WHITE & CASE

Clearer, quicker, tougher: UK Pensions Regulator bares its teeth

The impact of pension deficits on M&A transactions and prospective debt or equity investors is ever-increasing, as is the role of the UK Pensions Regulator

Clearer, quicker, tougher: UK Pensions Regulator bares its teeth

Deficits in defined benefit pension plans remain front-page news—particularly in the wake of recent high-profile insolvencies. They are a critical issue for any M&A transaction as the Pensions Regulator expands its already extensive enforcement powers. **Nicholas Greenacre**, **Marcus Booth** and **Ben Davies** of global law firm White & Case, as well as **Andrew Vaughan**, Partner of UK pensions, actuarial and administration firm Barnett Waddingham, explain.

The plight of defined benefit pension plans is by no means a new issue, but historically low bond yields and lower expected returns from other investment asset classes will mean that the burdens these plans place on companies will likely only increase in the foreseeable future.

The risks arising from large defined benefits (DB) plan deficits can significantly affect the price and structure of a transaction, and can lead to financial liability as well as reputational damage if not carefully managed.

If a DB plan is in deficit—and roughly 4,000 of the 6,000 DB plans in the UK are underfunded—pension liabilities must be carefully considered and addressed at an early stage of an M&A transaction or another form of proposed investment in the business. This is critical when a DB plan employer is facing financial difficulties and may require a balance sheet restructuring in due course.

Increasing regulation

Pensions are subject to an extraordinary amount of regulation, including more than 20 acts of Parliament and more than 1,000 pieces of secondary legislation. This legislation is primarily aimed at protecting the members of existing DB plans. It was put in place in response to past crises, starting with the Maxwell scandal in the early 1990s, and with little regard to prior legislation—leading to an often overwhelming complexity. Trustees, whose key responsibility is protecting members' accrued benefits, and many of whom are unpaid member representatives, often struggle to cope with an ever-thickening tangle of laws.

Around

10.5 million

members in defined benefit pension schemes in the UK

Source: Department for Work & Pensions

£1.5 trillion

is held under management of defined benefit schemes

Source: Department for Work & Pensions

The latest scandals, most notably the collapses of BHS and Carillion, are triggering still more legislation designed to expand and strengthen the powers of The Pensions Regulator (TPR), to enable it to become 'clearer, quicker and tougher' in its approach to regulating the pensions space.

The proposed changes, set out in the Government's white paper *Protecting Defined Benefit Pension Schemes*, will empower TPR to impose punitive fines on those who deliberately put a DB plan at risk and introduce a criminal offence as a sanction for "wilful or grossly reckless behaviour" of directors (and any connected persons) in relation to a DB plan.

Impact of DB plans on investors

When considering a DB plan in the context of a proposed investment, parties should focus on the trustees rather than TPR, although TPR's powers and the associated guidance provides the framework for dialogue with the trustees.

Although trustee consent is generally not a formal requirement of M&A deals (even financial restructuring transactions often proceed without their consent), the significant powers trustees hold can be used in a way that make it advisable to engage with the trustees and ensure that they are comfortable with the transaction before proceeding.

By way of example, the trustees' powers include adopting a more conservative investment strategy, withholding their agreement to the required rate of employer contributions (some may even have a unilateral power to determine contributions), with the threat of TPR intervention, and in some circumstances, the 'nuclear option' of winding up the plan and triggering a Section 75 debt. The Section 75 debt is a lump sum calculated by reference to the 'buy-out' cost that is paid by the employer, which is the cost of securing the members' benefits by purchasing an annuity from an insurance company.

Notifiable events

Various events are categorised in legislation as 'notifiable events'. These are events of which the trustee or employer under a pension plan is legally required to notify TPR, unless certain conditions are satisfied. The purpose of the notifiable events regime is to reduce the risk of circumstances which may lead to compensation being payable from the Pension Protection Fund (PPF). Notifiable events give TPR an early warning of possible insolvency or underfunding, enabling TPR to assist or intervene before a call is made on the PPF.

