

MACFARLANES

PENSIONS

BRIEFING

REGULATION OF SCHEMES/REGULATORY APPROACHES

SUMMARY

The Pensions Regulator (TPR) has significant regulatory powers under Pensions Act 2004, including subject to a “reasonableness” constraint, power in certain circumstances to require other group companies (whether or not UK companies) to provide support for the pension plan, and to penalise corporate activity which potentially weakens the support which can be provided to the plan by the UK sponsor. TPR has shown an appetite to exercise its powers even in complex insolvencies of multi-jurisdictional companies and there is growing evidence in its published determinations of the circumstances in which TPR is likely to consider it reasonable to do so. TPR’s powers are exercisable in relation both to solvent ongoing businesses and to target companies in insolvency. As a result of the December 2010 High Court decision in Nortel and Lehman, the potential exists for TPR to be able to obtain priority for the pension plan over all other unsecured creditors and floating charges by choosing the date on which an FSD is issued. Issues remain with regard to the enforceability of regulatory powers in other jurisdictions.

Objectives and powers

1. TPR has two principal statutory objectives:
 - ◆ to minimise claims on the Pension Protection Fund (the statutory insurance scheme funded by levies on pension plans); and
 - ◆ to protect member benefits¹.
2. To achieve these goals, TPR has exercised a wide variety of powers:
 - ◆ in relation to scheme funding, where it has encouraged the use of guarantees and other contingent assets to improve scheme security in cases where there are affordability constraints;
 - ◆ by highlighting the risk of regulatory action (Contribution Notices (CN)) if money or assets leave the sponsor group or sponsor support is reduced, if other stakeholders or creditors are preferred or if attempts are made to avoid the employer’s statutory debt or action which otherwise materially reduces the likelihood of member benefits being paid². A CN can be

for the full statutory buy-out debt, or a lesser specified amount, against the employer or persons “connected” or “associated³” with the employer at the relevant time – six years ending with the date of the determination to issue a CN. Once issued, the CN becomes a debt due from the recipient to the scheme;

- ◆ by highlighting the risk of regulatory action (Financial Support Directions (FSD)) against persons who are “associated” or “connected” at the relevant time (two years ending with the date of the determination to issue an FSD) with the plan sponsor of an under-funded plan in cases where the sponsor does not have appropriate resources to fulfil its obligations to the plan⁴ and where the associated/connected companies are able to meet 50 per cent of the statutory buy out debt. The FSD is a direction to the target entity to put in place financial support until such time as the scheme winds up. The support could be to create joint and several liability among group employers, a parental guarantee or the injection of additional resources. Enforcement is by issue of a CN; and
 - ◆ by creating an environment in which scheme trustees are encouraged to be more assertive in dealings with the plan sponsor and where trustees are expected to “comply or explain” i.e. follow regulatory guidance and codes or justify their not having done so. This extends to issues as diverse as the management of conflicts and the measures trustees are expected to take to monitor corporate activity and performance in order to assess the value of the company covenant. The use of guidance and statutory codes of practice have been particularly effective in driving behaviour of plan trustees and the advice they are likely to get from their advisers.
3. The Regulator has various ways of promoting its objectives, some of which are contained in legislation and others which have developed as practice:
 - ◆ mandatory reporting by filing of annual returns, the requirement for trustees and employers to notify prescribed events and “blowing the whistle” obligations;
 - ◆ creating a “comply or explain” environment by the use of codes of practice and guidance;
 - ◆ using guidance to influence voluntary clearance applications in corporate transactions;

¹ S5(1) Pensions Act 2004.

² Contribution Notice powers were significantly extended by Pensions Act 2008 (s38(5)), and the “material detriment” test contains no bad faith requirement. CNs can be issued against individuals. A statutory defence exists.

³ A company is broadly associated or connected with the employer if it owns or controls one third or more of the employer’s shares, or is a sister company or subsidiary.

⁴ FSD powers extended by Pensions Act 2008 by providing that group companies’ assets should be aggregated for the purposes of the “insufficiently resourced” test (sometimes called the “rich man/poor man” test). FSDs may also be issued against service companies (see Sea Containers, below).

- ◆ proactive statements of its view of the law (not necessarily shared by pensions lawyers) and careful and repeated PR around certain cases and intervention;
- ◆ refusing to give redacted details of the outcome of its general case load although it does publish reasons for its Determinations; and
- ◆ international co-operation e.g. Memorandum of Understanding dated 4 November 2009 between PBGC, PPF and Pensions Regulator.

TPR approach

TPR considers that it has a reputation “as a pragmatic and proportionate” regulator (2011-2014 Corporate Plan). This is not always the view of practitioners.

