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BRIEFING

SUMMARY JULY 2010

Section 75 of the Pensions Act 1995: two new easements

EMPLOYMENT, PENSIONS AND BENEFITS BRIEFING 197

Since 6 April 2010, employers have been able to use two new easements during corporate restructurings to manage pension scheme debts that can arise under section 75 of the Pensions Act 1995.

This briefing analyses the changes, discusses whether they will be helpful to employers and considers how they compare to tried and tested strategies for managing section 75 debts and the role of trustees if employers choose to use these new tools.

The Employer Debt Regulations 2005 (employer debt regulations) were amended on 6 April 2010 to make it easier to carry out some corporate restructurings without triggering a debt under section 75 of the Pensions Act 1995.

The relaxed rules can be used only in one-to-one restructurings between two current employers – and one of the employers must agree to take over all the other's employees, assets, scheme members and scheme liabilities. Other conditions must also be satisfied.

Background

If an 'employment-cessation event' (ECE) occurs, an employer that participates in an underfunded defined-benefit (DB) scheme will be required by statute to pay the trustees their share of the pension scheme's liabilities – these can be substantial when measured on the required buy-out basis. An ECE occurs if an employer stops employing its last active member in a multi-employer pension scheme and another employer continues to employ an active member in the scheme.

ECEs can, for example, commonly occur if a company sells its subsidiary so that the subsidiary leaves the corporate group (assuming it ceases to participate in the scheme) or if a company's employees transfer to a new employer on a business sale. This can therefore hinder a restructuring.

What has changed?

On 6 April 2010, the former Labour government amended the employer debt regulations so that it could introduce 'greater flexibility for employers, whilst at the same time maintaining member protection' (September 2009 consultation paper).

The amended employer debt regulations now contain a 'general' and '*de minimis*' easement that can be used in, for example, an intra-group re-organisation. These easements mean that, in some limited circumstances, an ECE that would otherwise occur will not be treated as occurring – therefore, no section 75 debt is triggered.

Broadly, the general easement is meant to allow restructurings that do not entail a weakening in the employer covenant and the *de minimis* easement applies to small-scale restructurings.

A key feature of both easements is that they can only be used in 'one-to-one' transactions, where one employer (the 'receiving employer') agrees to take over all the other employer's (the 'exiting employer') employees, assets, scheme members and scheme liabilities. The easements are not available, for example, in multiple restructurings across an employer group.

Both employers must already participate in the multi-employer scheme and employ at least one active DB member. The receiving employer must also either be 'associated' (within the meaning of the Insolvency Act 1986) with the exiting employer or itself is the 'new legal status' of the exiting employer (see below).

Who will the changes help?

Only companies that are employers

The easements are only available for restructurings between two parties that employ at least one person who is an active DB scheme member.

Employers that do not employ an active DB member would need to do so before using either easement. If the receiving company is not yet an employer, it would need to become one.

According to the former government, if the receiving employer is newly created it may not be possible for that employer to be already participating in the scheme before completing the restructuring: 'The policy is, therefore, that the receiving employer only has to employ at least one active member in respect of whom defined benefits are accruing once the transaction is completed.'

For restructurings involving newly created employers (and companies that are not yet employers) the trustees may, in practice, be able to veto the transaction. In many schemes, the trustees must consent before a new company becomes a participating employer.

When will the two employers be associated?

The concept of 'associated' will normally catch companies in the same group but can also catch a much broader ranger of entities. For more information see our briefing *Who is 'connected' or 'associated'?*, January 2009.

The employers can cease to be associated after the easements have been used in the restructuring – but this may trigger a section 75 debt for different reasons.

What is the 'new legal status' of an employer?

The employer debt regulations do not explain what is meant by 'new legal status'. But the former government's September 2009 consultation stated that the effect of this provision is that if a change is made to the legal status of an employer (for example, a general partnership becomes a limited liability partnership, which is a body corporate) the parties can use the general easement to ensure no debt is triggered on that change in status. This may also cover the conversion of a company into a European company (SE) under the relevant European legislation.

Under the employer debt regulations, a section 75 debt may otherwise be triggered where there is a change of legal status. So this provision may be some help.

No record of insolvencies

There is an additional requirement that neither the exiting nor receiving employer must have previously suffered an insolvency event, been voluntarily wound up or a section 129 of the Pensions Act 2004 notice have been made[1].

This appears overly restrictive. If an insolvency occurred in the past but has since been discharged, there is no obvious reason why the easements should not apply.

A closer look at the changes

Taking over the exiting employer's assets, employees, scheme members and scheme liabilities

To use either the general or *de minimis* easement, the receiving employer is required (on or after 6 April 2010) to use a legally enforceable agreement to take over *all* the exiting employer's:

- assets ('without exception', even if greater than the exiting employer's liabilities to the scheme);
- employees (regardless of whether they transfer under the Transfer of Undertakings (Protection of Employment) Regulations 2006 (TUPE));
- pension scheme members; and
- DB liabilities to the scheme (including any liabilities that are not attributable to any employer – ie orphan liabilities – or any scheme funding liabilities under a schedule of contributions or recovery plan).