The notifiable events regime will frequently not capture M&A activity. The most relevant notifiable event in this context is a decision by a controlling company to relinquish control of the employer company, but this event would only be relevant in share sales below 'topco' level; i.e., not asset sales or group takeovers.

The Government's white paper acknowledges that the coverage of the notifiable events regime is limited, and indicates that TPR may review this provision and widen its coverage to all relevant transactions.

'Moral hazard' powers
TPR's Clearance Guidance provides an indication of the circumstances in which TPR may use its 'moral hazard' powers. The key trigger is a 'Type A Event', which includes any event that will significantly weaken the employer covenant, i.e., the ability of the sponsoring employer to meet its ongoing commitments to the DB plan.

A Type A Event can take a number of forms, including financial restructurings, incurrence of new debt, acquisitions or disposals, payment of dividends and many others.

The two main 'moral hazard' powers at TPR's disposal are the powers to issue financial support directions (FSDs) and contribution notices (CNs).

FSDs can be issued to impose liability on the employer or (more likely) an associated entity for all or part of the employer's liabilities within a specified period. They can be used in particular to ensure that a DB plan is supported by a parent or other group company, where the subsidiary alone is unable to support the plan.

CNs impose liability on the employer or an associated entity to pay the whole or part of the plan deficit, measured by reference to the potential or actual Section 75 debt. A CN can also be issued where there has been non-compliance with an FSD. It is significant that the Section 75 debt is relevant here, rather than the notional DB deficit identified in the employer's accounts (see graph opposite "Valuation methods of pensions deficits").

TPR's 'moral hazard' powers create a clear risk of DB plan deficit liabilities being extended to equity investors holding a significant or controlling stake in a business. In addition, the possibility of pensions liabilities being extended to non-employer operating companies gives rise to the risk that these liabilities would dilute—or even attract a (structurally) senior status to—other creditors' claims in an insolvency scenario.

TPR's use of its powers
Nortel and Lehman are prime examples of both the use by TPR of its 'moral hazard' powers and (at least in an insolvency context) certain limitations of those powers.

TPR issued FSDs to both Nortel and Lehman companies after they had entered an insolvency process. Debts arising during an administration could fall to be treated as an expense of the administration, and as such rank ahead of all other claims against the insolvent estate.

However, the Supreme Court found that, notwithstanding that the FSDs were issued after the commencement of the insolvency process, the debt arising pursuant to the FSD was simply a provable debt and would therefore rank pari passu with all other unsecured debts.

Pre-pack controversy
Pre-packaged ('pre-pack') administrations have been controversial for a number of reasons, but one particular concern has been the use of the procedure to avoid or 'strand' a company's pension liabilities. A recent example is the case of UK turkey producer Bernard Matthews, which was put into a pre-pack administration in 2016. This facilitated a sale of the business and its assets to a new owner in circumstances where the historic pension liabilities were severed from the company and became the responsibility of the PPF.

The fate of the Bernard Matthews pension liabilities is by no means a rare occurrence. An investigation last year by the *Financial Times* revealed that, since 2006, £3.8 billion of pension liabilities have been effectively offloaded on to the PPF via pre-pack administrations.

Other case studies
The deficit of the BHS pension plan was assessed at £571 million at the time of its collapse. Against a backdrop of hearings before Parliament's Work and Pensions Committee, TPR commenced enforcement action against Sir Philip Green, which resulted in the former BHS owner contributing £363 million to the pension deficit.