It is clear that TPR considers that whenever there is value within the direct employer group, this should be available to support the pension scheme. The competition for sponsor resources is particularly acute where a company enters administration, but TPR also focuses on the preservation of the underlying employer business at a much earlier stage in its life, which requires an examination of ongoing corporate activity. For example, certain transactions have been characterised in regulatory guidance as “Type A events” which should be considered for clearance⁵, thus giving TPR an opportunity to intervene and engineer the payment of a “price” for clearance. The concept of the “company covenant” (the ability of the employer to support the plan) has been developed through regulatory guidance with an associated obligation on plan trustees to monitor the covenant, and to negotiate “mitigation” (compensation) if corporate activity adversely affects the company covenant. TPR encourages trustees to involve it where necessary, and has been keen to emphasise its view that employers should provide as much information as possible on corporate activity.

In its recently published Corporate Plan, TPR states as a deliverable in 2011/2012 that it will “proactively scan the market and engage with schemes and employers where our intelligence indicates that there may be issues. In particular, we will seek to identify corporate activity that might signify a reduction in corporate support to a pension scheme.”

A longstanding criticism of TPR in some quarters is that it has tried to push the pension scheme (which is in law an unsecured creditor of the employer) to “super creditor” status (albeit that one of the factors that TPR is required to

consider before issuing a CN is the likelihood and extent of relevant creditors being paid). It has also suggested, with studied ambiguity that in certain circumstances the payment of dividends might not be appropriate where a pension deficit exists. In considering whether it is reasonable to exercise its anti-avoidance powers, TPR also looks carefully at whether companies operating in more than one jurisdiction have manipulated costs, income and profit flows.

An overseas company may of course assume a direct legal obligation to the UK pension plan, typically by entering into a parent guarantee. This may be limited in amount, or could extend to the full amount of the statutory buy-out debt, but in either case will normally be in PPF standard form so as to be taken into account for PPF levy calculation purposes. However, we are concerned in this paper with the indirect risk that UK or overseas group companies assume as a result of the existence of TPR’s FSD and CN powers. Here, TPR makes no distinction in principle between UK and overseas companies and has shown a willingness to participate in litigation to assert those rights, albeit that resource may become an issue and that not all of these interventions have been successful (see for example a US Court’s refusal in Visteon to entertain an FSD claim in Chapter 11 proceedings and the subsequent withdrawal of proceedings by TPR). TPR’s position is well illustrated in its December 2010 press release following the Lehman/Nortel case.

“Our statutory objectives require us to protect pension scheme members and the Pension Protection Fund. In pursuit of these objectives we can issue an FSD (financial support direction) to secure reasonable financial support is provided to a pension scheme. We are required by the Pensions Act 2004 to act reasonably in using these powers and to have regard to the interests of those directly affected by them. Where schemes are left with inadequate financial support, the regulator engages with all who might have a responsibility to support the scheme to ensure, where possible and reasonable, that the interests of scheme members are protected...”

Legislative changes since 2004 continue to bring overseas parents within the scope of regulatory activity, even if this is not always appreciated, e.g. corporate activity by guarantor may also affect the company covenant and raise “material detriment” issues. The question is whether or not the regulatory action can be enforced, rather than whether there is the intention and willingness to target overseas

⁵ Clearance is a voluntary procedure which if obtained provides protection against CNs/FSD’s.

group members in certain circumstances. (See helpful paper produced for Association of Pension Lawyers Annual Conference 2010 by Dan Schaffer and Roderick Morton of Herbert Smith in relation to overseas enforceability of CN's and FSD's either in another EU state or an EFTA state under the Brussels Regulation or Lugano Convention, in Commonwealth or other countries where reciprocal enforcement of judgement treaties apply, and countries where no such treaty exists). The key in all cases is likely to be whether CN's/FSD's can be regarded as civil or commercial matters and whether or not they go beyond the assertion of private law rights such as could be brought by plan trustees (when they would likely be enforceable) towards public laws constituting a governmental interest when they would not).

Constraints on TPR

The overall constraint on TPR's main regulatory powers is that it must act reasonably in issuing CN's or FSD's, albeit that it is TPR's own view of what is reasonable rather than an objective standard which is relevant⁶. The legislation gives TPR wide discretion in arriving at decisions, providing only a non-exhaustive list of relevant matters which should be considered, including the relationship with the employer, the degree of involvement the person has had with the scheme, its financial circumstances and the value of any benefits directly or indirectly flowing to that person from the employer. TPR is also potentially constrained in the exercise of its regulatory activity by its statutory duty to have regard to the "interests of such persons as appear to the Regulator to be directly affected by the exercise⁷," as well as the interests of the generality of scheme members.

