux qui militent pour la mise en place de systèmes de garantie des prestations de pension – en l’occurrence la défaillance du marché et la diversification. Les arguments contre tournent autour de l’impact sur les autres créanciers et du risque de perturbation des marchés financiers.

Le rapport de l’OCDE sur le caractère plus ou moins prioritaire des droits à pension en cas de faillite a montré que ces droits (à la différence des salaires) ont rarement priorité sur d’autres types de créances. En outre, il peut être difficile pour les membres des fonds de pension (ceux-ci constituant un groupe divers sans capacité financière forte) de faire entendre leur voix dans les procédures de mise en liquidation. La difficulté qu’il y a à leur reconnaître le statut de créanciers privilégiés vient de la difficulté qu’il y a à modifier le droit des faillites et de la force des autres créanciers financiers. La conclusion du rapport de l’OCDE est que les cotisations de pension exigibles non versées devraient constituer une priorité et qu’il faudrait veiller à ce que les bénéficiaires de droits à pension soient traités au moins aussi bien que d’autres créanciers en cas de faillite ou de restructuration (ils devraient, par exemple, être représentés au comité des créanciers).

Classification JEL : G23, J32
BENEFIT SECURITY: PRIORITY CREDITOR RIGHTS FOR PENSION FUNDS

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I. Introduction

1. A topic which leads naturally on from the discussion of pension benefit guarantee schemes, is the issue of the position of pension fund claims within bankruptcy proceedings. The rights of pension fund beneficiaries within the corporate bankruptcy process has returned as a topic for debate in several countries, due to a series of high profile corporate failures which caused defined benefit occupational pension fund members to lose part of their expected retirement income.

2. The ultimate risk for pension beneficiaries is the loss of their retirement income. One way in which this can happen is if the corporate sponsor of their pension plan – which is responsible for the funding of the plan – becomes insolvent whilst at the same time the plan does not have sufficient assets to cover its pension liabilities. This is more likely if pension assets are not held separately from the sponsoring company’s assets, but is also a risk even when pension assets are ring fenced as achieving full funding at all times is not always feasible. The questions then arises, once it has been ascertained that the pension beneficiaries have such a claim on the sponsoring company’s assets, where does this claim rank vs. other creditors? Do the accumulated pension rights of the plan beneficiaries have a higher ranking claim upon the sponsoring company’s assets than other creditors, rank equally, or indeed do they come lower down the creditor rankings, only receiving any remaining company assets after other creditors have been paid? Where a pension benefit guarantee scheme exists, the scheme takes on the credit claims of the pension beneficiaries, and consequently faces the same issues of where its claim stands in the credit rankings - which inevitably has an impact on its financial stability and the cost of its premiums.

II. Arguments for Priority Rights

3. One form of benefit protection for pension fund beneficiaries would be to give their claims against company assets priority standing, ahead of other creditors – either through a ‘preferred’ creditor ranking, with priority over other unsecured creditors, or via a ‘super preference’ over even secured creditors. The arguments for giving such priority claims are similar to those used to justify the introduction of pension benefit guarantee schemes, namely:

   • Employees, though they effectively act as creditors of their sponsoring firm, (trading current wages for the promise of future pension income), do not necessarily understand the trade off they are making, are exposed to issues of asymmetric information and do not necessarily undertake a rigorous credit analysis of their employer. They consequently remain more exposed to the bankruptcy of the sponsoring firm than their wage bargaining implies. Whilst an investor such as a bank or a credit provider can consider the risk of a default in pricing their rates, employees are not usually in a position to detect and price or bargain over the respective risks.

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1 The author would like to thank OECD delegates for providing contacts and information on their countries’ systems. The views expressed herein are those of the author and do not necessarily reflect those of the OECD or its Member countries.

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Even if workers are aware of the credit risk to which they are exposed, they are unable to manage this risk effectively as it cannot be successfully diversified. Workers with an occupational pension receive their current and future income from one source, and their pension may be the only substantial financial asset they own. They therefore receive a double blow if their employer becomes bankrupt, and the pension scheme on which they are relying is under-funded, having no other source of income or savings. Other financial creditors, meanwhile, will have a portfolio of lendings, whilst trade creditors are likely to have a range of clients. Pension creditors therefore are especially exposed to credit risk, particularly if their pension scheme is mandatory, they have life-time employment with one firm or if the pension is funded by book reserves (though, as mentioned, extra protection may still be required even with a separating of assets as 100% may not always be achieved).

III. Actual situation

4. It would therefore seem natural to assume that, to the extent that pensions are an obligation of the plan sponsor and considering the fact that they are the promised benefit of a vulnerable group, pension credits would receive priority ranking over other creditors. Yet this is rarely the case, despite pensions frequently being recognized as deferred wages, and wage and other employment claims often having a priority ranking. For example though pensions may be legally recognized as deferred pay, bankruptcy courts may not recognize this status and offer no priority ranking. An added complication in some countries is that bankruptcy and pension law may actually clash, therefore in practice denying pension claims the priority rights they may have in theory. For example, the bankruptcy law in the USA does not recognize the priority creditor rights given to pensions by the ERISA pension legislation of the 1970s. The position of pension credit rankings remains contested, with current court cases attempting to secure these priority rights (see USA country section for further details).

5. International law also offers pension beneficiaries limited protection. The legislation of the European Union and International Labour Organization (ILO) does offer protection for employees in the case of the bankruptcy of their employer, covering areas such as wages, outstanding holiday, sick leave and maternity leave (which receive priority rankings) - but surprisingly pensions are not covered (though the interpretation of international treaties does differ between countries). One exception involves systems of severance pay, which have traditionally received greater protection - given, unlike pension plans, they are not funded by independent entities separate from the plan sponsor and are therefore exposed to the plan sponsor’s insolvency risk at all times (not only in the case of the pension scheme being underfunded as with other funding arrangements). For example, the ILO sets out rules on the base level of entitlements in the advent of an employer’s insolvency which employees should be able to expect. These include a severance allowance or separation benefits based on length of service. Yet these systems are gradually being phased out (for example in Italy, Japan and Korea) and replaced with more conventional pension arrangements which generally receive lower creditor ranking in the case of the bankruptcy of the plan sponsor.

6. In reality, in some countries not only do pension beneficiaries not receive priority status, but may be disadvantaged vs. other creditors, particularly during the bankruptcy negotiation process, or when a

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2 There is EU legislation on pension transfer rights in the event of M&A (under the 1998 European directive amendment), and the ‘Barber Judgement’ of the European Court has recognized some pensions as deferred pay. See: [http://www.law-lib.utoronto.ca/Diana/fulltext/flyn.htm](http://www.law-lib.utoronto.ca/Diana/fulltext/flyn.htm).

corporate restructuring rather than a full bankruptcy takes place. Though legally all unsecured creditors should be treated equally, this can happen in several ways:

- **Strategic Bankruptcies:** bankruptcies are normally considered to be the result of financial distress, but in some cases bankruptcy filings are made by companies as part of a corporate strategy. Such ‘strategic bankruptcies’ may be used as a way of employers to renegotiate wages or pension rights. It has been suggested that such tactics have been used by companies within the airline industry, whilst a major steel company was accused of similar tactics by the PBGC - indeed, the risk can be argued to exist where companies have the opportunity to pass on their pension obligations to a guarantee scheme.

- **Legal Incentives:** bankruptcy laws themselves may sometimes make the position of the pension beneficiaries more difficult. For example, courts or parliaments may have the power to grant plan sponsors facing financial difficulty pension contribution suspensions, which may increase any underfunding which already exists at the sponsor’s pension plan. Indeed pension regulation may also have unforeseen effects, such as loopholes allowing solvent firms to terminate pension plans, thereby improving cashflow and the position of other creditors. For example, the initial ERISA pension legislation in the USA, by determining the event insurable by the pension benefit guarantee scheme as the termination of the fund rather than the insolvency of the plan sponsor, allowed many solvent companies to hand their underfunded pension plans over to the guarantee scheme the PBGC, until legislative amendments were made in the 1980s (see McGill, Brown etc. (1999)).

