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BRIEFING

SUMMARY AUGUST 2010

UK defined-benefit pension schemes and corporate restructurings

EMPLOYMENT, PENSIONS AND BENEFITS BRIEFING 198

This briefing explains why pension deficits can be a critical issue in a corporate restructuring and how pension scheme trustees, the Pensions Regulator and the Pension Protection Fund can be key players in the process and outcomes.

A prominent aspect of the most recent wave of restructuring is the significant role often played by defined-benefit (DB) pension liabilities. This can partly be explained by the following:

- poor investment returns, the loss of significant tax relief to pension funds in 1997, low bond yields and increased longevity have all contributed to larger funding deficits in DB pension schemes. For some companies their pension scheme will be one of their largest creditors or at least comparable with obligations owed to banks and other holders of corporate debt. Furthermore, pension liabilities can be highly volatile;
- pension liabilities are reflected on the corporate balance sheet, but the accounting treatment of those liabilities is increasingly viewed as unreliable. The basis on which the liabilities are valued will often be the focus of negotiations in restructurings;
- the risk of triggering section 75 of the Pensions Act 1995 heightens the importance of pensions in restructurings. Section 75 imposes a debt obligation on employers if (broadly) the pension scheme starts to wind up or the employer enters liquidation or ceases to participate in the scheme. The debt is the shortfall in the scheme funding measured on a buy-out basis, which tests whether there would be sufficient assets to secure liabilities with insurance policies – this will often show a larger deficit than when measured on an FRS17 or IAS19 accounting basis. Many DB schemes will have substantial buy-out deficits (sometimes, even if there is an FRS17/IAS19 surplus). Furthermore, the last underlying full scheme valuation can be up to three years out of date (depending on when the last triennial valuation took place), so may not reveal the true deficit;
- pension scheme trustees are subject to special rules and not necessarily able to negotiate and settle liabilities on a commercial basis;
- if a restructuring leaves the pension scheme worse off, this may trigger the Pensions Regulator's (TPR) 'moral hazard' powers under the Pensions Act 2004. These powers allow TPR, in certain circumstances, to make third parties that are 'connected' or 'associated' with the employer liable for a pension scheme deficit (eg other group companies, directors and investors with a one-third or greater shareholding). Given the size of pension scheme deficits, the risk of being made liable will be a serious concern to a number of parties in a restructuring; and
- if the employer suffers a 'qualifying insolvency event' the Pension Protection Fund (PPF) may assume the rights of the pension scheme as a creditor. The PPF's powers and policies can exercise a major influence in the restructuring or rescue of an insolvent company.

The pension scheme trustees

Why is it important to include trustees in negotiations?

The practical effect of the Pensions Act 2004 and TPR's moral hazard powers is that the trustees are often given significant leverage in negotiations. For example, because trustees need to agree to a proposal if the parties are

seeking clearance from TPR: ie confirmation that TPR will not later use its powers (see below).

Trustees may also have significant power under the scheme's governing documents (but this will turn on the terms of the deed). For example, the trustees may have the power to wind up the scheme (triggering a section 75 debt). Inviting trustees into negotiations at an early stage may reduce the likelihood of trustees later taking actions that delay or frustrate a restructuring.

How will trustees act in negotiations?

TPR expects that 'when negotiating with an employer, trustees should generally adopt the approach of a bank that has advanced a large unsecured debt'. Trustees are expected to assess how the transaction would affect the pension scheme as an unsecured creditor, negotiate with the employer or, if they lack the necessary negotiating skills, instruct independent professional advisers to assist them in negotiations.

What result do trustees want from a negotiation?

A key objective for trustees will be to protect the pension scheme members. If a restructuring weakens an employer's financial ability or legal obligation to fund the scheme, then trustees will often seek some mitigation. TPR in its clearance guidance gives a non-exhaustive list of the types of mitigation that trustees can consider. These include: additional employer contributions of cash or assets; fixed or floating charges; escrow accounts; letters of credit, guarantees or insurance; and parental and intra-group guarantees.

