

WHEN PENSION REGULATORS INTERVENE IN YOUR CORPORATE TRANSACTION

PENSIONS

WHAT POWERS DOES THE UK PENSIONS REGULATOR HAVE?

Introduction

The UK Pensions Regulator has no direct powers to intervene in a corporate transaction. So, what happens?

The UK Pensions Regulator (locally known by the acronym "TPR") has very significant powers to accelerate funding obligations of employers and to extend such funding obligations to entities that are "associated or connected"¹ with an employer sponsoring a defined benefit pension scheme. In other words, entities that have not participated in the pension scheme and have not assumed any commitment to it may be made liable to fund the pension scheme.

Financial support directions and contribution notices

Key provisions are TPR's ability to impose a financial support direction ("FSD") or a contribution notice ("CN"). These are known as the "anti-avoidance" provisions.

A CN is an immediate obligation to pay an amount specified (not exceeding the buy-out deficit²) into a scheme. A CN may be imposed on an individual as well as a company. TPR may only impose a CN on any person who is (or was at the relevant time) "associated or connected" with an employer and who has been involved, within the six years before the issue of the CN, in an event that either:

- a. Had as one of its main purposes:
 - ◆ preventing recovery of the whole or any part of a statutory debt;
 - ◆ preventing a statutory debt becoming due or compromises it;
 - ◆ reducing the amount of a statutory debt which would otherwise become due; or
- b. With effect from 14 April 2008, detrimentally affects in a material way the likelihood of scheme benefits being paid.

An event could have a detrimental effect if it:

- ◆ has an impact on the employer's or guarantor's ability to meet ongoing funding commitments or an impact on those commitments; or

¹ The terms "associated" and "connected" have a technical meaning. Principally, an entity will be associated or connected with another if either of them controls the other or both are controlled by the same entity (directly or indirectly). A person will have control if they have 33 per cent of the voting shares in a company or if the directors are accustomed to act in accordance with his instructions. Directors are also associated with the company on whose board they sit and a company is associated with its directors and employees.

² The buy-out deficit is the shortfall in the assets on the assumption that all accrued liabilities are to be secured immediately with current and deferred annuity contracts (i.e. the additional funds required to meet the insurance market cost of the benefits).

- ◆ reduces the dividend that would be available to the scheme in the event of the sponsoring company's insolvency.

TPR must also consider that it is reasonable to impose the CN having regard to the recipient's relationship with the employer and the pension scheme, any benefit it has derived from the employer and its involvement in the relevant transaction.

A FSD is an obligation to provide financial support satisfactory to TPR in relation to an employer's liability to a defined benefit pension scheme. A FSD may not be imposed on an individual. A FSD may be issued against any entity that is "associated or connected" with an employer that is "insufficiently resourced" or has been within the 24 months before the FSD is issued.

An employer that participates in a pension scheme will be "insufficiently resourced" at any time if:

- ◆ the value of its resources is less than 50 per cent of its share of the scheme deficit on a buy-out basis; and
- ◆ the aggregate of the value of the resources of entities "associated or connected" with it exceeds the shortfall.

TPR must also consider it reasonable to impose the FSD having regard, amongst other matters, to the relationship of the party with the employer and the scheme, any benefit it has derived from the employer and its financial resources.

These powers are dramatic and wide-reaching and there is significant uncertainty over when they can or may be used. TPR has only issued four FSDs (against Sea Containers Limited, Nortel Networks, Lehman Brothers and ITV) and two CNs (against Belgian Company Michel Van De Wiele and two directors of Desmond & Sons Limited). One reason for this may be that the process is slow and requires TPR staff to make an application to an external Determinations Panel that exercises these powers on its behalf.

However, this is not to say TPR has not been using these powers. It has been using the very significant leverage they provide to intervene in corporate transactions and restructurings so as to secure accelerated funding, parent company guarantees, security over group assets and other commitments to improve the financial position of the pension scheme.

Clearance

Many corporate transactions may potentially give rise to liability under TPR's anti-avoidance powers. Sellers may also be concerned to draw a line on pension liability. TPR's look-back period in relation to these powers is also very long and may extend well beyond the sale of the employer (up to 24 months for FSDs and up to six years for CNs).

To mitigate this uncertainty, provision was made for concerned parties to be able to apply to TPR to seek confirmation that a particular transaction would not create liability under the anti-avoidance powers. The process is known as clearance.

Clearance is voluntary. It requires an application that sets out the circumstances for which clearance is sought (typically some corporate transaction or refinancing), any adverse impact on the pension scheme and details of arrangements made to "mitigate" that adverse impact. Mitigation may take the form of cash contributions (60 per cent of cases), parent company guarantees, escrows, the grant of other security to the scheme, negative pledges or increased power for the pension scheme trustees.

While TPR has been slow to issue FSDs and CNs (or, rather, to apply to the Determinations Panel to issue FSDs and CNs on its behalf), it has strongly encouraged corporate groups to apply for clearance and has encouraged trustees to report any corporate transaction which might adversely affect the pension scheme for which clearance is not being sought. This makes clearance seem slightly less voluntary.

The upshot is that TPR most often intervenes in a corporate deal because one at least of the parties has invited it to – by applying for clearance.