- **Avoidance tactics:** various ‘tactics’ can be used by sponsoring firms in financial trouble to avoid paying pension contributions. For example, where obligations are the liability of the controlled group as whole, companies may try to break ownership links or rearrange the corporate structure in order to avoid payment. Likewise, some creditors, sensing that a firm is heading for financial difficulties, may try to improve their position in the creditors rankings – for example by extending or increase the size of a short-term loan when it comes due in return for becoming collateralized against specific assets such as those held in inventory. Indeed in many bankruptcy cases substantive deviations from priority rules do occur. Legal safeguards exist to protect against such evasive behaviour, but it is often hard to prove that the main purpose of the action was to evade liability for pension underfunding.

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4 It should be noted that such renegotiations may be for valid business reasons. For example, where a company faces financial difficulties due to a large increase in pension contributions required due to an ‘actuarial deficit’ (e.g. caused by changes in assumptions), it may well make sense to renegotiate contribution terms with pension beneficiaries. Equally, if a restructuring results in an on-going company, the pension deficit is in effect ‘actuarial’ and can be made up over a period of time.

5 See paper from Pace University: [http://webpage.pace.edu/iteall/Corp7.pdf#search=chapter%2023%20corporate%20bankruptcy,%20restructuring%20and%20divestiture](http://webpage.pace.edu/iteall/Corp7.pdf#search=chapter%2023%20corporate%20bankruptcy,%20restructuring%20and%20divestiture)

6 See the Economist, ‘Nest Eggs without the yoke’, 8 May 2003.


Work-out negotiations: the insolvency process in some countries allows companies experiencing financial difficulties a period of time in which to negotiate new terms and settlements with its creditors in an attempt to keep the firm as a going concern and avoid full liquidation. Different creditors have different incentives for either keeping a firm as a going concern or to liquidate, these incentives also being affected by the size and seniority of the different creditors. Deviation in the priority of creditors is more likely (and indeed less of an issue) in work-outs, as creditors negotiate with each other as they try to find a satisfactory deal and avoid full bankruptcy procedures (see Franks, Nyborg (1996)). An issue often up for negotiation is the payment of pension contributions, particularly where underfunding is considerable. An interesting counter to such practices exists under Australian bankruptcy law by which employees’ entitlements, including superannuation contributions, cannot be avoided through agreements and transactions, even if approved by the courts.

7. Pension creditors may well be adversely affected by such work-outs and negotiations as current and retired workers are often not able to defend their position, and have been described as the ‘lost voice’ in bankruptcy proceedings. Where they exist, unsecured creditors committees tend to be dominated by larger financial institutions, which do not necessarily share the interests of the former employees, with the ‘natural’ representatives of pension claims potentially not having such a strong voice (e.g. unions may be weak, pension fund trustees inexperienced or guarantee funds, where they exist to take on pension creditor claims, may be politically constrained). Former and current workers may also have lost a great deal of their wealth and therefore may not be able to afford representation and consequently may not be able to make their position fully heard in the reorganization process. In some countries the restructuring courts can require the debtor to cover third party legal or financial expert costs to ensure proper representation. German bankruptcy proceedings provide a notably exception, where the major pension creditor, the PSVaG, has a strong voice on the creditor committees of the major cases affecting the organisation, and all creditors are able to vote on restructuring agreements (see German country section for further details). The pension regulator in the UK is also encouraging pension fund trustees to be more assertive when making deals with corporate plan sponsors, with the pension fund representatives of the UK auto parts company Turner and Newell being an interesting current example of trustees playing a more active role in bankruptcy negotiations.

IV. Arguments against priority status

8. One argument against awarding pension creditors priority status is that if this were allowed a range of social issues could come forward claiming priority rights, such as health benefits or environmental claims. The vulnerability of pension vs. other creditors can also be challenged. For example, should small, unsecured creditors, highly exposed to one corporate client, rank behind what could be high financially

9 The employees of the US firm Enron organized an official committee to represent their interests in the bankruptcy process (regarding deferred compensation, health and welfare benefits etc. – the PBGC handling pension claims directly). Their motivation was the fact that: “The existing unsecured creditors’ committee is dominated by the largest financial institutions in the United States. It does not share the interests of former employees and retirees and cannot adequately represent their interests” – according to David P. McClain (of McClain & Siegel the Houston bankruptcy firm acting on behalf of former employees). Richard D. Rathvon, co-chair of the Employee Committee pointed out that: “The Committee has ensured that the interests of employees were not eclipsed by more powerful creditors as the cumbersome bankruptcy process rolled forward.” For details see www.employeecommittee.com.


secure pension beneficiaries (given that higher paid workers are more likely to be members of occupational pension plans than the lower paid in many countries)?

9. However, a strong case can be made against changing the position of pension claims within the creditor rankings, centreing upon the fact that - aside from the complications of changing bankruptcy legislation - doing so may be harmful to capital markets and therefore the investment climate of a country. If pension funds rights increase in status other creditors (who may themselves be small trade and personal creditors) naturally have to drop in the rankings, increasing their credit risk, which might be passed onto corporations in the form of more expensive capital or a general impact on the markets with increased bad debts and potential failures. The impact of ‘super priority’ rights over secured creditors would of course have an even bigger potential impact, particularly on small trade and personal creditors. (DN: This would have a general impact in that the cost of borrowing would increase if secured creditors were not able to rely on their security, given in exchange for lending.)

10. The argument countering priority status for pension credits is outlined in the World Bank’s ‘Guidelines for Effective Insolvency and Creditor Rights Systems’12. This argues that as a general principle creditor rights through commercial laws should both preserve the legitimate expectations of creditors and, most importantly, encourage greater predictability in commercial relations by upholding to the maximum extent possible the relative priorities of creditors established prior to insolvency. The easiest way to ensure this is to have a flat hierarchy of priorities, which consists of only two levels: secured and unsecured creditors, with few deviations from this general rule. The more predictable and transparent the insolvency process the greater the chance of retrieving collateral in the advent of bankruptcy and the more willing lenders should be to lend at rates that reflect lower risk premiums13. Similar arguments were made in Germany, where the abolition of rights of preference was one of the main aims of the insolvency reforms in 1999. This implies that employment contracts, which cover pension rights, should be treated in the same way as other trade and service contracts. This is not to say that the repayment of employee entitlements is of less importance than payment of collateral, but rather that there may be more efficient ways of ensuring workers entitlements while still preserving a strong and predictable financing market (for example in the case of pensions through strict funding rules).

11. It could also be argued that any change in the ranking of pension obligations would now have an even greater impact on credit cost and availability than in the past. New accounting standards increasingly treat such pension obligations the same as other forms of debt and demand that they are shown on companies’ balance sheets. Pension deficits can no longer be ignored or smoothed over long periods of time, implying a greater impact on cashflow and consequently the potential for other creditors to be paid. Though noting that there are differences between pension obligations and other forms of debt– notably the size of the debt is uncertain and indeed volatile – the major creditor rating agencies are increasingly acknowledging the impact of pension deficits on their corporate credit ratings. They also acknowledge importance of the priority of creditor’s rankings14:

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13 It should be noted that, though transparency is important, it does not necessarily mean that priority rankings in a liquidation situation need to be the same as the pre-bankruptcy order. Lenders need to be able to obtain information necessary to make lending decisions taking account of the priority situation in event of bankruptcy.


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“Standard & Poor’s treats unfunded pension liabilities, health care obligations and all other forms of deferred compensation as debt-like….For companies with significant unfunded post retirement benefit obligations, the standing of such obligations in bankruptcy can be an important consideration for creditors. It may affect their willingness to lend, as it obviously has a bearing on ultimate recovery in a reorganization or liquidation. Analysis of this matter is highly specific to the legal system and type of benefit in question, as well as to the legal structure of the corporation.”

“In its credit analysis of pension obligations, Moody’s places greatest emphasis on assessing the future cash flow requirements to fund a company’s defined benefit pension plan….Moody’s views underfunded pension liabilities as debt-like and incorporates them into certain adjusted leverage measurements as debt equivalent… It is crucial to understand how pensions can affect a company’s overall credit quality, including… potential issues affecting priority of claims.”