The cases

The Kvaerner group

In March 2005, Aker Kaverne, the Norwegian shipbuilding and construction company sold Kvaerner plc, the principal employer of the Kvaerner Pension Fund to its management under a management buy-out for nominal consideration of £1. Aker Kvaerner denied that the UK buy-out was driven by its pension liabilities and said that it did not believe that it ever had responsibility for the scheme.

At the time of the buy-out, a spokesman for TPR said that... "it would be foolish for any company to think we wouldn't use our powers and try to enforce [overseas]. Obviously it's a new era and it's yet to be tested, but we would do everything we had to do."

TPR was ultimately successful in making good its overseas reach claim without having had to establish that a FSD would be enforceable by a foreign court. This was achieved by the parties agreeing to a schedule of contributions into the scheme by Kvaerner plc (£101m over a six year period) with most of the funding coming from Aker Kaverne. This case is believed to be the first when TPR agreed to a request from an employer to cut all formal ties with its own retirement scheme in exchange for a series of payments into the scheme. Other domestic examples exist.

Sea Containers Limited

The first FSD issued by the Determinations Panel (Panel) of TPR was against Sea Containers Limited (SCL). SCL was the Bermuda registered parent company of Sea Containers Services Limited (SCSL), the principal employer of the Sea Containers 1983 Pension Scheme and the Sea Containers 1990 Pension Scheme. A formal determination notice was issued by the Panel on 15 June 2007 indicating its intention to issue an FSD against SCL on the grounds that SCSL was a service company and thus within the FSD regime without the need to satisfy the "insufficiently resourced" test. Prior to this, on 15 October 2006, SCL, SCSL and a subsidiary of SCL had filed for Chapter 11 protection in the US.

In its determination notice, the Panel noted that SCSL was set up as a service company in the UK for the Sea Containers group, and in particular SCL, and had effectively operated the container leasing business for the group. The Panel also found unchallenged evidence that it had always been the intention of SCL to stand behind the obligations of SCSL, its representative in the UK, and that this intention applied equally to SCSL's pension liabilities as it did to other liabilities.

The main focus of the submissions made by the parties was whether it was reasonable to issue an FSD against SCL. In establishing that it was, the Panel gave particular regard to the fact that SCSL was wholly owned and controlled by SCL and that SCL was closely connected to the schemes, with many of SCL's officers acting as trustees of the schemes. The Panel also found sufficient evidence of benefits having been provided by SCSL to SCL and that these benefits included services provided by SCSL, which were not paid for by SCL (albeit that these services were recognised by inter-company balances on the accounts). The Panel also held that SCSL's function as a service company benefited the group as a whole by enabling SCL to benefit from the Bermudan tax regime while keeping a London trading base.

⁶ s38(3)(d) and (7) and s43(5) and (7).
⁷ S100(2) Pensions Act 2004.

The Panel also held that issuing an FSD would not infringe the automatic stay on proceedings that arose from the filing for Chapter 11 protection. While it was unclear to the Panel whether the US courts would accept the FSD, it was thought that an FSD would give the schemes' trustees a direct claim against SCL so that they would rank equally with SCL's other unsecured creditors. The Panel did not believe that issuing an FSD gave the trustees "super-priority". The fact that the amount available to other creditors would be reduced as a direct consequence of issuing an FSD was not held to be an adequate reason for refraining from the issue of an FSD. The Panel also noted that, whatever the US courts' view of the FSD, and the possibility that it might not approve a claim based on the FSD, (SCL had argued that it would be unfair if it were required to do something when the outcome of the US court process was unclear) SCL would have a further opportunity to put its case if a CN were to be issued, when the question of reasonableness would once again fall to be considered. It also rejected any suggestion that FSD's and CN's could not be issued against insolvent companies – jurisdiction is exercisable "at any time".⁸

SCL appealed against the Panel's determination, but that appeal was subsequently withdrawn, resulting in the FSDs being issued on 5 February 2008. After negotiations between the parent company, TPR and the schemes' trustees, TPR approved an arrangement under which the trustees were issued with 25 per cent of the shares in the company which inherited the relevant business of the parent company under a business rescue plan approved by the US court in the Chapter 11 proceedings. The shareholding was less than the statutory buy-out debt, but was regarded as reasonable by TPR in the circumstances. The US court approved the arrangement in the face of opposition from the committee of unsecured creditors of the parent company on 19 September 2008.