Presumably, the requirement to transfer all the exiting employer's assets means that the benefit of being able to enforce the legally enforceable agreement against the receiving employer would also have to be transferred to that receiving employer – ie this will give the receiving employer the ability to enforce the transaction against itself. It is not clear if this was the former government's intention.

[1] Section 129 applies to some employers who cannot enter an insolvency process (eg charities or trade unions). It allows the trustees and pensions regulator to trigger the Pension Protection Fund (PPF) process by a notice to the PPF if the scheme's employer is unlikely to continue as a going concern.

All the employees need to transfer or cease to be employed. Not one employee can remain with the exiting employer.

- If TUPE applies (eg because it is a transfer of the whole of the business of the exiting company), the employees will transfer automatically. TUPE allows for employees to refuse to transfer, but the exiting employer will need to treat them as having resigned or as dismissed. In either event, they will cease to be employees of the exiting company so the obligation that the receiving employer takes over all employees will have been met.
- If TUPE does not apply (probably unlikely), the employees will almost certainly need to consent if they are being transferred to the receiving employer. Consent may be relatively easy to obtain, since the exiting employer will presumably cease to trade once the transfer takes place. However, if any employees do refuse to transfer then the exiting employer will either have to persuade them or dismiss them.

The transfers must take place within 18 weeks of the trustees notifying the receiving and exiting employers they are satisfied that either the restructuring test is met (in the case of the general easement) or the relevant thresholds are not exceeded (for the *de minimis* easement). This period can be extended by up to 18 additional weeks if the trustees agree.

Unfortunately, the legislation does not explain how this legally enforceable agreement is meant to operate when taking over the pension scheme members and liabilities.

If it is 'impossible' for the receiving employer to use a legally enforceable agreement to take over 'all' its scheme liabilities, the exiting employer's liabilities have to be 'treated for all purposes as being the responsibility of the receiving employer' instead. Again, the legislation does not explain how this is to be achieved.

General easement

To satisfy the general easement, the trustees and employers are required to carry out seven steps (see table below).

The main financial test is for the trustees to be 'satisfied' that the receiving employer will be 'at least as likely' to meet the exiting employer's scheme liabilities and their own pre-existing liabilities after replacing the exiting employer – the 'restructuring test'.

The former government, in its consultation response, stated that its policy intention is for the trustees to be 'broadly satisfied' (ie 'all things considered and taking one thing with another') that the restructuring test is met and not necessarily 'certain'.

When applying this restructuring test, the employer debt regulations state that trustees must take into account the change in employer covenant – ie 'factors including any material change in legal, demographic or economic circumstances… that would justify a change to the method or assumptions used on the last occasion on which the scheme's technical provisions were calculated [under the scheme-specific funding requirements]'.

Although this easement is only meant to apply to 'one-to-one' restructurings, the former government commented that 'there is no limit on the number of such transactions that can be undertaken by employers for the general easement'. But, in practice it is not clear how attractive it is to repeat the procedure a number of times, given the prescriptive nature of the seven-stage test and the cost of a covenant review to help satisfy the 'restructuring test'.

De minimis easement

The *de minimis* easement is intended to apply only in cases of small-scale corporate restructuring.

To use this easement, the trustees and employers need to take five steps. However, there is no need to satisfy a restructuring test or funding test (as there is for scheme apportionment arrangements – see below).

The former government suggested that this easement may be helpful where, for example, it is inappropriate to use the general easement because of 'potential extra cost that covenant assessments could entail (which could well outweigh the actual level of employer debt)' due to the restructuring test.

The *de minimis* easement states that a section 75 debt will not be triggered if, among other things, the trustees are satisfied that:

- the scheme is funded up to Pension Protection Fund (PPF)-protected levels;
- the number of DB scheme members who are attributable to the exiting employer is either no more than two, or less than three per cent of all the DB scheme members, whichever is greater;

- the total annual amount of accrued pensions of the members that are transferring does not exceed £20,000 in the 2010-11 tax year (this figure will be increased by £500 in subsequent tax years); and
- in a rolling three-year period the *de minimis* easement is not used to transfer more than five members, or 7.5 per cent, of all the DB scheme members – whichever is larger. The total annual amount of accrued pensions of members who are transferring must also not exceed £50,000 in this three-year period. The former government commented that these restrictions are intended to 'limit the number of times the *de minimis* easement can be used in a multi-employer scheme'.

Cut-off date and moral hazard

An ECE will be treated as having occurred as normal (and therefore a section 75 debt will be triggered) if some of the steps necessary for the general and *de minimis* easement are not carried out before a six-year 'cut-off date'.

