New powers for UK Pensions Regulator affects restructurings

Restructuring advisers and investors involved in restructurings with a UK component need to know about the new powers given to Britain's Pensions Regulator over how defined benefit pension schemes are dealt with. **Devi Shah**, a partner in Mayer Brown's London office, outlines the changes to the Regulator's moral hazard provisions. These changes are broad and are intended to tackle new alternative buy-out models. They will affect restructurings more widely and potentially lead to an increased number of clearance applications.

Devi Shah, Mayer Brown

'Moral hazard' upgrade

On 14 April 2008, the British Government announced, and subsequently consulted on, its plan to upgrade The Pensions Regulator's (tPR) 'moral hazard', or anti-avoidance, powers requiring employers to support a defined benefit pension scheme if their actions could threaten the security of scheme members' benefits.

The Government's particular focus was the launch of new business models which involve severing the link between the employer and the pension scheme to the detriment of scheme members.

The proposed changes are, however, wide ranging and will need to be considered in any restructuring which involves a defined benefit pension scheme.

Current powers

At present, tPR can impose a Financial Support Direction (FSD) or Contribution Notice (CN) on a party which is connected with or an associate of the employer if tPR considers it reasonable to do so, with reference to specified criteria.

In the case of an FSD, a party with sufficient resources, as defined, is required to provide suitable financial backing for a scheme whose employer is either a 'service company' or 'insufficiently resourced'.

In the case of a CN, the connected party is required to pay a specified sum to a scheme. In order to issue a CN, tPR must believe that the party acted, or deliberately failed to act:

- in order to prevent recovery of the statutory debt, the 'section 75 debt', which falls due in certain circumstances, including on the employer entering into liquidation, administration, administrative receivership or a CVA and on the winding up a pension scheme itself; or,
- otherwise than in good faith, to prevent the full amount of the s75 debt becoming due.

S75 debts, although generally unsecured, are now calculated on the much higher 'buyout' basis. On this basis, many final salary schemes' deficits run into tens or hundreds of millions of pounds.

> Both FSDs and CNs have the effect of piercing the corporate veil. Those caught include directors and parent companies as well as lenders to, and purchasers from, distressed companies.

A clearance procedure is available: parties can ask tPR to confirm that it will not issue an FSD or CN in connection with a particular transaction. Pension trustees will be looking for mitigation from the parties involved so there will in practice be a 'price' for clearance.

The proposed amendments include:

- enabling tPR to impose an FSD on a number of entities, spreading the obligation to provide financial backing among those entities and allowing the group's resources to be taken into account.
- enabling tPR to issue a CN where an act or course of conduct is materially detrimental to the scheme's ability to pay member benefits, hence shifting the focus from motivation of the parties (which can be difficult to establish) to the effect of their acts.
- removing the requirement that the entity which is to be the subject of the CN acted 'otherwise than in good faith'.
- clarifying that the issue of a CN can be triggered by a course of conduct, not just a single act or omission.
- A statutory defence to CNs is also proposed where a party can show that it could not reasonably have foreseen the effect of its act.

It is not yet clear when the changes will become law but the amendments will have retrospective effect from 14 April 2008. According to the consultation paper, the course of conduct clarification will take effect from 27 April 2004.

Potential impact

Government and tPR have both issued assurances that the new powers are intended to be used only in limited circumstances. But the proposed changes are wide.

A typical operational restructuring which might be impacted could include where a group, to remain competitive, wishes to close its UK operations conducted through a company which is an employer with respect to a defined benefit pension scheme.

The group will not want to go through a restructuring only to find that liability for any deficit is imposed elsewhere in the group, and may now look more closely at seeking clearance. Even where connected companies are located overseas and they have advice that any judgment based on a CN may not be enforceable locally, unsatisfied judgments may affect credit ratings, trigger event of default provisions and, worse still, form the basis of winding up proceedings in England where the company has a 'sufficient connection' with this jurisdiction, such as assets and creditors here.

Although the consultation document offers some assistance as to how the new legislation will be interpreted, clearance applications and queries are likely to increase unless clear, detailed guidance, including complex worked examples, is provided.

The need for such clearance has cost and timing implications which may threaten the viability of proposed restructurings.

Responses to the consultation paper have yet to be published but restructuring market players are understood to have raised concerns about the proposed amendments.