12. Large underfunded pension schemes are already impacting the credit ratings of companies in the USA (notably the auto companies GM and Ford) and Europe. Different methods for dealing with pension underfunding can also have different impacts. Even the premiums due to the new Pension Protection Fund in the UK could potentially have an impact on other creditors (these being paid from cashflow which is therefore being used to protect one class of creditors – i.e. pension fund beneficiaries, including other unconnected employers with relevant pension schemes). Pension debt has also been impacting M&A deals. ‘Pension debt’ is therefore already increasingly impacting other creditors as both funding and accounting standards move towards fair or market valuations. The potential disruption to capital markets from ranking pension creditors preferentially ahead of other unsecured creditors, or even ‘super preferentially’ ahead of secured creditors as well, could be huge. Yet some may argue this would be a good thing as it would mean pension obligations being priced properly by markets – being reflected through the increased cost of the rest of the plan sponsor’s debt (see Lindeman 1993). The impact could also be lessened by ‘grandfathering’ in the change in rankings so that it only applied to new debt issuance. It is also interesting to consider the example of Sweden, a country with well functioning capital markets, where the major pension creditor has a strong position within the insolvency process (through the ability of the guarantee scheme - the FPG - to take collateral lines against company assets – see DAF/AS/PEN/WD(2004)19 report on guarantee schemes for further details).

V. Conclusion

13. The issue of the rights of pension creditors within bankruptcy proceedings is clearly a complex one – not least as it may be difficult to establish what contractual, debt-like obligations a plan sponsor is actually liable for. Are plan sponsor pension contributions a contractual (legal) obligation or conditional


one? Does the plan sponsor decide the contribution rate or is this done by the pension trustees? Is the plan sponsor liable for pension underfunding due to poor investment performance, incorrect assumptions etc. – or can extra contributions also be required from plan members? The first conclusion which can be drawn is that the obligations of the plan sponsor toward the pension fund should be clearly laid out in the plan documents.

14. Once established, where these pension obligations should stand in creditor rankings needs to be assessed. Though arguably more vulnerable than other creditors, in many countries pension beneficiaries do not receive priority treatment within the bankruptcy process. Should this be the case? What can be said is that pension creditors should be treated at least as well as other unsecured creditors. They should receive proper representation within insolvency and bankruptcy proceedings (e.g. on legally required creditors committees), ensuring their position is articulated as clearly as other, often more heavy weight, financial and trade creditors – the German bankruptcy system being a possible example of good practice. What should also be ensured is that loopholes and other incentives do not exist within the bankruptcy system allowing plan sponsors to avoid pension contributions in order to improve cashflow and pay other unsecured creditors ahead of pension beneficiaries – the UK, for example having recently moved to close down such possibilities.

15. Whether pension creditors should receive priority rights is more controversial. It may be possible to ‘grandfather’ in preferential rights ahead of other unsecured creditors in order to minimize the impact on financial markets and credit availability. However assigning ‘super priority’ rights ahead of even secured creditors would likely have a major impact on capital costs, particularly given increasingly market based pension accounting and funding standards. Whether these rights should be extended beyond unfunded contributions to underfunding in general is also controversial, and possibly priority for such underfunded claims only being given in cases where the fund is to be terminated.

16. The OECD ‘Guidelines for the protection of the rights of members and beneficiaries’ recommend that, in the event of the insolvency of a plan sponsor with an underfunded pension scheme, there should be rules to allocate available assets to members in accordance with accrued rights and with general principles of equity, as well as rules concerning the responsibility of plan sponsors for any unfunded liabilities. Where insolvency guaranty schemes do not exist, there should be a priority position for due and unpaid contributions, equal at least the position of due and unpaid taxes (NB in some countries this would imply a ‘super preference’). Where such guarantee schemes do exist they would normally become a preferential creditor. The guidelines recommend that priority rights may also be appropriate for underfunded pension commitments that are the responsibility of the plan sponsor – depending on whether a guarantee scheme exists and the likely impact on credit availability. As in the discussions on other benefit protection measures, it should be stressed that priority creditor rights should not be seen in isolation – rather protection measures should be looked at in combination. Given that bankruptcy laws are difficult to change (due to their economic, social, political impact), it may be simpler to focus on introducing efficient funding rules as a ‘first line of defence’ with additional measure such as benefit guarantee schemes and priority creditor rights being introduced as back up measures, protecting pension beneficiaries in the ‘worst case scenario’ of their plan sponsor becoming bankruptcy whilst the pension scheme (for which they are responsible) is underfunded. The combination of protection measures used should reflect the nature of the pension system in individual countries.

18 e.g. as is the case with the pension fund of retailer Marks and Spencer in the UK, which caused problems in a recent M&A deal. See ‘Pensions key in 13.5bn bid for M&S’, 3 June 2004 available on www.ipe.com.


20 In some cases income tax taken from employees’ pay but not yet remitted to the authorities would be considered, whilst corporate taxes due to the state could be considered.
4.2 The legal provisions recognize the creditor rights of pension plan members and beneficiaries in the case of bankruptcy of the plan sponsor, unless benefits are assured by insolvency guaranty schemes. Where such schemes do not exist, priority rights relative to other creditors should be required for due and unpaid contributions. Priority status may also be recommended for underfunded pension commitments (with reference to the terminal liability) that are the responsibility of the plan sponsor.

VI. Country Profiles

Australia: Outstanding contributions due to superannuation funds from a corporate employer are preferred creditors within the Australian bankruptcy system. Under section 556(1)(e) of the Corporations Act 2001, employment entitlements are given priority over other unsecured debts, except liquidation expenses. Where money is available to pay employees entitlements it is allocated in the following order: wages, superannuation contributions, injury compensation, leave entitlements, and retrenchment payments. A further provision (section 596AA) protects employees entitlements, including superannuation contributions, from agreements and transactions entered into with the intention of defeating the recovery of those entitlements (even if the company is not a party to the agreement or transaction or the agreement is approved by a court).

Canada: Canada’s insolvency system is primarily based on two statutes, the Bankruptcy and Insolvency Act (BIA) and the Companies’ Creditors Arrangement Act (CCAA). The BIA provides the framework for bankruptcy as well as for commercial and consumer proposals to restructure debts. The CCAA is a corporate restructuring statute, which provides the basic framework for a court-driven process of reorganization. Any entity may choose the proposal process under the BIA, while only companies with debts in excess of C$5 million may choose to reorganize under the CCAA. With respect to private pension plans, the federal and provincial governments share jurisdiction depending on the industry. The statute governing pension plans established for employees in areas under federal jurisdiction, such as banking, inter-provincial transportation, and telecommunications, is the federal Pension Benefits Standards Act, 1985 (PBSA). While some 1,300 pension plans fall under the purview of this act, this represents only 10 per cent of the assets of all registered plans in Canada. All of the provinces except Prince Edward Island have legislation governing pension plans under provincial jurisdiction.

Currently, pension obligations are not specifically addressed in the priority-ranking scheme in bankruptcy proceedings. As such, outstanding pension funding obligations are treated as unsecured debts. That said, pension funds are held in trust separately and apart from the assets and as such do not form part of the bankrupt’s estate. Where the outstanding contributions are subject to a trust, pension legislation states that the contributions will also not form part of the estate (see below for description of the “deemed trust”). In CCAA cases or proposals under the BIA, pension obligations may be altered by negotiation between the parties- provided consent is obtained from the appropriate regulatory body- along with all other claims.

At present, the creditor priority rankings in bankruptcy proceedings are as follows:

- Unpaid suppliers, who have a right to repossess goods delivered within 30 days of a bankruptcy under certain circumstances, and farmers and fishers, who have a right to a priority charge on the inventory of the bankrupt.
• Canada Revenue Agency with respect to source deductions (i.e., amounts deducted by the employer from employees’ pay cheques in respect of income tax, employment insurance and Canada pension plan and not remitted).

• Secured Creditors.