An ECE will be treated as having occurred if the employers provided incorrect or incomplete information and the trustees are satisfied that they would 'have made a different decision' when deciding if the restructuring test was satisfied for the general easement. This makes accurate and full information fundamentally important. Employers will also not be sure about how much information they must give the trustees, so it would be unreasonable for the trustees to claim that any gaps in the information (that are subsequently discovered) would have been fundamental to their decision.

An ECE will also be treated as having occurred where either easement was used and there has been an incomplete transfer of assets, employees, scheme members or scheme liabilities; or the employers failed to notify the trustees of the transfer. Again this creates some uncertainty because it is not clear how parties are expected to use a 'legally enforceable agreement' to transfer scheme members and scheme liabilities, as discussed above. Also, it is not clear who should be a party to or be able to enforce such an agreement, as discussed below.

The former government introduced this six-year cut-off date to 'address situations where the general easement could otherwise hamper future corporate mergers and acquisitions if a potential debt continues to hang (for an indefinite period) over a company or companies eg where the group later wishes to dispose of that company or those companies.' However, the many uncertainties discussed in this briefing will make it difficult for employers that use the easements to be confident that a section 75 debt will not still be triggered within the six years.

Cost of the restructuring

The trustees or managers may allocate 'any costs' incurred by them because of a restructuring under easement to the exiting, receiving or both employers.

The amended employer debt regulations do not contain any provisions for the employers to dispute these costs.

Are the easements more useful than scheme apportionment arrangements?

The easements do not replace scheme apportionment arrangements (SAA) under the employer debt regulations. SAAs allow trustees to agree to the exiting employer paying an agreed share of the scheme's liability, which can be less than their default share. The remaining employers must, however, be able to meet the 'funding test' (see below).

In practice, only the general easement will be relevant to most transactions, given the low thresholds for the *de minimis* easement.

It appears easier for employers to satisfy the restructuring test for the general easement than the funding test for SAAs – giving them an important advantage in the limited circumstances under which the easement can be used.

For SAAs, the trustees have to be reasonably satisfied that 'the remaining employers will be reasonably likely to be able to fund the scheme' in accordance with the scheme-specific funding requirements. Depending on the scheme liabilities, the employers may have a task on their hands persuading the trustees that they can meet this standard – giving the trustees greater bargaining power in a transaction.

In addition, the trustees' consent is needed for the SAA.

Conversely, for the general easement the trustees only need to be satisfied that the receiving employer's ability to fund the scheme is no worse than the exiting employer's (even if the outlook is poor for both companies).

However, uncertainties and practical difficulties may undermine the advantage of using the general easement instead of the SAA.

For the general easement (and the *de minimis* easement), it is unclear who must be a party to and be able to enforce the 'legally enforceable agreement' to take over the receiving employer's assets, employees and pension scheme members. It could be argued that the trustees or pension scheme members should be able to enforce the legally enforceable agreement and/or be a party to it (not just both employers). If this is correct, the trustees and members may have a greater role to play in restructurings. For example, they would have significant discretion when deciding whether to agree to the legally enforceable agreement. This would undermine the supposed benefit of using the general easement instead of the SAA.

However, the drafting of the employer debt regulations suggests that the former government probably did not intend anybody other than the exiting and receiving employer to be a party to the agreement or be able to enforce it. Nevertheless, it would be helpful if it had addressed this point (especially given that we made the former government aware of this uncertainty when it consulted on the changes).

A practical difficulty with the general easement is that the trustees must be convinced that the restructuring test is satisfied right up to the point of transfer to the receiving employer. The employers will therefore need to co-ordinate their signing of the agreement with the trustees' confirmation of their continued satisfaction. To overcome this, the trustees will probably either need to meet (at the point of transfer) to confirm this decision or delegate it to someone who will be present at the time of transfer.

These uncertainties and practical difficulties do not necessarily mean that the general easement is less useful than the SAA, just that it is less tested.

Clearance?

The former government also commented that 'there is nothing in these regulations that would prevent the Pensions Regulator from using its anti-avoidance powers [to issue a contribution notice or financial support direction] where it considers it reasonable to do so, and the legal tests for using those powers have been met'. So clearance from the Pensions Regulator may still be necessary, or at least desirable.

Should the parties notify the Regulator?

There is probably an obligation to notify the Pensions Regulator when using either of the easements. The requirement for the exiting employer to transfer all its assets and employees will probably mean that it will 'cease to carry on business in the United Kingdom', which must be notified to the Regulator under the Pensions Regulator (Notifiable Events) Regulations 2005. This notifiable event is *not* one that benefits from the exemption that applies to some notifiable events if the relevant scheme is funded over the PPF level.