But there may be circumstances in which the trustees may not ask for additional mitigation, agree to compromise a section 75 debt or perhaps give up a cash guarantee from an external institution (or perhaps replace it with alternative securities). The trustees may be willing to agree to this if it achieves a larger amount for the scheme than the trustees would obtain on the employer becoming insolvent and the scheme entering the PPF. The trustees may also be more amenable to such a proposal if it would prevent the employer from entering insolvency altogether – this is especially so given TPR's February 2009 statement on repairing pension scheme deficits. TPR stated that 'the best outcome for scheme and employer is a viable sponsor that will continue to support the scheme'. Also the Court of Appeal in *Foster Wheeler v Hanley* (2009) stated that trustees should act fairly towards the employer.

How can you implement an agreement with the trustees?

Schemes of arrangement under the Companies Act 2006 and company voluntary arrangements (CVAs) under the Insolvency Act 1986 can bind trustees to a compromise of the pension scheme debt if they are parties to it. However, a decision to compromise a pension scheme debt gives rise to a duty on the employer and the trustee to notify TPR (section 69 of the Pensions Act 2004). This may lead to a review of the proposed transaction by TPR. Unless clearance is obtained in respect of the compromise, it is possible that TPR may use its moral hazard powers – see below.

In addition, trustees will be unwilling to enter any agreements if doing so leads to the pension scheme becoming ineligible for entry into the PPF. If there is a legally enforceable agreement that has the effect of reducing a section 75 debt (eg a compromise of a scheme debt) the scheme may be excluded from the scope of the PPF. This does not apply to an agreement under a Companies Act scheme of arrangement.

There are also a number of statutory mechanisms under the Employer Debt Regulations 2005 that allow an employer, which is exiting a group scheme, to agree with the trustees for it to pay a lower share of a section 75 debt. For example, a regulated apportionment arrangement (RAA) can be used if the trustees are of the opinion that there is a reasonable likelihood of the scheme entering the PPF assessment period in the next 12 months (ie the trustees believe that there is a reasonable likelihood of the employer becoming insolvent) or an assessment period has already started. Such RAAs may help stave off insolvency but will need approval from TPR and the PPF must also not object.

TPR and its 'moral hazard' powers

TPR has significant powers to make third parties that are 'connected' or 'associated' with the employer liable to an employer's pension scheme. 'Connected' or 'associated' persons can include a range of parties including companies in the employer's corporate group, the directors of controlling entities and investors with

a one-third or greater shareholding in the employer (in a restructuring, this may concern a bank that is considering a debt-for-equity swap).

Financial support directions (FSDs) require a person to put in place, and maintain, financial support (broadly, funding or guarantees) for an employer's scheme if the employer is 'insufficiently resourced' or 'a service company'.

Alternatively, TPR may try to issue a contribution notice (CN) requesting that a person make a contribution to the scheme. TPR can issue a CN in the following circumstances:

- main purpose test: if TPR is of the opinion that the person was a party to an act or failure to act that occurred within six years, a 'main purpose' of which was to prevent or reduce the recovery of, or the amount of, any debt payable by the employer to the scheme under section 75 of the Pensions Act 1995; or
- material detriment test: if an act or failure to act has occurred on or after 14 April 2008 and, in TPR's opinion, it has detrimentally affected in a material way the likelihood of accrued scheme benefits being received.

The effect of the material detriment test, which was introduced in 2008, is that CNs can now potentially be issued in a wider range of circumstances. Simply weakening the financial position of the employer, even if unintended, could be interpreted as satisfying the material detriment test.

However, there are a number of safeguards in the legislation and steps that can be taken to minimise this moral hazard risk. For example:

