PENSION CHALLENGES IN BANKRUPTCY AND RESTRUCTURING PROCESSES

This is an extract from Financier Worldwide's August online publication entitled "Pension challenges in bankruptcy and restructuring processes."

REFLECTING ON THE LAST FEW YEARS, HOW WOULD YOU DESCRIBE OVERALL PENSION CHALLENGES ARISING FOR COMPANIES FACING BANKRUPTCY / INSOLVENCY AND RESTRUCTURING PROCESS? WHAT MAJOR TRENDS HAVE DEFINED THIS SPACE?

The biggest trend is the ever-increasing value of defined benefit pension liabilities. Deficits keep growing, even when the plans are frozen and the businesses supporting them are shrinking.

The key challenge in the UK is the inability to do deals with the pension scheme trustees to reduce or manage the defined benefit pension liabilities so as to avoid an insolvency process. Any such deals now effectively require the approval of the Pensions Regulator and the Pension Protection Fund. For very sound policy reasons, the Pensions Regulator and the Pension Protection Fund have sought to discourage such deals and have set tough terms, generally requiring a material shareholder contribution to the pension plan in excess of the amount the pension plan would receive in an insolvency scenario. The upshot is that companies generally cannot reduce or terminate their pension liabilities without a formal insolvency process, which may destroy value in the business.

LOW INTEREST RATES ARE OFTEN BLAMED FOR TODAY'S HUGE DEFICITS – WHAT DO YOU THINK WOULD BE THE IMPLICATIONS OF AN INCREASE IN INTEREST RATES FOR COMPANIES CURRENTLY STRUGGLING WITH A PENSION FUND THEY CAN'T AFFORD?

It is tempting to believe in miracles. Unquestionably, today's huge deficits are driven by the low interest rate environment. To explain, pension liabilities are future cash obligations. To assess a company's pension liabilities or the sufficiency of pension plan assets, a present value is calculated using a discount rate. For various reasons, the discount rate used is often based on gilt yields or corporate bond yields. As the period to which it is applied is very long – the expected lives of the members and their dependants – even a small fall in gilt yields has a dramatic effect on the present value of the liabilities. The flipside is that a reversal could make deficits evaporate.

IN YOUR OPINION, HOW SHOULD DEBTORS GO ABOUT RESOLVING THEIR PENSION LIABILITIES DURING BANKRUPTCY PROCEEDINGS? FURTHERMORE, WHAT STRATEGIES CAN BE DEPLOYED SO THAT ANY LEGACY PENSION LIABILITIES FORM PART OF THE RESTRUCTURING PROCESS?

In the UK, an insolvency process will trigger a statutory debt and transfer the pension liabilities to the Pension Protection Fund, with a haircut to benefits. It may be tempting to create an insolvency process in order to shed pension liabilities, as the statutory debt will be dealt with in the insolvency process. The Pension Protection Fund and the Pensions Regulator are willing to take any steps to challenge any liability avoidance, if their powers enable them to do so, including challenging pre-pack administrations and imposing liabilities on associated parties.
To avoid a formal insolvency, pension liabilities can be included in a restructuring but only with the approval of the trustees, the Pensions Regulator and the Pension Protection Fund. The latter will insist on fair treatment relative to other creditors, a material contribution and a stake in the business, and will only agree if there is no basis for using anti-avoidance powers.

HAVE ANY RECENT, HIGH-PROFILE BANKRUPTCY RESTRUCTURING PROCESSES WITH PENSION OBLIGATIONS CAUGHT YOUR ATTENTION? WHAT LESSONS CAN PARTIES INVOLVED IN SUCH PROCEEDINGS LEARN FROM THE OUTCOME OF SUCH CASES?

BHS is a good example of how not to do it. Passing on a shaky business with unaffordable pension liabilities and hoping to get far enough away before it blows is not a good strategy. A negotiated strategy is better. For Monarch Airlines, terms were agreed to sever the pension liabilities without an insolvency process, which would have been catastrophic given the nature of the business. In the recent Halcrow case, the members of the pension plan were given an option to transfer to a new plan with reduced benefits or transfer to the Pension Protection Fund. New funding has been provided by the shareholder. A similar structure was considered for BHS but then abandoned without agreement.

