The right balance

DAVID POLLARD LOOKS AT THE IMPACT OF THE RECENT CHANGES IN UK PENSIONS LEGISLATION, THE POWERS OF THE NEW PENSIONS REGULATOR AND THE SUBSTANTIAL CHANGES TO THE LEGAL OBLIGATIONS OF SPONSORING EMPLOYERS AND SOME THIRD PARTIES IN RELATION TO PENSION LIABILITIES.

Participating employers in defined benefit occupational pension schemes have an increased funding liability, both as an ongoing matter and as a debt liability on a scheme or employer insolvency.

MORAL HAZARD PROVISIONS To reduce the risk of pension schemes falling into the new Pension Protection Fund (PPF), the Pensions Act 2004 (PA04) includes 'moral hazard' provisions. From 6 April 2005, the Pensions Regulator (TPR) has significant powers to look to third parties (i.e. not just participating employers) to contribute to pension schemes in certain circumstances.

These powers are:

- Contribution notices: TPR can require contributions to schemes (other than money purchase schemes, unapproved schemes, schemes for overseas employees and most public sector schemes) not only from participating employers but also, in appropriate circumstances, from other connected and associated persons.

- Financial support directions: TPR can require financial support to be put in place where a participating employer is a "service company" or is "insufficiently resourced".

In addition, there is a new funding requirement on ceasing to participate. From 2 September 2005, the debt arising under s75 Pensions Act 1995 (see *Box 1*) when an employer ceases to participate in a multi-employer scheme has increased from the Minimum Funding Requirement (MFR) level (see *Box 1*) to the buy-out level. This is a very significant change with a major impact on corporate transactions and internal restructurings.

These provisions can affect intra-group reorganisations as well as

Executive summary

- **The Pensions Act 2004 includes moral hazard provisions to reduce the risk of pensions schemes falling into the new Pension Protection Fund.**

- **The Pension Regulator has the power to issue a contribution notice to say a person is liable to pay the full s75 debt.**

- **The s75 debt triggers a statutory debt on an employer when it stops participating in a multi-employer scheme; the debt is a share of any total funding deficiency in the scheme.**

- **The power of the Regulator has major implications for employers.**

sales to third parties if the effect is that the employer ceases to be a participating employer.

CONTRIBUTION NOTICES

The power TPR can issue a contribution notice (CN) to a person stating that the person is under a liability to pay the full s75 debt. The notice may be issued to an employer or a person "connected with" or "an associate of" the employer (see *Box 2*) where:

- an act or deliberate omission (on or after 27 April 2004 and within the last six years) reduces the recovery of a s75 debt or, otherwise than in good faith, reduces the amount of the debt;
- the person was a party to (or "knowingly assisted" in) the act or omission;
- TPR considers that reducing the s75 recovery/debt was the main purpose (or one of the main purposes) of the act or omission; and
- TPR thinks it is reasonable to impose the debt on that person.

What is reasonable? This requirement is what is likely in practice to limit who will be issued with a CN or financial support direction (FSD), despite the width of the connected and associated parties category. TPR assesses what is reasonable, and must have regard "to such matters as [it] considers relevant"(see *Box 3*) . TPR's guidance on "reasonableness" is summarised in the box.

Practical effect Whether the "main purpose" test is met is again TPR's decision. If the employer is aware of the potential impact of an act on the pension scheme, it may be more difficult to show that this is not one of the main purposes of the act.

FINANCIAL SUPPORT DIRECTIONS

The power TPR can issue an FSD where, at any time within the last 12 months, the employer is or was:

- a service company (i.e. turnover principally derived from providing services to other group companies); or
- insufficiently resourced (lacked sufficient assets to meet 50% of the s75 debt in relation to the scheme and at that time there was a connected or associated person who did have sufficient resources).

An FSD requires the person to whom it is issued (again, it must be reasonable for TPR to do this) to ensure that financial support for the scheme (broadly, funding or guarantees) is put in place within a specified period and maintained throughout the life of the scheme. (Companies must notify TPR of anything that later has an impact on the financial support.)

The FSD can be directed at the employer or person "connected" with the employer but (unlike CNs) cannot generally be issued against an individual.

Practical effect This provision could be triggered even where the sale or restructuring has been set up for legitimate reasons.

Recipients of an FSD will have to consider carefully the most appropriate type of financial support to provide. Agreeing that all group companies will be jointly and severally liable could cause problems with later transactions.

FUNDING ON CEASING TO PARTICIPATE (SECTION 75)

Section 75 debt The s75 debt triggers a statutory debt on an employer when it stops participating in a multi-employer scheme (but other employers continue to participate). The debt is a share of any total funding deficiency in the scheme. The share is normally based on the share of the liabilities attributable to employment with that outgoing employer (including its share of "orphan" members whose service did not relate to a current employer).

Before 2 September 2005, the funding deficiency was calculated on the MFR basis. Because this is a relatively low test, often no debt arose.

From 2 September 2005, this debt has increased to the much higher buy-out level, potentially giving rise to a funding deficiency in most occupational pension schemes.

Approved withdrawal arrangements TPR, the trustees and the leaving employer can agree that the debt payable by the leaving employer is less than the buy-out debt. The minimum is the MFR level (presumably in future the scheme-specific level) plus any cessation expenses; the balance must be guaranteed, with payment triggered if the scheme starts to be wound up, a relevant insolvency event occurs in relation to all the current active employers or TPR reasonably so decides.

The detail is complex and there are numerous conditions, e.g. TPR must be satisfied that the s75 debt "is more likely to be met" if the agreement is approved. It is not yet clear how TPR will interpret this condition.