The employer will probably have to notify the Regulator as soon as reasonably practicable after it decides to enter such a transaction, which will be before the transaction is finalised. The Regulator's guidance indicates that this obligation implies urgency: 'For example, where a trustee is made aware of a notifiable event on a Sunday, the Regulator should be notified on Monday.'

Failure to notify, without reasonable excuse, can lead to a civil fine on the employer (and the directors and officers who cause a company to fail to comply with its obligations). The maximum civil fine is £5,000 for individuals and £50,000 for a company.

The Pensions Act 2004 also stipulates that failure to report a notifiable event may, in some circumstances, make it 'reasonable' for the Regulator to issue a contribution notice under its moral hazard powers.

For more information see our briefing *Obligation to report specific events to the Pensions Regulator*, March 2009.

Steps needed for general and de minimis easements

General easement	*De minimis* easement
Employers should also consider whether it is necessary to notify the Pensions Regulator and/or desirable to ask it for clearance. This may affect the timetable below.	
Step 1 – must take place before step 2 (exiting employer to decide when) Exiting employer to write to trustees asking them to make their decision on restructuring test in step 4.	**Step 1 – must take place before step 2 (exiting employer to decide when)** Exiting employer to write to trustees asking for them to make decision.
Step 2 – must take place 'without undue delay' Both exiting and receiving employer (unless receiving employer not yet created) provide information to trustees. Trustees may request information (which employers must provide).	**Step 2 – must take place 'without undue delay'** Trustees to decide if they are satisfied that restructuring is below the de minimis threshold tests.
Step 3 – must take place 'without undue delay' Trustees consult both exiting and receiving employer (unless receiving employer not yet created) about restructuring test in step 4.	**Step 3 – must take place 'without undue delay'** Trustees to notify both exiting and receiving employer (unless receiving employer not yet created) in writing of their decision and reason for decision in step 2.
Step 4 – must take place 'without undue delay' Trustees to decide if they are satisfied that restructuring test is met.	**Step 4 – must take place within 18 weeks (or up to 36 weeks if trustees agree) of step 3** Receiving employer to take over exiting employer's assets, employees, scheme members and liabilities under a legally enforceable agreement.
Step 5 – must take place 'without undue delay' Trustees to notify both exiting and receiving employer (unless receiving employer not yet created) in writing of their decision and reasons for decision.	**Step 5 – must take place 'without undue delay'** Both employers notify trustees that step 4 is completed and date of completion.
Step 6 – must take place within 18 weeks (or up to 36 weeks if trustees agree) of step 5 Receiving employer to take over exiting employer's assets, employees, scheme members and scheme liabilities under a legally enforceable agreement. Receiving employer decides whether to take step 6, but can only do so if: □ trustees decided they were satisfied in step 4; □ trustees are satisfied there has been no change that would alter their decision in step 4; and □ within 18 weeks (or up to 36 weeks if trustees choose).	
Step 7 – must take place 'without undue delay' Both employers notify trustees that step 6 is completed and date of completion.	

Other legal issues

The other legal implications of a relevant transfer will also need to be considered, including those listed below.

- Employee notification and consultation: the transfer is likely to be a transfer within TUPE, so appropriate notification and consultation will be needed. In practice, these may be minimal if no changes in employment terms or working conditions are envisaged.
- Onward position of exiting employer: the exiting employer will cease to have any assets or employees (it may perhaps retain non-scheme-related liabilities). In practice, this is likely to mean that the exiting employer is technically insolvent, so its directors will aim to transfer all liabilities as well (or perhaps look for some legal support for them from the receiving company).
- Implications for benefits under the scheme: in practice, it is likely that benefits will continue as before for the relevant employees (ie their service will be treated as continuous). The terms of the scheme need to be checked to confirm this. Schemes that have closed to new entrants and are relying on the exemption from indirect age discrimination under the relevant regulations will need to check that this exemption continues to be available.
- Providing information: the fact that the exiting employer will cease to be an employer probably needs to be notified to the trustees within one month, under the Scheme Administration Regulations 1996 – for background information on these regulations see our briefing *When should employers disclose a proposed transaction?*, March 2010. The trustees will want to inform the advisers (eg actuary and auditor) and consider if any change to, for example, the schedule of contributions is desirable as a result.

More to come?

The former government stated that technical clarifying amendments would be made to the employer debt regulations – although there has been no indication that these will clarify how the new easements are intended to operate. It had originally proposed making some of these changes in its September 2009 consultation but they did not materialise.

The former government suggested that it would consider whether multiple transactions (eg one-to-many) in a group of associated companies 'should not trigger a debt where all the assets remain within the same group, and what safeguards might be appropriate to recognise the complexity and increased risk to members of such transactions'. We do not yet know if the recent change in government will affect any of these policy commitments.

In June 2010, the Regulator stated that it will issue guidance on these new easements.

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