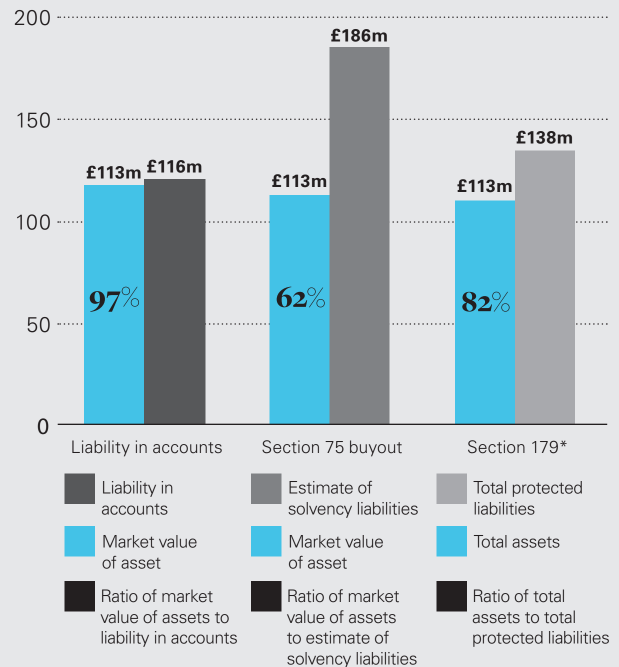
At the time of writing, TPR's anti-avoidance action continues against Dominic Chappell, who has been ordered to pay £87,000 for failing to comply with TPR's requests for information under Section 72 of the Pensions Act 2004.

Toys "R" Us is another recent high profile insolvency with a DB plan. The PPF reached an agreement with the company to take on its pension plan in December 2017 after initially resisting its voluntary arrangement proposals, with

The UK DB pe

With low interest rates and QE pushing down bond yields, UK DB pension plans have seen deficits rise in recent years

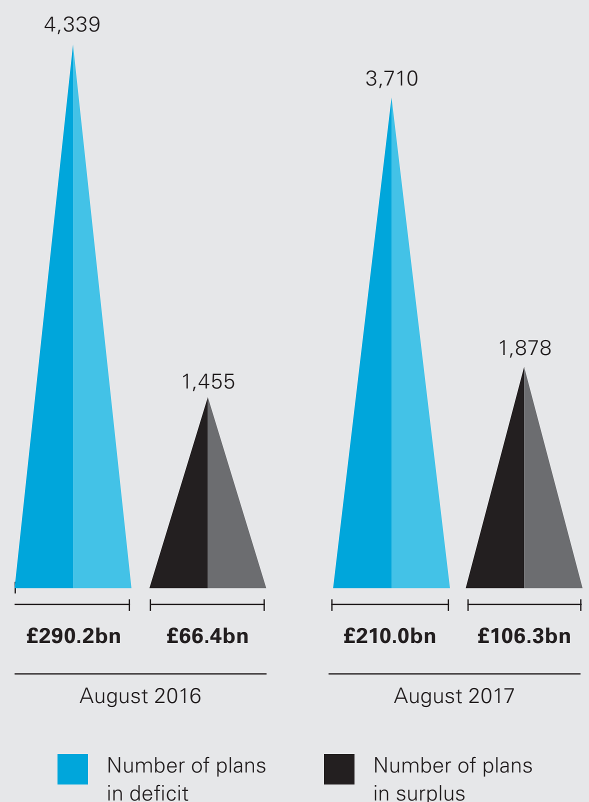
Valuation methods of pensions deficits



* Section 179 valuation determines the 'protected liabilities' figure for the purposes of calculating the PPF levy

