Managing pensions risk in corporate groups

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Introduction

Recent high profile insolvencies have demonstrated that Corporate groups can face intense and sometimes high public scrutiny if they make decisions that could detrimentally impact a defined benefit pension scheme operated within the group. That scrutiny may take place a considerable time after the corporate activity in question, when the circumstances of the group have radically changed, and will inevitably be conducted with the benefit of hindsight. For example, companies may face investigations from the Pensions Regulator (the **Regulator**) where funds have been returned to shareholders (eg through dividends or capital reductions) many years prior to its financial difficulties. Proposals in the pensions White Paper 'Protecting Defined Benefit Pension Schemes' (see our briefing), published in March 2018, to extend the Regulator's powers will mean that corporate groups could face punitive fines if their actions detrimentally impact on a defined benefit pension scheme. This will extend to individual directors who will also face criminal sanctions for 'wilful or grossly reckless behaviour' in relation to a defined benefit scheme. Most changes to the Regulator's powers are expected to be laid before Parliament in the 2019-2020 Parliamentary session, but some powers could have retrospective effect from 19 March 2018. As a result, it will be more important than ever for corporate groups to ensure that the impact of corporate activity on their defined benefit pension schemes is carefully considered and appropriately mitigated.

This briefing considers what corporates and their directors can do to ensure that their corporate decision-making properly considers and addresses the impact of corporate activity on group pension schemes (and to ensure that such steps are properly documented) with the aim of both reducing the risk of any future investigation being instigated, and putting the group and its directors in the best position possible to defend any such action.

When do you need to think about pensions?

All sorts of corporate activity can have significant implications for pension schemes. These risks can be more obvious where there is a transaction which involves the sponsoring employers of the scheme. However, corporate activity involving group companies can also affect the financial ability of the employer to meet its liabilities to the scheme.

1. Unless otherwise stated, references in this briefing are to the Articles of the GDPR

Corporate activity that affects pension schemes

Have you made a decision in the right way?

Corporates, shareholders and directors may be more likely to face regulatory action to protect the pension scheme if they have not properly considered the impact of their decisions on that scheme. If a transaction is likely to affect the pension scheme, there may be ways to mitigate that effect and protect group companies from regulatory action — if you consider the key issues at the right time.

Proper consideration which has been thoroughly documented will put corporates, shareholders and directors in the best place to defend any subsequent regulatory action.

What type of corporate activity can affect a pension scheme?

The pension scheme will be affected by anything that affects the 'employer covenant', that is 'the legal obligation and financial ability of the employer to support the funding needs and investment risk of the scheme.' Examples of this type of activity include:

- reductions of capital;
- dividends;
- restructurings and reorganisations;
- new debt or security to creditors;
- sales and acquisitions (and related financing and restructuring); and
- switching to having a service company (rather than trading entity) as principal employer.

Scheme trustees, and the Regulator, will be concerned about any events which would significantly weaken the employer covenant — ie events which are materially detrimental to the ability of the relevant pension scheme to meet its liabilities. These are known as 'Type A' events.

Type A events (1)

How do you spot a 'Type A' event?

In order to assess whether a Type A event will occur, you need to compare the employer covenant before and after that event has occurred, both:

(i) on an ongoing funding basis (ie what is the impact on the employers' ability to meet the ongoing funding payments); and
(ii) on a distressed scenario for the employer group (even where that distress scenario is considered highly unlikely).

A key test for sponsoring employers will be whether the financial support for the relevant scheme (looked at on an individual supporting entity basis) is weakened by any of the proposed transaction steps.

Examples of Type A events are events which reduce:

- expected contributions to the pension scheme;
- the ability of the sponsoring employer or group entities to pay such contributions to the scheme — eg additional financial commitments, restrictions on capital flow, increased dependency on other parts of the group; and
- what the scheme can recover if insolvency occurs — eg reducing assets of supporting entities through dividends, or granting, repayment or change in the priority status of intra-group loans.

This can be complicated, as:

- identifying the extent of the employer covenant may not be straightforward. It will include not only the employers of the scheme, but other companies which lend covenant support to the scheme — such as any guarantors, subsidiary companies and other group companies on which the employers rely;
- the relevant corporate activity may involve a large number of individual steps which will need to be considered both separately and in the round to establish the potential impact on the schemes; and
- some steps may appear to be neutral to the scheme's covenant, but in fact involve a potential detriment (for example, because they result in structural subordination of the scheme's claims).

This is likely to require both a legal and financial assessment.

Type A events (2)

What will happen if a Type A event occurs?

If a Type A event occurs without appropriate steps being taken there can be a number of consequences.

(i) Impact on relationship with pension scheme trustees

Pension schemes have long term liabilities. Sponsoring employers therefore generally expect to have a long term relationship with the trustees of their scheme. That relationship could be damaged if a Type A event occurs and the trustees are not kept informed or if they consider that their concerns about such events have not been addressed. This could mean that the trustees will be less likely to accommodate employer requests on the funding or investment strategy of the scheme in the future.

It may even mean that they look to use any powers available to them under legislation or the scheme rules to address any impact on the scheme and/or raise concerns with the Regulator.

(ii) Regulatory risk

The Regulator has powers (known as 'moral hazard' powers) to make third parties contribute to or support the pension scheme by issuing contribution notices or financial support directions — even if they do not have a direct legal relationship with that scheme. A Type A event will not in itself necessarily provide a legal basis for the Regulator to use its powers, but it can provide a trigger and justification for the Regulator to consider doing so.

