Insight: Financial Restructuring & Insolvency

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Fewer sleepless nights over defined benefit pension plans – a bonus for backers

Silentnight & Bonas

Anyone investing in, financing or restructuring a corporate group that operates defined benefit pension schemes will be aware of the potential powers of The Pensions Regulator (the Regulator). The recent decision in Bonas, that ailing companies operating defined benefit pension schemes do not need to be kept on life support by the parent or other group companies, is a welcome insight into how the courts will interpret the Regulator's powers.

The Facts

The Regulator's key "moral hazard" powers

The Regulator has power under the Pensions Act 2004 to pierce the corporate veil and impose pension liabilities on persons other than the sponsoring employer of a pension by issuing:

- financial support directions, where the sponsoring employer is insufficiently resourced or a service company and, in very broad terms, where other entities within the corporate group are better resourced or have benefited from services provided by the sponsoring employer; and
- contribution notices, where the sponsoring employer and/or another person has taken action or failed to take action with the specific intention of avoiding pension liabilities, or has done something which has a materially detrimental effect on the pension plan (for example, the assets of the sponsoring employer have been transferred to another entity, whilst "leaving behind" the pension liabilities with the now asset-less sponsor).

The Bonas case

Bonas, the sponsoring employer of the pension scheme at issue, was acquired by Michel Van De Wiele N.V. ("VDW") in 1998. VDW made several attempts to turn the Bonas business around before ultimately making Bonas the subject of a pre-pack administration in December 2006. Under the terms of the pre-pack, the business of Bonas was sold to a newly created subsidiary of VDW, for £40,000, representing the value of the office furniture and goodwill of Bonas. In contrast to other cases in which the Regulator has exercised its moral hazard powers, there was no clear evidence of VDW having procured any financial benefit from its ownership of Bonas.

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The Decision and its implications

In reaching its decision, the court gave a clear insight into the approach that it is likely to take in reviewing the Regulator's moral hazard powers.

The critical point made in the 17 January 2011[1] decision is that, in the absence of a financial support direction to the contrary (or, we would presume, a direct contractual guarantee entered into with a pension plan's trustee), a parent of a sponsoring employer is not under any legal obligation with respect to the sponsor's pension plan. Two important consequences flow from this determination:

- where a parent company has, historically, provided financial support to a sponsoring subsidiary in order to enable that subsidiary to meet its obligations to the pension plan, it is at liberty to withdraw that support. In other words, past support does not of itself generate future obligations; and
- where there is no hope for the financial future of the sponsoring subsidiary, the parent retains the ability to place that subsidiary into insolvency and the commencement of insolvency does not, of itself, form a basis for the issue of a contribution notice.

The decision and resulting protection of the parent and other group companies is not, as recent press reports in relation to the *Silentnight*[2] and *Polestar*[3] cases would suggest, a "loophole", but a faithful interpretation of the moral hazard provisions. The moral hazard provisions are designed neither to penalise parent companies for "mere abandonment" of non-viable sponsoring subsidiaries with pension debts, nor do they embody a "deep pockets" approach whereby other group companies are, merely by virtue of association or connection with the pension debtor, viable targets of action by the Regulator.

It is our view that each case will have to be approached on its facts and that a key distinction must be drawn between:

- on the one hand, instances where the putative target has clearly derived "benefit" from its relationship with the pension debtor (either by remittance of cash sums, or less tangible benefits, such as the "tax and other advantages of being registered in Bermuda whilst having the headquarters … in London", as in the *Sea Containers*[4] case) – such entities are, either pre- or post-insolvency of the pension debtor, legitimate targets of Financial Support Directions; and
- on the other hand, instances such as that in *Bonas* where a corporate group, private equity investor, or other entity acquires a sponsoring employer from which (either by virtue of that entity's overwhelming pensions burdens or otherwise) it derives no net "benefit" (see our comments below) during the period of ownership – such parent entities are neither legitimate targets of financial support directions during the period of ownership of the pension debtor nor are they legitimate targets of contribution notices as and when they decide to "call it a day" on further attempts to revive the financial fortunes of the non-viable sponsoring subsidiary.

Clearly parent companies will have to conduct a detailed analysis to enable a vigorous defence of any assertions by the Regulator that they have enjoyed net "benefits" either directly from the sponsoring subsidiary or by virtue of the nature of their relationship with that entity. However, we consider that in cases where the sponsoring subsidiary is, always has been, and is likely for the foreseeable future to continue to be, a financial "dud", there is little scope for the Regulator to impose liability on the parent or other group companies either:

- under Financial Support Directions, on the basis of a parent's decision to refuse to enter into a parent company guarantee; or
- under Financial Support Directions or Contribution Notices, on the basis of a parent's decision to terminate a (contractually terminable) existing guarantee, or to place the ailing subsidiary into insolvency.

We also consider that, for the purposes of determining "benefit" under the statutory reasonableness criteria, the correct test is whether the putative target stands in net benefit. If, for example, a parent's contributions to its subsidiary's pension scheme exceeds, in aggregate, dividends received from the subsidiary during the same period, then we do not consider that the parent has enjoyed any real "benefit" for the purpose of the Pensions Act 2004's moral hazard provisions.

Moreover, in instances where the parent has derived a net benefit from the subsidiary, the *Bonas* decision strongly suggests that a "but for" test will have to be applied in determining the parent's maximum potential moral hazard liability. That is to say, the amount of the moral hazard liability will be limited to that amount of the scheme's deficits which is causally attributable to the conduct of the entity being targeted by the Regulator. The mere fact of there having been a benefit does not place the target on the hook in an amount up to and including the subsidiary's full section 75 debt: the moral hazard provisions are not intended to penalise.

In practice – stand firm

From the standpoint of current commercial practice, the *Bonas* decision raises interesting questions about the "strong-arming" of numerous companies by pension plan trustees into the giving of parent company guarantees. Whilst it is well established that such guarantees can constitute contingent assets of a pension scheme which will reduce the (potentially

1 Citation of Upper Tribunal decision in Bonas.

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substantial) risk-based levy payable by such schemes (or in effect their sponsors) to the Pension Protection Fund, it is our view that potential guarantors should think carefully before signing-up to direct contractual obligations on the basis of threats that they will otherwise "have the Regulator breathing down their neck". Moreover, where existing guarantees are terminable on the basis of their amendment provisions (most commonly, because the pension plan has reached 105% funding on the Pension Protection Fund valuation basis), there is good reason for guarantors to re-consider their position and contemplate discontinuance of support of the sponsoring subsidiary's pension obligations.

In summary

The Bonas decision suggests that the Regulator's powers are, perhaps, not as extensive as the Regulator and many in the pensions industry had previously thought. Our view is that the decision is a clear indication that parent companies are not necessarily "on the hook" for the defined benefit pension obligations of UK subsidiaries where there has been no demonstrable "benefit" received by the parent from the subsidiary in question. Where a benefit has been received, the parent should only be "on the hook" to the extent that the pension plan's finances have suffered as a result of that benefit and not – as previously considered – be liable for the entire deficit within that plan. Contrary to much of the current perceived wisdom, the decision indicates that entities saddled with defined benefit pension liabilities do not have to be kept "on life support" to stave-off the risk of action by the Regulator against the parent of the relevant entity or other group companies.

This decision should be of comfort to parent companies with subsidiaries burdened by UK pension deficits, as well as those who provide finance to such corporate groups.

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