Source: Barnett Waddingham

Deficit/surplus among plans in the PPF 7800 index



Source: Pension Protection Fund

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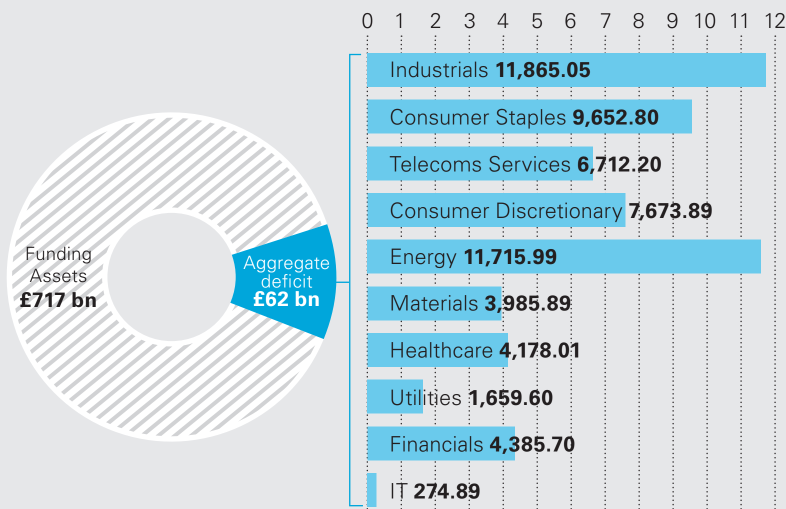
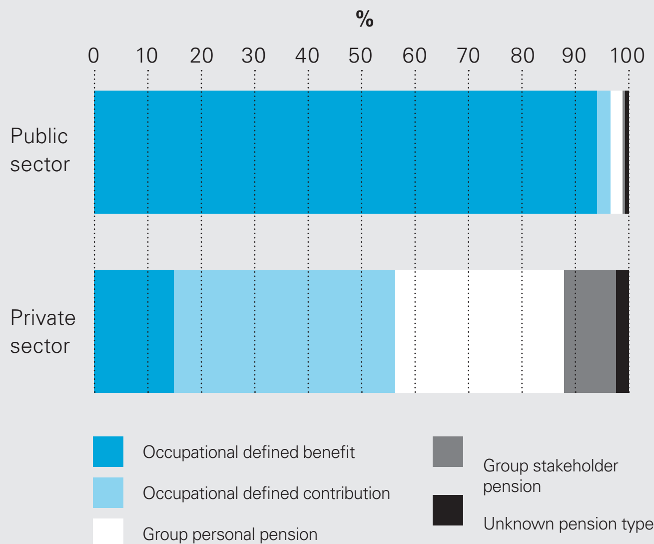
FTSE350 aggregate deficit by sector



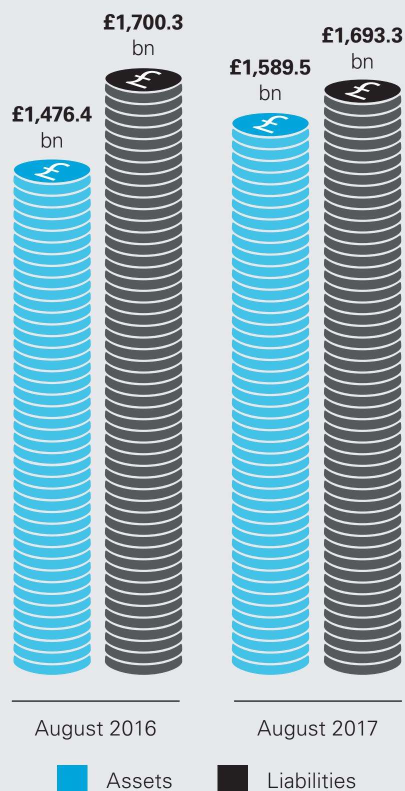
Source: Barnett Waddingham, FTSE350 survey

