

# MACFARLANES

## PENSIONS

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### BRIEFING

#### RESTRUCTURING OF PENSION SCHEMES – RECENT TRENDS IN THE UK

The point of a pension scheme, one would hope, is that it will be around for a very long time – ideally, as long as its members and their dependants. Corporate life expectancy has diminished significantly in the last 50 years just as human life expectancy has increased. Change for corporate groups has become a normal part of business life and this typically requires the restructuring of the group's pension schemes. A key element driving new trends in pension scheme restructuring is the maturity of the schemes and the fact that many of them are now closed to current accrual. The connection of a pension scheme with the business that sponsors it is often tenuous.

For the purposes of this article, what I refer to as pension scheme restructuring is the manner in which pension scheme assets and liabilities are grouped or held, rather than any change to the liabilities. For simplicity, this article considers only the issues affecting defined benefit pension schemes. There may be a range of motivations for restructuring a pension scheme:

- ◆ the desire to minimise administrative costs;
- ◆ to share or spread or reallocate the cost;
- ◆ to increase security for the scheme;
- ◆ to limit a company's exposure to the scheme or to some part of the scheme;
- ◆ to limit cross-subsidy between different businesses; or
- ◆ to insulate certain tranches of benefits.

As one would expect, the point of any restructuring is to ensure the structure meets the commercial objectives.

What has changed in recent years is that, in the main, schemes are no longer contributing to the success of the businesses that support them by helping to recruit and retain employees because in most cases they have been closed to new entrants or even closed to future accrual. The weight of liabilities relating to former employees outstrips those relating to current employees. For a variety of reasons, most schemes are now in deficit on some basis or other, whereas in the past funding surpluses (or what were then perceived to be funding surpluses) were not uncommon. As a result, pension schemes are not seen as an asset to the business but as legacy liabilities, a burden bringing little benefit. This has driven new trends in restructuring.

A merger is perhaps one of the most traditional forms of pension scheme restructuring. Under English law, pension schemes can't strictly be merged. Instead, the assets and liabilities of one scheme are transferred to another which becomes the merged scheme. Scheme mergers remain common. When pension schemes were generally open, merging pension schemes following corporate acquisitions was sometimes a way of signalling the unity of the group to employees and harmonising benefits available to all employees. Today, those objectives apply less frequently and it is rare to see pension scheme benefits being harmonised on a merger. The key objective is more often to save costs having regard to increasing regulatory and administrative obligations: one scheme means one set of trustees; one set of trustee advisers; and one actuarial valuation.

In the days of surpluses and more relaxed funding regulation, a merger might also enable the cost of benefits being accrued in one pension scheme to be met from the existing resources of another. Today, despite greater legal protections for schemes, including the obligation of employers to meet the insurance market cost of benefits on winding up, there is more sensitivity over funding levels and a stronger focus on the potential impact on members' benefits of future employer insolvency, even where such an event is seen as unlikely. As a result, there is a trend towards so-called segregated mergers which bring several funds together under the umbrella of a single pension scheme (a "sectionalised scheme") but without actually merging the assets and liabilities. This is sometimes done on a transitional basis to allow time for the funding of the two schemes to level with each other. In other cases, it may be permanent, either to protect certain groups of beneficiaries from dilution in the event of an insolvent winding up of the merged scheme or to protect employers from cross-underwriting each other's solvency risk. The result is that mergers are now more often about amalgamating different schemes while preserving the existing benefit designs and separate funding.

To segregate or not to segregate is a crucial issue for pension schemes and employers. This leads to internal restructuring either to "sectionalise" an unsegregated fund or to remove existing segregation and pool funding.

The advantages of running a single fund are many:

- ◆ it allows collective investment of assets without the need for a common investment fund (a separate trust through which several pension schemes may invest their assets to get the advantages of size);
- ◆ for multi-employer schemes, discounts apply on levies

payable to the Pension Protection Fund to recognise the lower risk associated with a non-segregated fund and the cross-underwriting of solvency risk by the participating employers;

- ◆ no part of the scheme will transfer to the Pension Protection Fund or be required to wind-up until the last of the participating employers suffers an insolvency event;
- ◆ the ability to look to several employers for the security of the scheme may enable the trustees to take a more relaxed view on investment and funding and fluctuations in the financial standing of the employers;
- ◆ there may be further advantages in respect of tax relief as profitable entities participating in the scheme may be able to benefit from tax relief on contributions made in respect of pension liabilities actually attributable to less profitable employers participating in the group; and
- ◆ it avoids the need to make internal transfers in relation to employees moving around a group; and it provides simplicity in the administration.

On the downside, in the event of an insolvent winding-up of the scheme, members with high value benefits will suffer more dilution than in a sectionalised scheme.