• Preferred Creditors
  1. Reasonable funeral and testamentary expenses of the debtor
  2. Costs of administration of estate
     - Expenses and fees of receivers
     - Expenses and fees of trustees
     - Legal costs
  3. Levy due to Superintendent of Bankruptcy
  4. Wages to a maximum of 6 months or $2000 and disbursements to a maximum of 6 months or $1000
  5. Family support claims accrued in the year prior to bankruptcy
  6. Municipal taxes accrued within 2 years immediately preceding bankruptcy
  7. Rent owed to a landlord accrued within 3 months of bankruptcy and for up to 3 months following a bankruptcy, if applicable
  8. Legal fees related to first garnishment order made against the bankrupt’s property
  9. Claims resulting from injury to workers where government program for workers’ compensation does not apply

• Unsecured Creditors

Currently, unless the outstanding contributions are subject to a trust, pension obligations are treated within the insolvency system as unsecured debts. Therefore, in insolvency law, pension obligations do not have a priority status. Both federal and provincial pension legislation, however, provide protection for pension plan members by creating a “deemed trust” in favour of the pension plan for specific employer and employee contributions owed to the pension fund. While the wording of the “deemed trust” provisions varies by jurisdiction, they also usually require that these monies do not form part of the employer’s estate in the event of bankruptcy or insolvency. Conflicts may arise between provincial pension legislation and federal bankruptcy and insolvency laws. For example, there may be questions about the application of provincial “deemed trust” provisions under provincial pension legislation with respect to bankruptcy, which is governed by federal legislation.

In a restructuring, whether under the CCAA or a BIA proposal, creditors are entitled to vote on the plan. The creditors are divided into classes based on commonality of interest and each class may vote on the proposal. To be binding on the class, creditors who are the majority in number and holding two-thirds of the claims of that class must approve the plan. This ensures that, while larger creditors generally
participate more extensively in the bargaining, the smaller creditors have rights during the restructuring approval process.

Pension beneficiaries may generally be divided into two groups – retirees and active employees. The first group currently receive pension benefits and the second are potential recipients. Because their interests are not necessarily the same, they may be represented separately in either a bankruptcy or restructuring event. In a bankruptcy, there is no obligation to create an official creditors’ committee. Rather, at the creditors’ meeting the claimants may make their views known. In addition, the claimants may choose to create a creditors’ committee for dealing with the trustee or receiver. In a restructuring, a union may represent both retirees and active employees. In that situation, the union negotiates amendments to the collective agreement, which dictates employer pension obligations post-restructuring. However, because of differing interests, retirees may have their own representation. Any reduction in pension benefits or accrued pension benefits must be authorized by the regulator.

Proposed Legislation

On June 3, 2005, the Canadian government introduced Bill C-55, An Act to establish the Wage Earner Protection Program Act, to amend the Bankruptcy and Insolvency Act and the Companies’ Creditors Arrangement Act and to make consequential amendments to other Acts, in the House of Commons. The Bill proposes to provide greater protection for pension contributions during corporate restructuring and bankruptcy. The Bill would provide regular employer and employee pension plan contributions, which are unremitted at the time of bankruptcy or receivership, with a priority claim over the claims of secured creditors. In a restructuring under both the BIA and CCAA, the payment of unremitted contributions has to be addressed in the plan of arrangement unless otherwise agreed to by the company, the pension beneficiaries, and the pension regulator. At this point in time, there is no guarantee that the Bill will come into force or that it will remain in its present form. However, if Bill C-55 comes into force in its present form, the following changes would occur.

In CCAA cases and BIA proposals, the court could not approve a plan unless it requires the payment of unremitted regular employer and employee pension plan contributions. However, the parties can reach an agreement to allow for payment of a lesser amount with the approval of the relevant pension regulator.

In bankruptcy, the following priority ranking would apply:

- Unpaid suppliers, who have a right to repossess goods delivered within 30 days of the bankruptcy under certain circumstances, and farmers and fishers, who have a right to a priority charge on the inventory of the bankrupt.

- Canada Revenue Agency with respect to source deductions (i.e., amounts deducted by the employer from employees’ pay cheques in respect of income tax, employment insurance and Canada pension plan and not remitted).

- Wage earners, who have a claim for unpaid wages, including disbursements and commissions, are granted a priority charge over current assets.

- Regular employer and employee pension plan contributions, which are unremitted at the time of bankruptcy, are granted a priority charge over all assets

- Secured Creditors

- Preferred Creditors
a. Reasonable funeral and testamentary expenses of the debtor

b. Costs of administration of estate
   -- Expenses and fees of receivers
   -- Expenses and fees of trustees
   -- Legal costs

c. Levy due to Superintendent of Bankruptcy

d. Wages to a maximum of 6 months or $2000 and disbursements to a maximum of 6 months or $1000

e. Secured creditors whose security was compromised by the priority charge described in (2) to the amount that the security was compromised

f. Secured creditors whose security was compromised by the priority charge described in (3) to the amount that the security was compromised

g. Family support claims accrued in the year prior to bankruptcy

h. Municipal taxes accrued within 2 years immediately preceding bankruptcy

i. Rent owed to a landlord accrued within 3 months of bankruptcy and for up to 3 months following a bankruptcy, if applicable

j. Legal fees related to first garnishment order made against the bankrupt’s property

k. Claims resulting from injury to workers where government program for workers’ compensation does not apply.

• Unsecured creditors.

• Creditors whose claim relates to damages arising from the purchase or sale of shares, units or other ownership interest in the bankrupt entity.

Germany: Prior to the introduction of the pension guarantee insurance corporation, pensions in Germany were treated as wage claims in bankruptcy, with the book reserve system consequently forcing workers to take on significant risk. Since the introduction of the PSVaG in the 1970s, pension beneficiaries have received virtually full protection of their pension promises in the case of bankruptcy of their plan sponsor. Direct pension pledges by employers (i.e. book reserves), support funds (Unterstützungskassen) and pension funds are covered by the PSVaG. Upon insolvency the obligations of the corporate plan sponsor (both pensions and vested entitlements up to a ceiling level) are taken on by the PSVaG, which covers these with an annuity (see German country section in DAF/AS/PEN/WD(2004)19 report on guarantee schemes for more details). Pensionskassen and direct insurance schemes fall outside the PSVaG’s protection, but the risk to plan members is limited (these being supervised as insurance funds, protected via solvency margins etc. – indeed no defaults at Pensionskassen have taken place).

21 In some limited cases direct insurance is covered by the PSVaG.
From 1999 onwards Germany bankruptcy law was changed so that all unsecured creditors are treated the same and priority rankings were basically disbanded. The PSVaG therefore stands in the same position as all other creditors, and indeed it should be noted is a private creditor like all others, being a private company and not an agency of the State. What is perhaps different in Germany to other bankruptcy systems is that the ‘omnium creditorum’ position is genuinely applied, with all unsecured creditors treated equally, including employees. All creditors also have the right to representation through the ‘creditors committee’ (which may be established by law), and the ability to object to either the appointed bankruptcy administrator and the reorganization plan. The PSVaG, having only around 140 staff members, but facing 500-700 claims in recent years, is not able to sit on all these committees but will be a major voice where large claims of economic significance are involved. What is also different in Germany is the structured nature of the bankruptcy process (with the administrator usually achieving a quick insolvency work-out solution). Less negotiation is possible on the part of individual creditors than, for example, within the US bankruptcy system. Priority rights may not exist in Germany, but at least the PSVaG has a strong place at the negotiating table when bankruptcies do occur. The asset recovery rate for the organization is still low (informally estimated around 5%). What the German system does seem to show is that pension creditors do not necessarily need priority ranking within the bankruptcy process to receive fair representation. Rather what are needed are clear, objectively fairly and rigorously applied bankruptcy proceedings, operating for the benefit of all creditors equally.

**Italy:** Severance pay has been the traditional form of retirement income in Italy (though a transition is taking place to DC style pension plans). This is known as Trattamento di Fine Rapporto (TFR), and is calculated as a career average lump sum (indexed annually for inflation + 1.5% fixed rate), and is accrued as an unfunded liability in the company’s book reserve.

Bankruptcy proceedings in Italy are governed by the Royal Decree 16th March 1942 n.267, and the priority rights of creditors are also affected by the rules of the Civil Code. According to these, all credits relating, in general, to the salary due by the employer, included the TFR (severance pay) are priority credits on the movable properties of the debtor. The same status is awarded for credits related to the non-payment of the contributions to the first pillar (compulsory state pension system) and the non-payment of the contributions to others forms of social protection. A wide interpretation of the code could take this to include contributions to pension funds, but there have not been any court decision to clarify this point. The ranking within priority creditors themselves is as follows:

- credits for judicial expenses;
- credits regarding, in general, the salary due by the employer, included the TFR;
- credits regarding the non-payment of the contributes to the I° pillar (compulsory state pension system)
- credits for the payment of the taxes

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22 Details available from PSVaG Summary Annual Report – the 2003 report available in available in English on line at [http://www.psvag.de/pdf/gb03e.pdf](http://www.psvag.de/pdf/gb03e.pdf#search='PSVaG%20Summary%20of%20Annual%20Report%202004').