Employees with workplace pensions: percentages by type of pension, 2016



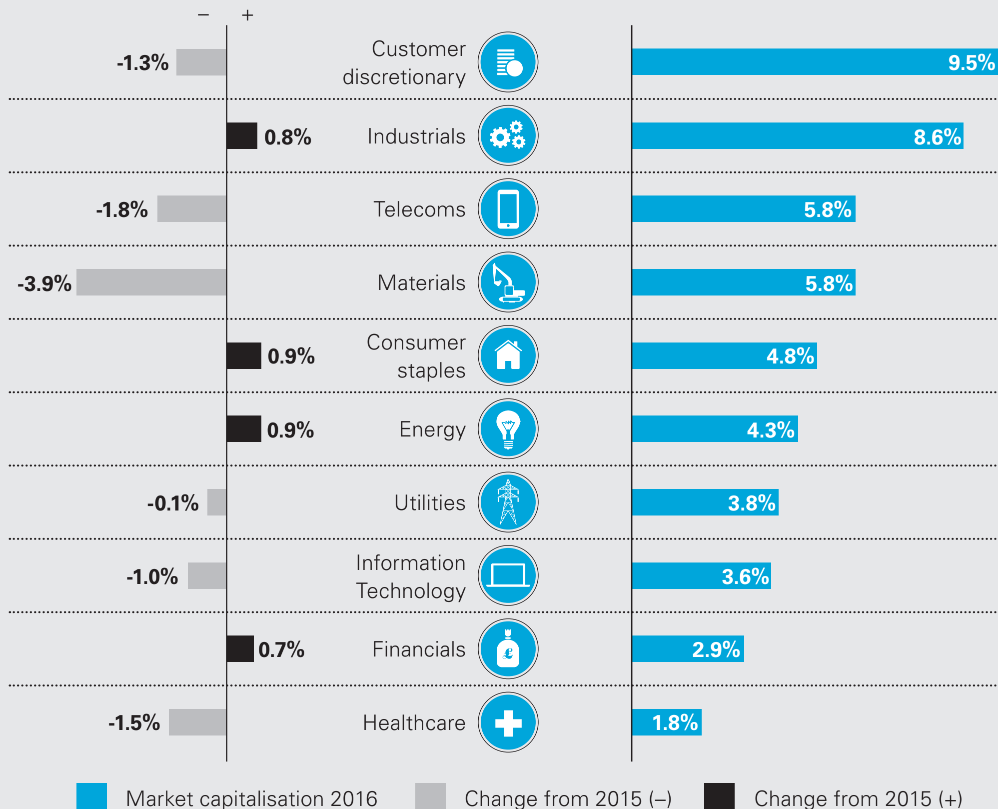
Source: Office for National Statistics Occupational

Deficit/surplus among plans in the PPF 7800 index



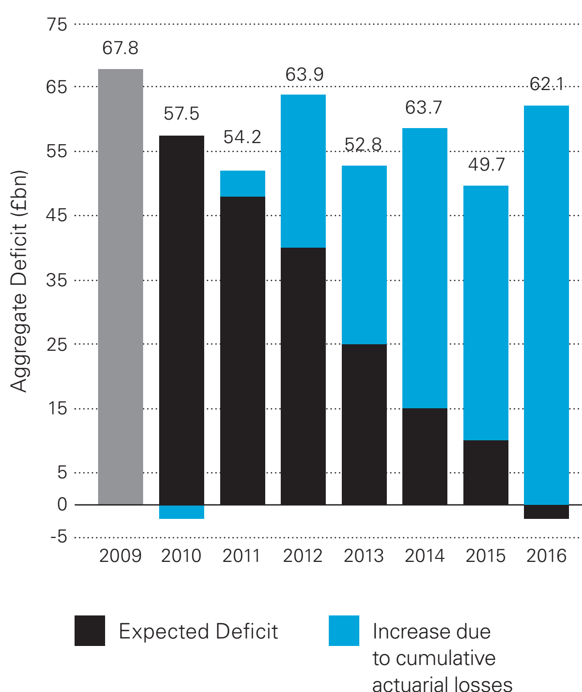
Source: Pension Protection Fund

Deficit as % of market capitalisation by sector (and % change from 2015)



Source: Barnett Waddingham

Progression of aggregate pension deficit since 2009



Source: Barnett Waddingham, FTSE350 survey

such agreement requiring the retailer to pay £3.8 million in 2018 and a further £6 million over 2019 and 2020 into the plan.