The Regulator can use its powers against any party which is 'associated with' or 'connected' to a participating employer (or former employer). This is a wide test and will, for example, catch other companies in the same corporate group as the employer, directors (or shadow directors) of an employer, or a shareholder with at least one-third of the voting rights with the employer or its parent company. In addition, the following tests need to be met.

- **For a contribution notice:** there has been an act with a main purpose of avoiding a pension liability or an act that has detrimentally affected the security of scheme benefits.
- **For a financial support direction:** the employer is 'insufficiently resourced' or a service company.
- **In both cases:** the Regulator considers it 'reasonable' to issue such an order.

The Regulator's powers are wide and this is a relatively untested area. Quantum will also depend on what the Regulator considers 'reasonable' (up to the value of the scheme's buyout deficit).

In March 2018, the government published its White Paper 'Protecting Defined Benefit Pension Schemes' setting out the next steps for reforming the regulation of defined benefit schemes. The government proposed a significant increase in powers for the Regulator which will impact on corporate activity for groups which operate a defined benefit pension scheme, both in terms of increased personal liability for individual directors of sponsoring employers (and others) and additional scrutiny and reporting requirements for corporate transactions.

Type A events (3)

Key proposals that will impact on corporate activity include:

- A power for the Regulator to impose punitive fines where the Regulator exercises its anti-avoidance powers. This power could be introduced retrospectively in respect of acts or omissions after 19 March 2018 (when the White Paper was published).
- A new criminal offence to punish 'wilful or grossly reckless behaviour' of directors and other connected persons in relation to a defined benefit pension scheme.
- A new requirement for sponsoring employers or parent companies to prepare a 'declaration of impacts' statement before a relevant corporate business transaction takes place, such as the sale or takeover of the sponsoring employer.
- Further strengthening of the Regulator's investigatory powers, including a power to require any person to attend an interview and a power to inspect records at parties' premises (including unannounced raids).
- A review of the current framework which requires certain events to be notified to the Regulator (see 'Disclosure obligations' below)

For further details about the proposals in the White Paper, see our briefing.

(iii) Disclosure obligations

Sponsoring employers are required to notify the Regulator about certain Type A events and may have further contractual obligations to notify trustees at an earlier stage in the corporate process. The White Paper on protecting defined benefit pension schemes proposed that the current framework for notifying the Regulator about certain events should be reviewed to consider whether more transactions should require mandatory notification to the Regulator and whether notification should be required in advance of decisions being taken. Currently, some of the key notifiable events such as the sale of a participating employer in a pension scheme, or compromise of a debt to the scheme, only apply when the decision is made to take that step.

Dividends

Dividend payments

Dividend payments by companies which sponsor defined benefit pension schemes are likely to be scrutinised where there is a significant deficit in the scheme. There is a risk that the level of a dividend or a return to shareholders could later be compared to pension deficit repair contributions and outstanding deficits (eg by the Regulator or the trustees of the scheme). In its funding statement published in April 2018, the Regulator made it clear that it expects fair treatment between shareholders and the scheme and that it would expect to intervene in schemes where the employer covenant is constrained and payments to shareholders are prioritised, impacting on the affordability of contributions to the pension scheme. Where there is significant disparity between deficit contributions and dividend payments, the Regulator expects trustees to negotiate robustly with the employer for a shorter recovery plan.

The government's White Paper on the regulation of defined benefit pension schemes (for further details, see our briefing), published in March 2018, did not specifically mention restricting dividend payment by scheme employers. While the government recognised that companies need to pay dividends to attract investors and for 'other good reasons', it considers that some companies that sponsor defined benefit pension schemes and make dividend payments could afford to increase their pension deficit repair contributions to the scheme without affecting the company's growth or sustainability. For further details on pensions issues on paying dividends, see our briefing.

Managing pensions risk

How can you manage your pensions risk?

Directors, employers and shareholders can manage their pensions risk through the following strategies:

- demonstrating that decisions were taken in the right way — ie considering the key issues at the right time and properly documenting that thought process in board minutes;
- preparing for future scrutiny — eg by anticipating any concerns that the trustee and Regulator might raise and engaging with them in a way that addresses those concerns;
- agreeing appropriate mitigation arrangements with the trustees of the Scheme; and/ or
- seeking clearance from the Regulator.

How can we help you manage pensions risk?

We have extensive experience advising employers and trustees on the impact of corporate activity on pension schemes and their employer covenant.

We can help you to identify and assess which entities in a corporate group have obligations to the pension scheme, where they support the employer covenant indirectly and how those will be affected by transactions involving group entities.

For instance, we can help you identify and assess:

- which entities are treated as current or former employers under statute;
- the balance of powers between employer and trustee in the trust deed and rules of scheme;
- the nature and value of obligations in funding arrangements for the scheme;
- which steps in a corporate transaction could benefit or weaken the employer covenant — and the extent to which these steps are linked legally; and
- indirect covenant support — ie support for employers to enable contributions to be made, such as:
  - supply of personnel agreements with operating companies (including reimbursement for services); and
  - parent company financing channels — even though there may not be any direct contractual obligations between employers and parent companies, trustees may take comfort that the parent will support a principal employer in meeting an obligation to procure that contributions are made to the pensions scheme.

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