Nortel group

On 25 June 2010, the Panel issued a determination notice of its intention to issue a FSD against 25 companies in the Nortel group following an application made by TPR, on the grounds that Nortel Networks UK Limited (Nortel UK), the principal employer of the Nortel Networks UK pension plan was "insufficiently resourced". The 25 companies targeted by the FSD included two Canadian parent companies, two associated US companies and 21 associated European and African companies. The determination was issued following the insolvency in January 2009 of a number of Nortel group companies, including Nortel UK.

The Canadian and US debtors obtained court orders in their respective jurisdictions to the effect that the imposition of the FSD would breach the automatic stay on proceedings that arose on insolvency and would therefore effectively be void. A subsequent appeal by TPR against the court order in Canada also failed. Notwithstanding these legal challenges overseas, TPR continued with its application to the Panel.

In its determination, the Panel found that Nortel UK was "insufficiently resourced" and that it was reasonable to impose an FSD on the target companies given the substantial benefits that had flowed to them from the UK business over several years. In relation to the reasonableness test, one of the notable aspects of the determination was the Panel's willingness to conclude that the financial affairs of the group companies worldwide were inextricably linked. It was also noted by the Panel that from around 1991 the Nortel group operated increasingly as a single entity with the distinction between corporate legal entities largely ignored. The Panel had regard to the level of control exerted by the Canadian parent companies over Nortel UK which was evidenced, amongst other things, by substantial inter-company loans made by Nortel UK at the behest of the Canadian parents, the appointment of directors by the Canadian parents to Nortel UK's board and the effective control over Nortel UK's financial position, including whether, and if so in what sum, Nortel UK should make contributions to the plan. The latter point was evidenced by a 13 year contribution holiday which Nortel UK (under the control of the Canadian parents) and the participating employers of the plan enjoyed between 1989 and 2002. The Panel also had regard to the failure to remedy the deficit in the scheme (which was created mainly as a result of the contribution holiday) in determining that the Canadian parents had received "considerable benefit" from Nortel UK's activities and that it was therefore reasonable to impose the FSD on them.

Separate benefits provided by Nortel UK were identified as accruing for each target company. These benefits included services provided by Nortel UK for which Nortel UK was under-compensated, and R&D benefits that flowed from Nortel UK to the targets for which Nortel UK was not adequately rewarded. In addition, the Panel broadly held that all the target companies had benefited from the failure by Nortel UK to remedy the deficit in the plan. It was therefore deemed reasonable to issue the FSD against all 25 companies in the Nortel group.

8 (s45(2)(a) and (b) Pensions Act 2004).

Lehman Brothers group

The Panel issued a determination notice of its intention to issue a FSD against companies in the Lehman Brothers group, including the group's main UK operating companies and Lehman Brothers Holdings Inc. (LBHI), its US parent company, on 13 September 2010 following the collapse of the Lehman Brothers group in 2008. The initial warning notice issued by TPR listed 73 Lehman Brothers group companies as possible targets of an FSD. However, following a thorough analysis of the underlying factual background, the Panel limited the issue of the FSD to six group companies. The determination notice was issued in this case on the grounds that the principal employer of the Lehman Brothers Pensions Scheme, Lehman Brothers Limited (LBL), was a service company, rather than on the basis that it was 'insufficiently resourced'.

In its determination, the Panel gave considerable thought to whether it was reasonable to issue an FSD to the six target companies. Emphasis was given to the value of the benefits that had flowed to the target companies from LBL and also to the corporate structure under which the Lehman Brothers group had operated. The Panel noted that the corporate structure was extremely complex with over 200 inter-connected corporate bodies. It went on to establish, without any serious dispute from the target companies, that LBL was a service company. The Panel found it clear on the facts that the target companies had received a benefit from LBL in the form of services and seconded employees, the cost of which was charged to the target companies.

Further benefits to the targets were also established and these included, amongst other things, LBL allowing inter-company balances to remain outstanding for months at a time, taking the position of lead company for corporation tax and nominated company for VAT purposes (thereby making LBL jointly and severely liable for group VAT), holding assets for operating companies in order to reduce their capital requirements and the target companies not having to hire their own staff and maintain their own HR departments. A further reason that aided in establishing reasonableness was the fact that LBHI, acting as the group treasurer, was the source of employer contributions to the Scheme and guarantor of LBL's liabilities to the Scheme.

A notable aspect of the Panel's determination was that employers who received the benefit of employees should also ultimately take the burden of their pension promises, even if they did not legally participate in the scheme. The determination also made clear that insolvency of a target company did not itself render the issue of an FSD

unreasonable, and that to do so might be necessary to protect members' interests.