Although Toys "R" Us collapsed into administration at the end of February 2018, it had already made some of the scheduled payments, putting the plan in a better position than if Toys "R" Us had collapsed in December 2017.

Carillion and its unexpected collapse into compulsory liquidation also warrant scrutiny. TPR has received some criticism from Parliament's Work and Pensions Committee for failing to agree to previous requests by the Carillion pension trustees for 'formal intervention' in their negotiations with Carillion. Instead, TPR opened its investigation into Carillion after commencement of the compulsory liquidation process. The outcome of that investigation, and any exercise by TPR of its moral hazard powers against those involved in Carillion's demise, remains to be seen.

Finally, House of Fraser has, at the time of writing, recently launched a company voluntary arrangement as part of a wider financial restructuring exercise and it has been reported that the business is in talks with TPR regarding two DB plans with liabilities in excess of £600 million.

TPR flexing its muscles

Recent actions by TPR in other contexts appear to be a reaction to criticism that it has been slow and ineffective in dealing with big cases like those described here. TPR has been driving up compliance with basic requirements in law, in particular auto-enrolment responsibilities and the submission of scheme returns for both DB and defined contribution schemes. These efforts have included prosecuting individual directors for deliberately avoiding their auto-enrolment responsibilities, as well as pursuing civil action for recovery of fines from non-compliant employers. TPR has been quick to publicise this action and to underline its renewed 'clearer, quicker, tougher' approach.

Impact on M&A transactions

On any transaction, trustees will need to assess the impact of the transaction on the employer's covenant to discharge its obligations under the pension plan and ensure the deal is in the best interests of the members.

The trustees' aim in negotiations is generally to secure clearance of the deficit (on the statutory basis) as soon as possible, ideally on completion of the transaction, and/or to leapfrog unsecured creditors in ranking priority with some form of guarantee or other security. They will also often want to plot a path to a full buy-out, so as to obtain full security for members' benefits within a reasonable period of time.

Impact on restructurings

Whilst trustee approval is not a legal requirement to any proposed restructuring of a group with DB pension liabilities, consideration must be given to TPR guidance, which makes clear that if there is a Type A Event, and the DB pension is in deficit, employers should negotiate with trustees with a view to providing mitigation for the event.

As in an ordinary M&A scenario, trustees would need to assess the current covenant and then assess the covenant as it would be after the proposed restructuring. If there is a material deterioration in the covenant, the trustees may seek to redress the balance by, for example, demanding a lump sum contribution or additional security.

Where the restructuring is pensions-driven, the PPF has issued guidance which provides that any agreement to enter into a solvent restructuring must be on the basis that the value to the PPF would be significantly greater than it would achieve in an insolvency scenario. This is a high hurdle to surmount and the PPF have stated that their agreement to these kinds of restructurings is rare and not entered into lightly.

Way forward

Meaningful and early engagement by the parties with the trustees is essential, as is a meaningful discussion as to how any proposed transaction and any associated proposals for the support of the DB plan can better secure the benefits members have accrued under the DB plan.

The parties may opt to apply to TPR for clearance of the transaction, which is the only way of obtaining certainty that TPR will not use its powers in relation to the transaction at a later stage. However, since reaching an understanding with the trustees is essentially a pre-requisite to obtaining clearance from TPR, the initial focus should always be on the trustees.

Trustees will likely feel emboldened by the extensions of TPR's 'moral hazard' powers and TPR's evident appetite for going to considerable lengths to demonstrate a proactive and robust stance.

The trustees to the GKN DB plan recently secured from Melrose a promise that Melrose would contribute up to £1 billion to the plan following the success of its hostile bid for GKN. This is just one of many recent events proving that trustees' demands on transactions are likely to continue to become more aggressive.

It's also a vivid demonstration that successfully securing benefits under a DB plan requires both attentive engagement with trustees and a watchful eye on TPR.

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