The process for clearance is reasonably confidential although TPR insists on full disclosure to the trustees of the pension scheme and requires the applicants to enter into negotiations with the trustees over the mitigation. Support from the trustees is however not essential or indeed sufficient for clearance to be granted. The process of clearance is entirely within the control of TPR staff and no application to the Determinations Panel is required.

It should be noted that the London Stock Exchange Takeover Panel will not allow an offer to be conditional on clearance.

Scheme funding powers

TPR also has power to intervene in the scheme's on-going funding arrangements. It may do this where either the employer and the trustees do not agree on the assumptions to be used for a valuation or the pace of funding or where it considers that the assumptions adopted or the pace of funding agreed are not sufficiently prudent or there is some other failure to comply with legislation.

TPR has recently merged its scheme funding department with its anti-avoidance department and is now using its scheme funding powers to intervene where it identifies a detriment to the pension scheme in relation to a corporate transaction.

As trustees have no powers to intervene in a corporate transaction or restructuring but do have powers to re-open the scheme funding arrangements, TPR is encouraging trustees to closely monitor the activities of the employer and its financial arrangements, and to revise the scheme funding arrangements if the employer's activities weaken its ability to fund the scheme, or might reduce the dividend the pension scheme would receive in an insolvent liquidation of the employer. Where trustees have re-opened negotiations on scheme funding but are unable to reach agreement with the employer, TPR may intervene. It may also intervene directly if it considers that the trustees have failed to act appropriately and it has significant additional powers over trustees³ to give it further leverage.

WHEN YOU SHOULD EXPECT INTERVENTION

Circumstances likely to lead to intervention

TPR has issued clearance guidance (last updated in June 2009) and has published a code of practice on circumstances in relation to the material detriment test (June 2009). The clearance guidance sets out the circumstances in which TPR expects the parties to apply for clearance, i.e. where it might consider intervening if the parties did not provide sufficient mitigation for clearance. The code of practice sets out when it would consider using its powers to impose a CN on the material detriment basis.

Under the clearance guidance parties are expected to apply for clearance where there is some event which is materially detrimental to the ability of the scheme to meet its liabilities (which it calls a Type A event). Such events are either events that could give rise to a CN or events that will otherwise:

³ For more information on the TPR's powers, see the article *What powers does the Pensions Regulator have, and what is the Pensions Regulator's approach to regulation?* published in the June 2008 edition of *International Pension Lawyer*.

- ◆ weaken the “employer covenant”⁴ by affecting its ability to meet its on-going funding commitments to the scheme or by reducing those commitments; or
- ◆ reduce the dividend that would be available to the scheme in the event of employer insolvency.

To assess the effect of a transaction, parties are expected to:

- ◆ compare and contrast the pre- and post-transaction “employer covenant”;
- ◆ assess whether any weakening of the employer covenant is materially detrimental to the ability of the scheme to meet its liabilities; and then
- ◆ identify whether the scheme has a relevant deficit.

There will be a relevant deficit if there is a deficit on any of a number of bases including the accounting basis (IAS19) and the on-going scheme funding basis but excluding the buy-out basis unless there is doubt about the status of the employer as an ongoing concern.

TPR expects to use its powers in respect of transactions that include any of the following:

- ◆ the transfer of the scheme out of the jurisdiction of the United Kingdom;
- ◆ the transfer of the employer out of the jurisdiction of the United Kingdom if by doing so there is a material reduction in the level of employer support or legal and regulatory protection for scheme members;
- ◆ a substantial reduction of employer support for the scheme;
- ◆ the transfer of liabilities of the scheme to another scheme which does not have sufficient employer support or is not sufficiently well funded; and
- ◆ a business model or the operation of the scheme in a way designed to create a financial benefit for the employer or some other person, but where inadequate account is taken of the interests of the members of the scheme.

In practice, any transaction that involves the assumption of material new borrowing or new liabilities or the provision of security or a return of capital by the employer may create concern.

⁴ The “employer covenant” is described as the ability and willingness of the employer to fund the pension scheme. It is measured by the employer’s legal obligation to the scheme and its financial position (both current and prospective).

A change of control is not necessarily relevant but it is often on a change of control that the parties want to gain certainty about TPR risk by seeking clearance. As a change of control signals the end of TPR’s powers to impose a FSD on the seller’s group (subject to the 24 month window referred to above), for TPR it may present a last chance to extract value from the seller’s group and an application for clearance will be its opportunity.

Timing of intervention

Bearing in mind TPR’s significant look-back periods - six years for CNs and unlimited for FSDs while the parties remain associated or connected with the employer - timing is generally in TPR’s favour.

This is a key reason for the parties to seek the certainty of clearance despite the hazards of inviting TPR to intervene and opening a negotiation with trustees while considering a significant corporate transaction.

How to prepare

Understanding how the financial standing of the employer compares with any deficit in the pension scheme is the first step. The next is to compare the financial standing of the employer before and after the transaction.

If there is a material impact the parties will need to consider their strategy: whether to mitigate the detriment; open a negotiation with the trustees and apply for clearance; or wait to respond to pressure from the trustees and TPR at a later stage. An application for clearance will take time and will bring additional parties (the trustees and TPR) into the transaction negotiations which can often be challenging.

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