"...There may well be situations where the particular circumstances of an insolvency [go against the imposition of an FSD] such as where there are no assets whatsoever available. In general and in principle we consider that insolvency is a situation where an FSD might be necessary and appropriate in order to protect the interests of members. In the case of the Lehman Group, given its complexity and multi-jurisdictional nature with consequential uncertainties as to outcomes, we consider that if anything it is more reasonable to impose an FSD on an insolvent target."

The Panel was further assisted in concluding that it was reasonable to impose the FSD on the target companies by the fact (evidenced by statutory accounts) that where the LBL employees had been seconded to other group companies, the recharge to those companies included pension costs.

Bonas group

The first CN imposed by the Panel (there is some doubt as to whether procedurally it was correctly issued) was made in June 2010 against Michel Van De Wiele N.V. (VDW), the parent company of the principal employer of the Bonas group pension scheme, Bonas UK Limited (Bonas). VDW was a Belgian registered company and Bonas was a wholly owned subsidiary of VDW. VDW was not a participating employer in the Scheme. The CN was imposed on the basis that VDW had carried out actions or failed to carry out actions, the main purpose of which was to prevent the recovery of the whole or part of the employer debt owed by Bonas to the scheme and it was reasonable in the circumstances for a CN to be imposed.

The Panel reached the view that it would not be reasonable to issue a CN against Mr Beauduin who was the Managing Director of Bonas and the Chairman of VDW. In doing so it paid regard to the fact that Mr Beauduin had personally concerned himself with ensuring the continuation of the employment of Bonas staff. It was considered to be significant that Mr Beauduin was acting as a director for and on behalf of VDW rather than in a personal capacity.

Having reviewed submissions made on behalf of all parties, the Panel made certain key findings of facts. This included the fact that Bonas was controlled by VDW and that VDW, having been advised by its legal advisers of the risk of TPR exercising its anti-avoidance powers, deliberately took that

risk and deliberately failed to inform TPR and the trustees of its plan to put Bonas into administration and arrange for a pre-pack process to sell Bonas' business to a new entity while retaining the pension liabilities within Bonas. The Panel commented that VDW was essentially abandoning the scheme "with its eyes wide open."

The Panel relied on two acts or deliberate failures to act, namely Bonas' abandonment of its pension liabilities without engaging with the trustees or TPR, and the retention of Bonas' business while abandoning the pension liabilities. The Panel held that a two-fold material purpose test should be applied, which required (a) considering the acts objectively to decide their purpose and (b) a further subjective test to establish what VDW intended to achieve by acting as it did. On the facts, the Panel held that main purpose of the pre-pack administration was to keep Bonas' business while escaping any liability to make further payments to the scheme. The determination made clear that on certain occasions the purpose of the act or omission would be plain and that the subjective test would be unnecessary. With regards to prevention of recovery, the Panel considered it plain that one of VDW's purposes in refusing to engage with the trustees and TPR was to avoid incurring a liability to the scheme to make immediate or future payments. In relation to reasonableness, the Panel held that it was reasonable to impose the obligation on VDW to make the payment of £5m into the scheme on the grounds that that figure represented the amount required to bring the scheme to solvency on the Pension Protection Fund basis. In assessing the reasonableness of the award, the Panel also took into account VDW's financial position, its close degree of involvement with the relevant act, its close association with the scheme and control of Bonas (in particular its control of all aspects of the pre-pack and sale and the abandonment of the scheme).

In an appeal to the Upper Tribunal, the Panel's reasoning was criticised.

According to Warren J "...there is nothing before me to suggest that VDW was legally bound to provide such support. Whether it is possible to issue a contribution notice to VDW on the basis that it could have chosen voluntarily to support Bonas and thereby the scheme but chose not to do so must be highly questionable..."⁹

After a week-long hearing in November 2010, a judgement was handed down by the High Court in December 2010 which excited much consternation and created a good deal of legal uncertainty. Determination notices of intention to issue an FSD had been issued by TPR following the insolvency and entry into administration of their sponsor employers (see above). Before the terms of the direction were agreed between the administrators and TPR, the parties applied to the court for directions as to whether, when such directions were agreed, the sums ranked as ordinary creditors in the insolvency proceedings or whether they had priority, and if so whether they ranked as preferred creditors or as expenses of the administration. The Court held that TPR could issue the FSD following administration, and that any debts emerging in consequence would rank as expenses of administration and thus have priority over everything except creditors whose security comprised fixed assets. So priority would be given over floating charges, which would include for example, charges over assets such as book debt and stock. Had the FSD been issued prior to the administration, the relevant debt would be provable in the normal way, ranking *pari passu* with other creditors. As Briggs J said "The outcome is, in my view, likely to be unfair to the creditors of an insolvent target..."

⁹ Nortel / Lehman: the High Court proceedings

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