23 Following the drawing up of insolvency papers a 3 month period exists when the company is run by an administrator – who is a person not a company - appointed by the court. Many of these are well known to the PSVaG, and the resulting close cooperation with insolvency executors ultimately serves to promote the fulfilment of the functions and responsibilities of the PSVaG. Employees are paid by the government in this period, during which much of the insolvency process will be worked out by the administrator (the bidding process, decisions on which division are to be sold etc.). Official bankruptcy proceedings then open, and the administrator’s plan is taken to the creditor committee and all creditors can vote on it.
• credits regarding the non-payment of the contributes to others forms of social protection

The Decree on bankruptcy discipline also prescribes the institution of a creditor committee formed of 3 or 5 members, generally chosen from all creditors (i.e. there are no special rights for workers and retirees).

From 1992 a further Decree (n. 80/1992) instituted a Protection Fund against the risk of the non-payment of employer pension contributions in the event of the employer’s bankruptcy.

Ireland: Section 285 of the Irish Companies Act 1963, (as amended by s.10 of the Companies Act 1982), gives certain debts a priority status over other claims made against a company during the insolvency process, namely:

- All sums due to any employee pursuant to any scheme or arrangement for the provision of payments to the employee while he is absent from employment due to ill health
- any payments due by the company pursuant to any scheme or arrangement for the provision of superannuation benefits to or in respect of the employees of the company whether such payments are due in respect of the company’s contribution to that scheme or under that arrangement or in respect of such contributions payable by the employees to the company under any such scheme or arrangement which have been deducted from the wages or salaries of employees.

As the definition of superannuation benefits includes pensions, unpaid pension benefits are therefore given preferential treatment in the winding up of companies. However, any claim in respect of enhancement of the value of the pension fund, if admitted, will rank only as unsecured debt. Section 285(7)(a) of the Act says that where there is an insufficiency of assets to meet these preferential debts then the assets will be divided on a pro rata basis (all preferential creditors will rank pari passu). It also states that this preferential treatment will occur only if the liquidator is notified of or becomes aware of the creditor’s debt within 6 months of his advertisement for claims. Preferential creditors rank as follows within the hierarchy of debts:

- fixed charges
- liquidators’ fees and expenses, examiners fees and certified creditors in an examinership
- preferential debt (including unpaid pension benefits)
- floating charges
- unsecured debts
- members of the company

The Government also protects employees of companies in liquidation by providing that the Minister for Enterprise, Trade and Employment can make payments to employees from the Social Insurance Fund in accordance with the Protection of Employees (Employers’ Insolvency) Acts, 1984 to 2003. The Acts provide for the payment into the assets of an occupational pension scheme of certain outstanding pension

24 After the case Re Cavan Rubber Ltd. (in liquidation) [1992] ELR 79, the Employment Appeals Tribunal (EAT) decided that a scheme which would not constitute an occupational pension scheme for the purposes of the pensions acts as it was not revenue approved, needed a lesser standard to be considered as an occupational pension scheme for the purposes of being eligible to recover funds from the Social Insurance Fund.
contributions. The outstanding contributions covered are those which both the employer and the employee were liable to pay in respect of the employee's occupational pension scheme during the year prior to the date of insolvency of the employer. In the case of contributions payable on behalf of an employee, payment can be made only where the amount of the contributions was deducted from the pay of the employee but was not paid over to the trustees/administrators of the occupational pension scheme. In the case of contributions payable on an employer's own account, the lesser of the following is payable under the Acts:

a. the balance of the employer's contributions remaining unpaid in respect of the period of twelve months immediately preceding the date of the employer's insolvency, or

b. the amount certified by an Actuary to be necessary for the purpose of meeting the liability of the occupational pension scheme on dissolution to pay the benefits provided by the scheme to or in respect of the employees concerned.

Where a payment is made out of the Social Insurance Fund in respect of unpaid pension contributions, the Minister is subrogated to the rights of the members as a preferential creditor in the liquidation or receivership (s.10(3) of 1984 Employee protection Act.)

Japan: Severance pay: this was the traditional form of retirement benefit in Japan, though it is now largely supplemented by or converted to more conventional externally funded pension or lump-sum arrangements. Under the new Corporate Reorganisation Law, one-third of the claim of a dismissed employee for his/her severance allowance up to 6 times of his/her monthly salary is given priority over other debts owed by the employer (i.e. is treated as one of the ‘Claims of Common Interests’ and should be paid back prior to any other debts, including collateralized debts and tax payments). Under the new Bankruptcy Law, the claim of a dismissed employee for his/her severance allowance up to 3 times of his/her monthly salary is given priority over general preferential claims, although inferior to collateralized debts.

Employee Pension Funds: Many Employee Pension Funds (EPFs) were established in the 1960s and 1980s. These are pension plans with over 500 members for single-employer schemes or over 3000 for multi-employer schemes. For EPFs newly introduced after April 2005, over 1000 members are required for single-employer schemes and over 5000 members for multi-employers schemes. As well as providing private pension benefits, EPFs also manage a portion of the public pension scheme (the Employee Pension Insurance or EPI, which is the employment related social security pension for private sector employees). This public pension portion of the EPF is known as the ‘Substitution Component’. The following priority rights exist in relation to EPF pension claims:

a. EPFs have a priority claim over employer contributions

b. the Pension Fund Association has a priority claim over the Substitutional Component

c. EPFs have a claim for the uncollected contribution due from the public nature of the EPF

If an EPF converts to the new pension system and decides to become one of the new Defined Benefit Pension Plans, the position of claims for contributions moves down in the rankings as the plan loses its public nature (as it ‘hands back’ the Substitutional Component to the government by the system know as ‘daiko-henjo”).

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<th>Pre 2005</th>
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<td>Taxes</td>
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<th>Pension Creditors (EPF)</th>
<th>Pension Creditors (EPF)*</th>
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<td>Labour Creditors</td>
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<td>Private Creditors</td>
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* Part of Pension creditors can be regarded as Labour Creditors

What is more complex in Japan is the nature and amount of contributions which are due from the plan sponsor, and what benefits they have an obligation for. This stems from the fact that historically retirement benefits were paid in the form of severance pay and that ways existed for companies to reduce the amount of severance allowance which they had an obligation to pay. When pension funds were subsequently introduced it was therefore difficult to include clear vesting rights. The new Defined Benefit Corporate Pension Law of 2002 set up common rules for the vesting issue but with some changes still needed, and clarified the termination liability which the plan is obliged to pay immediately to the plan participants when the plan is wound up. The termination liability is based on the concept of the ‘Minimum Preserved Benefit’ (MPB) – i.e. a scheme participant’s vested or regarded-to-be-vested benefit corresponding to his/her past service period and the benefit provision of the plan. The sum total of the present value of the MPBs minus the amount of plan assets is treated as uncollected contribution (i.e. this is the liability of sponsoring company when the plan terminates). The discount rate for calculating the present value is self-determined, with the range between 80% and 120% of the five year average of subscriber interest rates of 30-year Japanese Government Bonds. The total sum of the present value of the MPB is called as the ‘Minimum Funding Standard Amount’ (MFSA). EPFs and DB plans are required to keep the funded ratio above 100% (90% until 2007) of the MFSA. When the funded ratio goes below 100% (90% until 2007) the EPFs or DB plans should in principle draw up and implement a recovery plan to shore up the funded ratio over to 100% within 7 years (90% within 10 years until 2007).