TO WHAT EXTENT CAN BANKRUPTCY / INSOLVENCY PROCEEDINGS INVOLVING SUBSIDIARY COMPANIES IMPACT ON THE PARENT COMPANY OR BROADER GROUP? HOW CAN THE POTENTIAL EXPOSURE BE MANAGED AND MITIGATED IN CROSS-BORDER BANKRUPTCY SCENARIOS?

For groups that have pension liabilities in the UK, there is a special exposure. If the entity that sponsors the pension plan enters insolvency proceedings, there will be two issues.

First, a statutory debt will be triggered. This may be a very large debt which will dilute recoveries for other unsecured creditors and may have knock-on effects for the group. Secondly, the Pensions Regulator may impose liability on other group entities using its anti-avoidance powers. The conditions for such an intervention are complex and defending such a process can be onerous. If the trustees of the pension plan are promoting the case, the group is likely to be meeting the costs on both sides. The ability to demonstrate fair treatment of the pension plan will assist in managing both liability and reputational risks. Cross-border bankruptcy and enforcement issues depend on the particular jurisdictions.

COULD YOU HIGHLIGHT THE MAIN PENSIONS-RELATED LEGAL AND REGULATORY DEVELOPMENTS TO HAVE IMPINGED UPON THE RESTRUCTURING SPACE IN RECENT MONTHS? HOW WOULD YOU CHARACTERISE THE POWER THAT PENSION REGULATORS NOW HOLD AS FAR AS BANKRUPTCY PROCEEDINGS ARE CONCERNED?

There is still a great deal of uncertainty over the scope of the UK Pensions Regulator's anti-avoidance powers. The Pensions Regulator is canny about exploiting uncertainty and makes the most of the leverage these powers provide, but they are also quite unwieldy. The BHS case may lead to further enhancement of its powers. The scope for restructuring pension liabilities may also change as the UK government has been keen to find solutions for the British Steel Pension Scheme. The Pensions Regulator's powers are a bit like a nuclear deterrent, although not quite so unusable.

WHAT GENERAL PIECE OF ADVICE WOULD YOU OFFER TO DISTRESSED DEBTORS ON HOW TO OVERCOME THE PENSION CHALLENGES THEY FACE DURING A RESTRUCTURING PROCESS? HOW IMPORTANT IS IT FOR COMPANIES TO MANAGE REPUTATIONAL RISKS AT THIS STAGE OF PROCEEDINGS?

There is no one solution that is right for every group. Groups need to be clear about their priorities and risks, including market confidence and reputation. Exposure to the pension plan will depend on the history of the group and the level of integration of its businesses. Not every group values reputation in the same way. Pension plan failure creates reputational risks beyond the ordinary impact of a restructuring process – employees will be losing benefits, any regulatory investigation will be negative, the spotlight may be turned on historic transactions, as has been seen in the BHS case. In some cases, severance can be achieved with limited splash-back.

LOOKING AHEAD, HOW DO YOU EXPECT PENSION OBLIGATIONS TO INFLUENCE BANKRUPTCY / INSOLVENCY AND RESTRUCTURING PROCESSES IN THE YEARS TO COME? WHAT DEVELOPMENTS ARE LIKELY TO UNFOLD?

It is an unpleasant reality that pension obligations can be a material cause of insolvency processes. Deficits keep expanding, even as the businesses supporting them shrink or are starved of investment. Pension plans which are never likely to get fully funded have been nick-named "zombie schemes"' It is argued that there is no shareholder value in such cases and that the shareholders should surrender the group to the pension plan or the Pension Protection Fund. So far, the Pensions Regulator has not been able to trigger an insolvency process and has been wary of encouraging pension "dumping". There should, however, be scope for restructurings that suit all parties and enable the business to go forward. The attention generated by the British Steel Pension Scheme could lead to change. How far employers, shareholders and a younger generation of workers should be held to the task of funding ever-inflating legacy pension liabilities remains a difficult policy issue.

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