- FSDs cannot be issued against individuals (which will be of comfort to 'company doctors' and insolvency practitioners (IPs));
- a CN cannot be issued against an IP who is 'acting in accordance with his function as an insolvency practitioner';
- the parties can apply to TPR for confirmation that it will not use its powers (this is called clearance);
- TPR must consider a number of 'reasonableness' factors before issuing a CN or FSD – in particular, if relevant, the position of the employer's other creditors before issuing a CN. The previous government said that this was intended to allay concerns of pension schemes becoming a 'super-creditor' in an insolvency situation. The pensions minister in 2008 also said that this factor would protect 'company doctors' who cause detriment that was reasonable in the context of the outcome for other creditors and have behaved reasonably: eg not wilfully ignore information or take reckless risks;
- directors can carefully minute the purpose of decisions that might weaken the strength of the participating employer's ability (or obligation) to fund the pension scheme. This is so that they can later prove that a main purpose of an act was not to prevent or reduce a section 75 debt; and
- parties may be able to rely on a defence to a CN under the material detriment test. Broadly, the defence will be available to a person who considers the effect of an act on scheme benefits, takes all reasonable steps to eliminate or minimise the risk and it is reasonable for that person to conclude that an act is not materially detrimental to scheme benefits. Again, directors should take care minuting decisions to make it easier to later rely on this statutory defence.

The PPF and distressed restructurings

If an employer with an eligible DB scheme enters into a formal insolvency then the PPF will assess whether it should take over responsibility for the pension scheme. During this assessment period the rights and powers of the scheme trustees are exercisable by the PPF and it has the power to participate, on behalf of the pension fund, in the restructuring or rescue of an insolvent company.

The PPF can agree to compromise the employer's section 75 debt (and all other liabilities to the scheme). To enable this, it is necessary for the employer to have a qualifying insolvency event (eg administration or a CVA).

The PPF may in some circumstances be in a better position than trustees to engage in a restructuring. Trustees cannot invest more than 5 per cent of the scheme's assets by value in their employer (or an associated or connected person), whereas the PPF can accept a sizable equity stake in the employer – allowing it to agree a debt-for-equity swap and avoid a prolonged and value-destructive insolvency process.

In its guidance for insolvency practitioners (updated May 2010), the PPF states that it will only ever participate in a restructuring or rescue if:

- insolvency is inevitable and the scheme receives consideration that is significantly better than the dividend that would be received if the company went into an ordinary insolvency;
- what is offered is fair given what the other creditors and shareholders are to gain as a consequence of the rescue (for example, the insolvency return might be £0 and the PPF is offered £500,000 in respect of a £100m pension debt. However, the expectation is that after the restructuring, the irrecoverable bank debt of £100m would become fully recoverable over time because the pension debt is no longer in the company. In such a case, the PPF would seek to extract a suitable 'price' from the bank for allowing it the opportunity of getting its money back over time);
- the scheme is given 10 per cent of the equity where the future shareholders are not currently involved with the company and 33 per cent if the parties are currently involved;
- TPR would not be able to use its moral hazard powers to generate more money for the scheme than the deal the PPF has negotiated;
- TPR is prepared to clear the deal;
- the banks' fees are reasonable, if the deal involves a refinancing;
- the other party pays the PPF's and the trustees' legal fees for documenting and executing the deal; and
- TPR has considered a draft clearance application.

In the past, the PPF has consistently applied its rule (see above) of asking for more equity if there is 'old money' involved in the restructuring (note that if there is a mixture of 'new' and 'old' money, the PPF may ask for between 10 per cent and 33 per cent equity). Knowing that the PPF will insist on an 'equity price', calculated according to its rigid rules, can actually speed up a restructuring because it avoids protracted negotiations and parties can plan ahead before approaching the PPF.

The Readers' Digest case

In February 2010, Reader's Digest Association (RDA) stated that TPR 'would not support an agreement already reached between [its UK subsidiary], the trustees of its pension plan and the UK Pension Protection Fund (PPF) to settle a longstanding pension plan liability'.

TPR may have rejected this compromise because it expected that more could be recovered either by the trustees pursuing a section 75 debt in the administration or by TPR exercising its moral hazard powers to recover funds from other connected or associated companies.

The Readers' Digest case shows that the PPF's requirement that TPR 'clear the deal' is more than a formality, even if all other parties are in agreement. Previously TPR has indicated that it preferred being 'a referee not a player'; it would allow parties to reach agreement among themselves, rather than exercise its powers. However, this case represented a direct rejection of an agreement reached between the other parties (including the PPF).

Concluding thoughts

This area of law will be daunting for many. It is complex and there have been frequent changes.

But the main thing to remember is that DB pension schemes can be large creditors. This can make pension scheme trustees, TPR and the PPF key players in restructurings and they may need to be invited to the negotiating table early on.

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