However, these funding rules are relaxed in the case of insolvency. As a temporary measure, EPFs are allowed to reduce the amount of contribution which the sponsoring company is obliged to pay into the fund for making good the shortfall to the minimum funding requirement for the Substitution Portion alone – know as the ‘Minimum Technical Provision of the Substitution Portion’ or MTPSP25. Therefore in reality it is only the Substitutional Portion which is protected, not the purely private part of the occupational pension. The normal procedure after the dissolution of an EPF is that the Pension Fund Association (PFA) collects amounts equal to the MFPSP – in exchange for which it provides an annuity corresponding to the Substitutional Portion. Dissolved EPFs then distribute residual assets to plan participants, either in the form of a lump sum or an annuity (also provided by the PFA and known as the PFA Annuity) – however as funding has been reduced to cover only the Substitutional Portion, few residual assets are likely to remain. Since 1989 the Pension Fund Association has also operated a Pension Benefit Guarantee Program (PBGP) to provide a minimum guarantee to participants of dissolved EPFs, which supplements the PFA Annuity (i.e. it only covers participants who chose the annuity rather than the lump sum option regarding residual assets).

*Other pension funds:* Non EPF type defined benefit pension plans do not receive any priority status in bankruptcy proceedings, and rank in the same position as private creditors. However, if the pension benefits provided are legally regarded a severance (and the promise of paying the benefits are explicitly stated in the office regulations or in the severance allowance regulations of the sponsoring companies), they may then be treated as labour credits, ranking as a preferential claim (receiving the lowest priority order amongst these). However this status still exists only in theory and there is as yet no established precedence as the Defined Benefit Corporate Pension Law was introduced only in 2002.

25 The MTPSP is calculated in a retrospective manner, using actual rates of return achieved by the Social Security Fund (including the performance of the GPIF).
Korea: Corporate retirement income in Korea has traditionally operated as severance pay. This is treated as deferred wages and receives priority standing ahead of other creditors in case of the sponsor's bankruptcy. When the new occupational pension system goes into operation in Korea from the end of 2005, (by which company’s can voluntarily switch their severance pay systems in DB or DC pension plans), retirement benefit rights of the new DB schemes will receive priority standing ahead of other creditors in case of the sponsor's bankruptcy, in the same way as severance pay.

The Labor Standards Act Article 37 (Preferential Claims for Wages) outlines the following details:

- Wages, retirement allowance, accident compensation, and other claims arising from employment shall be paid in preference to taxes, public charges, or other claims except for claims secured by pledges or mortgages on the whole property of an employer; provided, that this shall not apply to those taxes and public charges which take precedence over said pledges or mortgages.

- Notwithstanding the provisions of paragraph (1), the claim falling under any of the following subparagraphs shall be paid in preference to any claims secured by the right of pledge or mortgage on the whole property of the employer, taxes, public charges and other claims:
  1. The wages of the last 3 months;
  2. The retirement allowance of the last 3 years; and
  3. Accident compensation allowance.

- The retirement allowance under paragraph (2) shall be the amount equivalent to a 30 days’ portion of the average wage for each one year of continuous employment.

Netherlands: In the Netherlands laws governing bankruptcy, unemployment and pensions and savings funds provide a substantial safety net for pension fund beneficiaries. In the case of the bankruptcy of the plan sponsor, there is a special fund that will pay pension premiums with a backlog of maximum one year. Legislation requires that the Articles of Association and regulations of a pension fund contain provisions in respect of winding-up, including that if the plan sponsor ceases to exist, (or the relationship between the pension plan and the sponsor is terminated in another manner), all accrued benefits must be transferred to another pension fund or purchased through an insurance contract, or if pension fund assets are sufficient to pay accrued rights, become a closed pension fund. Pensions funded through the purchase of insurance contracts may be protected, in the event that the insurer encounters financial difficulty, though the early intervention arrangement for life insurers. In such a case, the insurance portfolio would be transferred to a special purpose vehicle company set up by the insurance industry.

It should be noted that Dutch pension funds are independent from the plan sponsor(s), so that the only creditor rights which a pension fund can have towards a plan sponsor are overdue premiums. The pension fund is treated equally to all other creditors in the bankruptcy process, though unpaid taxes and social contributions have legal priority over unpaid pension fund contributions. However, the Department of Justice has put forward a bill to change the Civil Act so that pension providers will get a preferential position in case of bankruptcy of the plan sponsor.

The bankruptcy of a pension fund itself is not technically possible as legislation requires that a pension fund have assets sufficient to meet its liabilities – i.e. it must be fully funded at all times. In the

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26 Dutch funding rules require pensions to be fully funded at all times. On the liabilities side this includes the immediate coverage of all salary increases, pension indexing or retroactive plan improvements, and on the asset side the immediate correction of negative investment returns. Various reserves must be held by funds, including a general risk reserve of 5%, an investment reserve (covering a 40% decline in equity markets and a buffer for bond holdings) a future pension adjustment reserve, and any additional reserves demanded by the regulator (DNB). As a result, funding levels are generally around 120-125%. If the 105% funding
event that a pension fund has to be re-insured and the assets of the fund are insufficient to pay the full insurance premium, the benefits of all members (active, inactive, retired) would be reduced. The allocation of pension fund assets on winding-up (whether these assets are larger or smaller than the pension fund’s obligations) are not addressed in legislation (as is usually in the case in other countries – see Portugal, UK, USA), but are dealt with in the Articles of Association of the fund. Funding rules are the main protection measure for pension beneficiaries in the Netherlands – for example there is no Pension Benefit Guarantee Scheme operating. Overall, the legal structure and governance practices employed by pension funds in the Netherlands facilitate the adjustment of the benefits and contributions of a pension fund in response to changing circumstances. This contributes to the ability of pension funds to continue their operations, even in the face of financial difficulties, and lessens the need for a guarantee scheme.

**Portugal:** In Portugal occupational pensions schemes can be financed through the establishment of a pension fund or through an insurance contract, through no financing obligation exists in legislation. Occupational defined benefit (or hybrid) plans financed by pension funds, which are underfunded due to unpaid contributions due from the plan sponsor must be wound-up according to the legislation. In such cases the pension fund assets will be used to cover guaranteed pension benefits (i.e. pensions in payment, vested rights and pensions in formation). However, beneficiaries and active workers do not have any right to claim pension fund contributions due from the insolvent mass of the company, much less any priority credit status. Nor does a national pension benefit guarantee scheme exist.

When the assets of pension fund are liquidated under the terms laid out in the winding-up contract they should be distributed preferentially in the following order (on a pro-rata basis if necessary)\(^{27}\):

- Chargeable expenses (under Article 26 of the law)
- In the case of pension funds that finance contributory pension schemes, each member’s individual account, that should be applied in accordance with the rules laid down in the incorporation contract or management regulations;
- Single annuity premiums that guarantee pensions in payment in accordance with the amount of the pension at the time of the winding-up;
- Single annuity premiums that guarantee payment of pensions relating to members of an age equal to or greater than the normal retirement age laid down in the pension scheme;
- A sum that guarantees the vested rights of the members existing at the time of winding-up that should be applied in accordance with the rules laid down in the incorporation contract or management regulations;
- A guarantee for the pensions in formation as regards members who are not covered by the previous sub-paragraph;
- Sums that guarantee the up-dating of pensions in payment, provided that this is set forth in the contract.

**Sweden:** Occupational pensions for white-collar workers (ITP schemes) in Sweden are protected by a guarantee fund - the Pension Guarantee Mutual Insurance Company or FPG (see Sweden country section in Report on Guarantee Schemes for details). The FPG is not a preferential creditor in a bankruptcy proceeding, except - occasionally - for a very small part (max 5 %) of the total claim, i.e. for pension rights earned three months before the bankruptcy. However, the FPG is in a strong position as it is able to

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\(^{27}\) According to Article 24 of Decree-law no. 475/99, of the 9th of November, available in English on www.isp.pt.
demand collateral against the insured company’s assets. Indeed the scheme only allows creditworthy companies to participate, or those who provide adequate collateral (the amount demanded of the company depending on the FPG’s regular internal assessment of insolvency risk), or a surety bond issued by the parent company. During the last ten years FPG has had very few claims and the net losses, after recoveries, have been insignificant. What is interesting in the Swedish case is that the pension claims (through the FPG) are effective even higher than preferential claims, and indeed rank as secured creditors. Yet the healthy capital markets in the country imply that this has not affected company’s ability to and cost of raising capital.

Other pension funds in Sweden, not covered by the FPG insurance system, receive general preferential rights. Pensions can also be safeguarded through life insurance provided by life insurance companies or friendly societies (a kind of mutual economic association). In the case of life insurance companies, the company is obligated to keep a special register containing assets held to cover technical provisions. In case of bankruptcy, the insured will have a right to priority as concerns these assets. This system does, however, not apply to friendly societies (where the legislation is more complex), though funds are of course earmarked for pensions, as these societies are closed.