The advantage of having segregated funds (i.e. a sectionalised scheme) is primarily to protect employers from financial risk in relation to other employers and their pension liabilities and to protect members with high value benefits from greater dilution. In a segregated fund an employer is solely responsible for the funding in relation to its own section of the scheme both on an on-going and on a winding-up basis. It will not inherit liabilities when another participating employer goes into insolvent liquidation. The investment and funding strategy can be tailored to reflect its own financial standing rather than that of the group. Another technical advantage is that when an employer ceases participating in a single employer section of a pension scheme, no statutory debt is triggered (under section 75 of the Pensions Act 1995). Instead, the employer will remain contingently liable for a debt which will be triggered only on the winding-up of the section, as would be the case for a single employer pension scheme. As the statutory debt represents any shortfall in the assets below the cost of securing the pension promises on the insurance market, the triggering of such a debt when an employer ceases participating can be a material issue. Segregated sections may be wound up or transferred to the Pension Protection Fund independently of other sections.

Internal sectionalisation will not always provide sufficient separation on a corporate transaction. Corporate transactions are often the drivers for so-called de-mergers. For a variety of commercial reasons, a buyer acquiring a company may be willing to assume some of the liabilities of a pension scheme but not all. If some of the pension liabilities and associated assets are to remain with the seller's group, a de-merger will be required. This essentially requires the establishment of a new pension scheme to which some part of the liabilities are to be transferred. Typically, to secure the co-operation of the trustees of the existing scheme, the new scheme will need to be on similar terms. To avoid any group of members suffering a dilution of security the funding will have to be shared on a basis that acknowledges both the relative risk profiles of the different sections of benefit and the difference in the financial standing of the companies sponsoring each scheme. Commonly, additional funding may be required to recognise the loss of the element of cross-underwriting in a group scheme and the impact of any acquisition debt.

Sometimes there may be a need to completely sever the relationship between a company and its pension scheme. This may happen where a company is sold and the buyer does not wish to assume the pension scheme liabilities. This is most common where the pension liabilities are largely historical and do not relate to the current workforce, an increasingly common occurrence. Restructuring of the relationships between the corporate group and the scheme is then required.

To separate a company from a pension scheme was once a matter of terminating its participation in the scheme which would terminate the employees' benefit accrual. Typically, a simple notice to the trustees was required. Terminating accrual now requires consultation with employees. However, the real focus is now on achieving the effective release of the company from all financial obligations to the scheme. For this, its statutory liability, particularly under section 75, must be terminated.

If the funding obligations of the target company are to be discharged without full payment of any section 75 exit debt or without transferring the liabilities to an insurer and paying the insurance market cost of those liabilities, another company must be found, generally within the seller's group, to step into the shoes of the target company and assume its liability. There are statutory processes for achieving this, known as scheme apportionment arrangements, regulated apportionment arrangements and withdrawal arrangements. These require the involvement of the trustees and may require satisfaction of funding tests, some additional funding to the scheme and approval from the Pensions Regulator. In some cases guarantees, contingent assets or

security may be required in order to secure the agreement of the trustees or the Regulator. As liabilities can only be transferred to companies that qualify as employers in relation to the scheme, frozen schemes may need to be re-opened for short periods and employees may need to be transferred around the group just to enable the pension liabilities to be reallocated. Guarantees can be used to provide access to the resources of companies that do not qualify as employers, provided there is at least one company in the group that is a scheme employer.

Another new trend is the use of asset-backed arrangements to provide cash flows directly to pension schemes. There are a range of structures emerging. The principles are that, rather than providing additional contributions or collateral, companies with valuable income generating assets (such as a real estate portfolio or intellectual property rights) may transfer the asset to a special purpose vehicle, which is not treated as associated with any of the employers, often on a collateralised sale-and-lease-back basis to generate a flow of revenue to the pension scheme. Another recent development is for a group to contribute its stake in a subsidiary with a free-standing business into the scheme. The scheme will then receive not only the value of the free cash flow that that subsidiary might have been able to generate (and which could have been used to pay contributions) but also any increase in its equity value. This is particularly suitable for young businesses that have strong prospects but are not generating material profits from which to pay contributions (or need to reinvest their profits). As a recent example, John Lewis transferred its stake in Ocado to its pension scheme. Ocado's proposed flotation should secure more value for the scheme than could otherwise have been achieved from its business.

The most significant current trend in pension scheme restructuring is not in the internal reorganisation of schemes but in changing the relationships between the scheme and members of a corporate group. This is essential if pension schemes are to outlive the businesses whose recruitment and remuneration strategies they originally supported. As companies are reorganised, sold, or fail, pension schemes and their corporate ties must be restructured to ensure the schemes are around when the employees reach their golden years.

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