Practical effects on sales/acquisitions To protect against the risk of an acquired company being issued with an FSD within 12 months after the acquisition, purchasers may look for indemnities from sellers. Sellers might prefer to try to agree with the trustees and TPR (well in advance) the terms of a withdrawal arrangement.

The increased s75 debt since 2 September may now lead parties to make a clearance application even where previously they would have been happy with indemnities.

An alternative would be a sale of the business instead of the shares in the participating employer. Provided the relevant

Box 1. Selected terms

Buy-out debt The cost of securing all benefits by purchasing matching policies with an insurance company. Usually a far greater amount than applicable on other funding bases (i.e. MFR or FRS 17 *Retirement Benefits*).

Minimum Funding Requirement (MFR)/scheme-specific funding requirement Under the Pensions Act 1995 occupational pension schemes which are not money purchase schemes or of a prescribed description are subject to a funding requirement based on the value of their assets compared to the amount of the liabilities of the scheme calculated on the prescribed basis. PA04 replaces the MFR with a "scheme-specific funding requirement", to be agreed between the employer and the trustees or fixed by TPR in default. This will apply to any actuarial valuation completed after 30 December 2005 and based on an effective date on or after 22 September 2005.

Section 75 Pensions Act 1995 – deficiencies in the assets Where the value of the assets of such an occupational scheme is less than the amount of the liabilities, s75 imposes a statutory funding debt on employers in various situations; in particular, if the scheme winds up; the employer becomes insolvent; or (in a multi-employer scheme) the employer ceases to participate in the scheme, i.e. is sold or ceases to have any employees who are (or are eligible to become) active members.

Box 2. Connected persons and associates

This category is widely defined (using the definition in the Insolvency Act 1986). For a corporate employer, it includes:

- other group companies;
- 33⅓ shareholders;
- directors and employees of the employer;
- persons "connected" with a director of the employer (i.e. another company which has one of its directors in common with the employer).

Box 3. Reasonable to issue a CN – matters for consideration by TPR

TPR must consider:

- degree of involvement of person in act or failure to act;
- relationship of person with employer (i.e. director or parent company of the employer);
- any connection or involvement of person with scheme (i.e. trustee or employer);
- any failure to notify TPR if act or failure was a "notifiable event" under s69 PA04;
- purpose of act or failure, including prevention or limitation of loss of employment;
- financial circumstances of person, i.e less than the full s75 debt may be required if otherwise another pension scheme's contributions would be affected.

TPR may consider other factors, i.e. status of scheme.

participating employer retains some members in the scheme, this will not trigger the s75 debt. Obviously there will be other implications (e.g. tax, ability to transfer contracts, etc).

NOTIFICATION TO TPR Employers and trustees are obliged to notify TPR of certain events under s69 PA04, including any decision to take action so a pension debt is not paid in full; any change in an employer's credit rating and a controlling company decision to sell an employer.

What transactions are at risk of a CN or an FSD being issued?
TPR has a statutory power to give clearance from CNs and FSDs. Assuming full and accurate disclosure to TPR in a clearance application, the transaction will not be at risk of later being the subject of CNs or FSDs.

TPR believes that certain transactions could have a material detrimental effect on an employer. This could affect a defined benefit (DB) pension scheme as a creditor. TPR thinks that companies should consider seeking clearance for these "Type A Events". They include:

- companies issuing security over material assets (other than security for new borrowings);
- returns of capital – including special dividends, share buy backs and capital reductions; and
- changes in (direct or indirect) control of employers, e.g. a disposal or group reorganisation.

"Type B Events" are certain arm's length commercial transactions (such as initial public offerings, rights issues, mergers and acquisitions) that do not involve a risk of CNs or FSDs being issued unless they involve one of the other Type A Events.

TPR's approach to the clearance process:

- The clearance process is intended to be commercial, risk-based, responsive and confidential.
- Companies must treat their DB pension scheme members as major unsecured creditors with rights, keeping trustees fully informed and negotiating with them. TPR wants to be a referee, not a player.
- Trustees must be proactive, taking positive steps to protect pension liabilities, including calling for additional cash/assets to be contributed, escrow/deposit arrangements, enhanced security, equity stakes; gearing up their commercial expertise and skills; actively addressing conflict issues; and obtaining independent legal/actuarial/financial advice.

What does this mean for employers and trustees?

- Some 'normal' transactions at risk: wide ranges of normal commercial transactions (after 26 April 2004) are potentially at risk without clearance. Advice should be taken about whether to approach TPR for clearance and great care should be taken in drafting minutes, etc that could be used to establish evidence of "purpose".
- More negotiation with scheme trustees: DB scheme trustees potentially have considerable power and are a key negotiating party. TPR appears likely to give a clearance where the transaction has been approved by fully informed and properly advised trustees.
- Trustees gearing up their role: Trustees are required to increase their expertise. This will be reinforced by the PA04 requirement for trustee knowledge and understanding (probably from April 2006).
- Managing conflicts of interest: Trustees with potential conflicts issues (i.e. those who are also directors of the employer) must address conflict issues – particularly acute where there is a proposed Type A Event. Advice on handling conflicts should be sought immediately.
- Opportunities: despite press scare stories, this is not the death knell for transactions involving DB schemes. The commercial, flexible approach of TPR gives encouragement that acceptable solutions can be reached. TPR's guidance expressly states that TPR's preferred outcome is a properly funded DB scheme with a solvent employer and that it will seek to strike the right balance between reducing the risk to member's benefits and not intervening unnecessarily in the conduct of employers.

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