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<td>Mortgages on real property</td>
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<td>Mortgages on site-leasehold right</td>
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<td>Seizures</td>
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<th>General preferential rights</th>
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<tr>
<td>Costs for petitions by creditors and company reorganization</td>
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<td>Costs for accounting and yearly mandatory audit</td>
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<tr>
<td>Business mortgage with a right to 55% in all remaining assets</td>
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<tr>
<td>after creditors with superior rights have received dividend</td>
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<tr>
<td>Salary and pension claims</td>
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**Switzerland:** Regarding pension funds, when an employer is bankrupt or insolvent and is unable to make pension contributions, as special fund, known as the guarantee fund, intervenes to pay pension beneficiaries up to a ceiling level. The guarantee fund is subrogated to the rights of the members as a creditor within the bankruptcy proceedings but receives no priority ranking. Any benefits above the ceiling level remain with the beneficiaries, who do receive a preferential claim status (first class).

**UK:** Under a final salary scheme where the scheme’s liabilities exceed its assets, the shortfall becomes a debt owed by the employer to the trustees of the scheme. If the company becomes insolvent the trustee’s claims (other than those for some unpaid contributions) have to rank equally with all other non-preferential and unsecured creditors, so any recovery of the debt cannot be relied upon. There are some measures which the trustees can take to reduce the debt, other than relying on the company. A claim may be made for contributions due but unpaid by an employer to the state operated National Insurance Fund through the Redundancy Payments Directorate of the Insolvency Service. Where an insolvent employer has failed to pay contributions into a pension scheme, the scheme may be able to recover some of the missing contributions from the National Insurance Fund, via the Redundancy Payments Directorate. The contributions which may be recoverable are the employer’s own contributions as well as any employee contributions which the employer has deducted from wages but not paid over to the scheme. Unpaid employees' contributions are payable up to the actual amount deducted from wages during the twelve

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months prior to the date of insolvency. Unpaid employers' contributions for the twelve-month period prior to the insolvency date are also payable but are subject to monetary limits depending on the type of pension scheme. The Secretary of State then takes on this claim against the company, taking on the benefits of scheme trustees and enjoying any preferential status with in the creditor hierarchy which is as follows:

- Secured creditors – fixed (over company assets / property etc.);
- Preferential creditors – including employee claims (the government gave up claims to certain tax preferences in recent years). Employees rank as preferential for certain debts, and to the extent that the Secretary of State pays the employees, takes over that preferential status. The Secretary of State ranks as a preferred creditor for payments made as part of employment protection legislation (wages, holidays and the pension contributions mentioned above);
- Secured creditors - floating (no lien on a particular asset);
- Unsecured creditors – the rest of due pension payments ranking here, ranking pari passu with all of the other unsecured creditors.

This overall order of priority was debated as part of the Green Paper of the Pensions Bill (2004), but it was decided not to change the priority of pension claims within bankruptcy proceedings (due to concerns over capital market disruption and the effect on the other creditors generally).

The new Pension Protection Fund offers an additional layer of protection for pension obligations to defined benefit scheme members from April 2005. Its position as a creditor within the bankruptcy system is also as an unsecured creditor. The PPF also covers shortfalls in any pension schemes caused by fraud or theft.

The priority of rights amongst pension claims themselves has also been revised in the UK (where there is a statutory priority order established by law which overrides the priority order in pension scheme rules, unlike in the Netherlands where the hierarchy established in the Articles of the individual pension fund applies). The 1985 Maxwell scandal (hurting actual pensioners) resulted in the Pensions Act 1995. Regulations made under powers in the Act placed not only pensions in payment but also future increases in pension benefits ahead of the accrued pension rights of active, working members of the pension scheme. The recent round of companies becoming insolvent with underfunded pension schemes saw pensioners at some firms having their pension secured, whilst active members (even if one week away from retirement) lost a large percentage of promised benefits. The Regulations were amended for schemes which began winding up on or after 10 May 2004. The priority order was changed to put the rights of active pension scheme members ahead of the rights of existing pensioners to future pension increases.

A new statutory priority order was introduced under the Pensions Act 2004 for schemes which commenced winding up on or after 6 April 2005 when the Pension Protection Fund (PPF) commenced operations. The new Statutory Priority Order is broadly as follows:

1. any liability for pensions or other benefits to the extent that this does not exceed the corresponding PPF liability;
2. remaining voluntary contributions not covered in (1);
3. any other scheme benefits not covered in (1) or (2) above.
It will ensure that broadly speaking individual scheme members will be no worse off if their scheme winds up than they would be if the PPF were instead to assume responsibility for the scheme and pay compensation to members. The PPF will pay two levels of compensation:

- One level, commonly referred to as the “100% level of compensation” – this is for people who, at the start of the PPF’s involvement with a scheme (the assessment date), have reached the scheme’s pension age or are in receipt of survivors’ benefit or a pension on the grounds of ill-health. In broad terms, this means a starting level of compensation that could equate to 100% of the pension in payment immediately before the assessment date (subject to a review of the rules of the scheme by the PPF). However, only the part of this compensation that is derived from employment on or after 6th April 1997 will be increased each year (up to a maximum of 2.5%) – this could, potentially, result in a lower rate of increase than the scheme would provide.

- The second level is referred to as the “90% level of compensation” – this is for the majority of people below the scheme’s normal pension age. The 90% level is based on the pension an individual had accrued immediately before the assessment date (again subject to a review of the scheme by the PPF). This amount is then revalued in line with the increase of the Retail Prices Index between the assessment date and the commencement of compensation payments (subject to an overall maximum calculated by assuming RPI increased by 5% each year) – this helps to ensure the pension holds its value. Once revaluation is calculated a cap is then imposed – in 2005 / 06 this has been set at £27,777.78 at age 65. The cap will be reduced if members receive compensation before reaching 65 or if they have opted to commute part of their pension for a lump sum (as otherwise their overall compensation ‘package’ would be of a higher value and this would be unfair to other members). The final compensation is then 90% of the capped amount. Once in payment this is subject to the same increases as the 100% level of compensation.

The new Pensions Act also introduced various measures to close some of the loopholes which saw pension beneficiaries loosing out to other creditors, particularly during pre-bankruptcy negotiations. Previously when a sponsoring company was unable to cover the cost of buying out the required benefits, the trustees were allowed to come to a deal with the employer on how much of a contribution to accept. Before entering into a compromise deal with the company, trustees had to take appropriate independent expert advice (likely to include legal, actuarial and accounting advice). Whilst compromising on the debt paid is still possible, it has been actively discouraged. If scheme trustees decide to do this they are likely to make their scheme ineligible for the Pension Protection fund. If most of the trustees are senior members of the company, and are therefore not deemed to be sufficiently independent, the Pensions Regulator can appoint an independent trustee to oversee any negotiations involved.

The Pensions Act 2004 also contains a number of measures to address the risks of so-called ‘moral hazard’. Moral hazard is the risk that, because the Pension Protection Fund will compensate scheme members if their employer has become insolvent and the scheme is under funded, employers will deliberately manipulate their affairs so as to shift their deficits to the Pension Protection Fund, thus increasing the Pension Protection Fund levy costs for responsible employers. Three key elements of the Pensions Regulator's moral hazard powers are its ability to impose either a contribution notice, financial support direction or restoration order. Contribution notices are a regulatory tool intended to allow the Regulator to require a person (which can include a company) who has been involved in a deliberate act to avoid pension liabilities, to put money into a pension scheme up to a specified amount. However, before

29This principle was agreed by the Courts in the Bradstock case, where the trustees wanted to accept a lower contribution from the company than was required to secure the minimum benefits, rather than making the company insolvent by requesting the full amount, and thus risking much less. Opas – Office of the Pensions Advisory Service www.opas.org.uk/PensionRights/WindingUp/index.htm
issuing a contribution notice to anyone, the Regulator must be satisfied that it is reasonable to do so and there are a number of factors which must be considered set out in the legislation. Financial Support Directions are intended to allow the Regulator to direct that associated and connected persons put in place arrangements to guarantee the pensions liabilities of an employer who is insufficiently resourced to do so itself, or which a "service company" is as defined in the legislation. When an employer has been subject to a "relevant event", if the assets of the scheme have been reduced by virtue of a transaction at an undervalue involving assets of the scheme, the Regulator may make a restoration order to put the position back to what it would have been had the transaction not occurred. This applies to occupational pension schemes but not money purchase schemes, a prescribed scheme or a scheme of a prescribed description. The Regulator may only make an order in certain circumstances where a "relevant event" has occurred and where the transaction was entered into on or after 27 April 2004 and not more than two years before the occurrence of the "relevant event."

USA: Occupational defined benefit pension funds in the US are secured (up to a ceiling level) via compulsory insurance with the Pension Benefit Guarantee Corporation which takes over the position of pension creditor in case of the bankruptcy of the plan sponsor (see USA country section in DAF/AS/PEN/WD(2004)19 report on guarantee schemes for more details). There is, however, contention over the priority bankruptcy rights of the PBGC. The PBGC argues that the ERISA pension legislation of the 1970s affords the organisation priority treatment for certain of its claims against bankrupt employers with underfunded pension plans. In cases where plan termination occurs before a bankruptcy petition has been filed, the organisation argues these priority claims cover a shortfall of up to 30% of the net worth of the sponsoring firm and affiliates. In the bankruptcy courts this is known as the PBGC’s employer liability claim. Plan underfunding is typically large relative to the net worth of the firm terminating its plan, so the 30% rule normally applies. When the laws were introduced, Congress stipulated that this claim of employer liability would be treated as a tax due to the US, therefore being granted priority over general unsecured creditors. However, in the opinion of the PBGC, Congress also intended that the 30% net worth claim would have value after bankruptcy had been filed. The PBGC goes on to assert priority treatment for missed minimum funding contributions in excess of $1m30. However, these priority claims have been challenged by many bankruptcy lawyers, who dispute the PBGC’s interpretation of ERISA, the tax code and the bankruptcy code. They also argue that after a firm has filed for bankruptcy, it is not longer responsible for its minimum contributions to an ongoing pension plan as these are payments for ‘pre-petition debt’. The PBGC counters the argument by saying that pension promises are non-cash wages for workers’ ongoing labour and that pension contributions should be paid in full just like wages and other current compensation during bankruptcy.

The PBGC is again asserting its rights in the courts, trying to avoid companies exercising what is known as the ‘pensions put’, passing its pension obligations onto the guarantee fund before starting up again with lower costs. Bradley Belt, Chief Executive of the PBGC, wishes to strengthen the agency's status in bankruptcies. He has proposed a modest change to the law that would allow the PBGC to force the collection of unpaid, but owed contributions from companies in bankruptcy. In October 2004 he called on Congress (via the Senate Commerce Committee) to strengthen the agency’s hand in seeking to attach assets of bankrupt companies to protect those companies’ pension plan participants (explaining that the PBGC has the power to place lien on non-bankrupt co. assets if the co. misses pension contributions, but is

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30 Since enactment of the Pension Protection Act of 1987, a statutory lien on the assets of the controlled group arises 60 days after a contribution has been missed and the total amount of missed contribution exceeds $1million. The amount of the lien is the amount of missed contributions in excess of $1million. In general, the remaining portions of the PBGC’s bankruptcy claims are not entitled to priority status and are treated as general unsecured claims.
not able to do so for bankrupt companies). In order to enhance the PBGC’s ability to recover its claims, the organisation is also arguing that pension contributions should be treated as administrative expenses, thereby receiving priority status within bankruptcy proceedings - ongoing cases involving United Airlines being important test cases for this argument.

The following statutory ranking for the allocation of pension benefits supersedes any procedures laid out in plan documents. A PBGC regulation also permits for limited subclasses within each category (e.g. based on age, disability etc.).

- Benefits attributable to voluntary employee contributions (active workers, assets in individual accounts)
- Benefits attributable to mandatory employee contributions
- Benefits of a participant or beneficiary that had been in a pay status for at least 3 years on the date of the insured event, and the benefits that would have been in pay status for 3 or more years if the participants had retired with normal benefits 3 years prior to the insured event. Priority only for the lowest benefit level under the plan during 5 years prior to retirement (3 years lower benefit level to those already retired).
- All other benefits up to the applicable limits that would be insured except for the aggregate limit
- All other vested benefits
- All other benefits under the plan

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32 For details of the cases see press releases from the PBGC available on their website: www.pbgc.gov.
<table>
<thead>
<tr>
<th>Country</th>
<th>Pension Credit Priority</th>
<th>Ranking</th>
<th>Other Protection</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>Unpaid employer contributions</td>
<td>Behind insolveny charges and secured creditors</td>
<td>Clause overriding agreements to reduce superannuation contributions</td>
<td></td>
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<tr>
<td></td>
<td></td>
<td>Ahead tax and other unsecured</td>
<td></td>
<td></td>
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<tr>
<td>Germany</td>
<td>No – all unsecured creditors rank equally</td>
<td></td>
<td>Guarantee scheme, PSVaG, covers most pension obligations</td>
<td>PSVaG strong representation in work-out process</td>
</tr>
<tr>
<td>Italy</td>
<td>Severance pay</td>
<td>Behind judicial costs, ahead of tax</td>
<td>Protection fund for unpaid contributions</td>
<td></td>
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<tr>
<td></td>
<td>Unpaid employer contributions to state pension</td>
<td>State contributions as above</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Theoretically unpaid to occupational pensions</td>
<td>Occupational behind tax</td>
<td></td>
<td></td>
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<tr>
<td>Ireland</td>
<td>Unpaid contributions only</td>
<td>Behind fixed secured creditors</td>
<td>Social Insurance Fund covers unpaid contributions</td>
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<td></td>
<td></td>
<td>Ahead floating secured creditors</td>
<td></td>
<td></td>
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<tr>
<td>Japan</td>
<td>Severance pay (capped)</td>
<td>Behind secured creditors, ahead preferential</td>
<td>Guarantee scheme for EPF funds</td>
<td>Funding rules and contribution requirements mean that in reality only the substitutional component is protected</td>
</tr>
<tr>
<td></td>
<td>EPF substitutional component (public pension) + employer contributions</td>
<td>Behind wages/taxes, ahead private creditors</td>
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<tr>
<td>Korea</td>
<td>Severance pay and new DB schemes</td>
<td>Ahead tax and secured creditors</td>
<td>Pension benefit guarantee scheme under consideration</td>
<td></td>
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<tr>
<td>Netherlands</td>
<td>No</td>
<td></td>
<td>Social fund covers</td>
<td>Legislation currently</td>
</tr>
<tr>
<td>Country</td>
<td>Status</td>
<td>Description</td>
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<tr>
<td>Portugal</td>
<td>No</td>
<td>Plan sponsor not responsible for underfunding – full funding required.</td>
<td></td>
<td></td>
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<tr>
<td>Sweden</td>
<td>No - ITP plans, Yes - others</td>
<td>Behind secured creditors + bankruptcy costs, ahead unsecured creditors</td>
<td></td>
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<tr>
<td></td>
<td></td>
<td>ITP plans covered by guarantee scheme - FPG</td>
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<td></td>
<td></td>
<td>FPG takes collateral lien on company assets</td>
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<tr>
<td>Switzerland</td>
<td>No – guarantee fund subrogation, Yes – excess claims remaining with beneficiaries</td>
<td>Guarantee fund exists</td>
<td></td>
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<tr>
<td>UK</td>
<td>Limited unpaid contributions only</td>
<td>Behind fixed secured creditors, ahead floating secured creditors</td>
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<td></td>
<td>Unpaid contributions covered by National Insurance fund</td>
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<td>New guarantee scheme – PPF</td>
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<tr>
<td>USA</td>
<td>No</td>
<td>Guarantee scheme – Pension Benefit Guarantee Scheme</td>
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<td></td>
<td></td>
<td>Priority status claimed by PBGC not recognized by bankruptcy courts</td>
<td></td>
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<td></td>
<td></td>
<td>Claim secured status for underfunding up to 30% of firm’s net worth, + priority status unpaid contributions over $1m (ranking with tax and administrative charges)</td>
<td></td>
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</tr>
</tbody>
</table>
REFERENCES:


