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EDITORIAL

Defined Benefit Pension Schemes: A UK System with a Cross-border Impact

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Synopsis

Defined benefit pension schemes are often a key factor in many financial restructurings, particularly where there is a substantial or historically substantial UK subsidiary. They represent a large contingent obligation often in the region of hundreds of millions or even billions of GBPs.

In this article, we examine how such schemes can act as a significant impediment to a restructuring plan. This is the case even where the restructuring relates to a non-UK company (e.g. a US company in Chapter 11), so long as there is a related UK entity with a defined benefit pension scheme. We also examine how in recent years there has been an increase in political pressure and regulatory intervention to support the negotiating position of the scheme beyond its typically unsecured status.

The 'mood music' in the UK is that the position of scheme trustees will likely be strengthened due to proposed legislative changes, which include potentially far-reaching criminal and civil sanctions where a scheme's ability to pay its members their benefits has been compromised.

This provides a complicated framework for financial creditors within which to work out a viable restructuring plan that works for all, particularly for those who may be unfamiliar with the complexities of UK pension law.

However, a better understanding of the duties, powers and motivations of scheme trustees, the Pensions Regulator and the Pension Protection Fund can assist in allowing meaningful engagement with stakeholders, and hopefully lead to positive consensual outcomes that work for all.

Introduction

Defined benefit pension schemes ('DB Schemes'), or final salary schemes, have long been a feature of UK businesses. DB Schemes have often been an important consideration when a group of companies or a company requires reorganisation or restructuring.

The Pensions Regulator ('TPR'), the body set up to protect the interest of scheme members, has been in existence for over 20 years. The Pension Protection Fund (the 'PPF'), the lifeboat fund that guarantees that scheme members will get at least some of their benefits should the employing company become insolvent, was established 2005.

These regulatory bodies are familiar to the UK restructuring world. However, the powers they have been provided with, and the influence they now wield, have grown. As we shall explain in this article, such influence is likely to expand even further, with a potentially game-changing impact on the ability to refinance and restructure not just UK companies, but also the overseas parents of those companies.

The DB Scheme as a significant creditor

Before examining the current political landscape relating to DB Schemes, it is worth reviewing the impact they have already had on financial and operational restructurings.

Although DB Schemes vary in size depending on the number of members and the benefits they are entitled to, it is very common for there to be a deficit in most schemes. That deficit (albeit by way of an unsecured claim upon insolvency) is often material when compared to a company's other non-pension liabilities. It is not unusual for the DB Scheme to be the largest unsecured creditor in an insolvency, and because of the way the deficit is currently calculated, that unsecured claim can often be in the region of hundreds of millions, or even billions of GBPs.

The impact of the DB scheme deficit as an unsecured claim is well-illustrated where a company is seeking to compromise its creditors as part of an operational restructuring, executed through a Company Voluntary Arrangement ('CVA') which requires the support of the unsecured creditors. The DB Scheme may well be the largest single unsecured creditor, and it is therefore likely to have a casting vote as to whether any proposed plan is approved. Even if the DB Scheme is not the largest creditor, the powers of TPR are such that pension

interests are likely to have a significant seat at the negotiating table.

Such leverage has gained prominence recently in the CVAs of retailers such as Arcadia and Toys'R'Us. The principal purpose of those arrangements was to compromise the claims of landlords in respect of the loss-making or underperforming stores of the relevant retailer. In these cases, TPR and the PPF (responsible for exercising the voting rights of the DB Scheme in these scenarios) managed to extract additional value for the DB Scheme. This is because the size of the DB Scheme meant that they held the decisive vote on whether the CVA could be approved.

This 'blocking position' can reach beyond a debt compromise within the employer company. There are multiple instances where a company (often an overseas parent company) is subject to a restructuring which is impacted by the fact that a subsidiary or associate company, which itself is not insolvent and whose creditors are not being compromised, has a DB Scheme. For example, a US company in Chapter 11 may be seeking to implement a plan which has broad approval from creditors, and under its terms it will impact upon assets either directly owned by the company with the DB Scheme or indirectly through a subsidiary of that company. Most commonly this is because the restructuring is accompanied by enhanced security for the benefit of creditors providing new funding over all entities in the group, including a UK subsidiary with a DB Scheme.

In such a scenario, TPR may consider exercising (or threatening to exercise) its broad powers. If the DB Scheme is insufficiently resourced (which is determined by a statutory test), then TPR can require a parent company or any related or connected party (but not individuals) to provide financial support to the DB Scheme by issuing a Financial Support Directive ('FSD'). If TPR considers that any action would cause 'material detriment' to the DB Scheme, then if it considers it reasonable, it can seek to issue a Contribution Notice ('CN') against any related or connected parties (including, importantly, individuals such as directors) involved in the act. Material detriment occurs where the ability of the employer company to meet its obligations under the DB Scheme is effectively put at risk or compromised. FSDs and CNs are part of the armoury of powers available to TPR, which places a requirement on its target (usually a parent company, but it could be any company within a group or their directors) to financially support or contribute to a DB Scheme.

This power has been used effectively to create leverage again by blocking the critical path to a plan approval by creating uncertainty as to whether the proposed plan can be delivered in the short term, or indeed at all.

Although there are difficulties in a UK body (which derives its powers under an English law statute) bringing a claim against a foreign company subject to local bankruptcy protection, the disruption caused (and the threat of residual claims) have been sufficient for a settlement to be reached in several cases with value extracted for the benefit of the DB Scheme.

Notwithstanding the position of the DB Scheme as a material unsecured creditor, in the majority of UK restructuring cases, the process is driven by the secured creditors who, usually, through a combination of a covenant breach and the value of the business breaking at their level of the debt stack, are in control as the effective economic owners of the company's (or group's) assets.

In many cases, it has been possible for secured creditors to achieve a restructuring without having to deal with the DB scheme at all. They may even abandon the DB Scheme and its significant liabilities by enforcing over the company's business and assets, moving them to a new company and leaving the DB Scheme and other creditors behind in an insolvent company that is then placed into administration or liquidation.

This ability to abandon the DB Scheme, however, has become significantly curtailed in recent years and the current climate suggests that such tactics will be even harder to adopt in the future.

Powers, politics and public relations

Ask any restructuring professional in the UK what has had the biggest impact on the consideration of pension scheme issues in a distressed company, and without a doubt most will respond with 'the Frank Field effect'.

Frank Field MP is a Member of Parliament and chairs the Work and Pensions Parliamentary Select Committee (the 'Select Committee'). The Select Committee summons stakeholders for examination following high-profile business failures involving significant DB Schemes, in order to hold them to account for their conduct through the run-up to and the course of any restructuring and ultimate collapse of a company. These stakeholders include directors, TPR, trustees and professional service providers. It is also clear that, through their actions, the Select Committee has been placing pressure on the UK Insolvency Service to ensure that claims against directors are properly investigated where there has been a loss to a pension scheme or its members.

Whether these hearings really get to the heart of why a failure has happened, or provide an insight as to who was responsible and what lessons can be learned, is debatable. What is clear, however, is that such an experience is not welcomed by many. There is prevailing sentiment that stakeholders are now acting on the basis that, should they find themselves before a Select Committee or being investigated by the UK Insolvency Service, they want to be able to demonstrate that they have acted in an exemplary manner, whereby the best interests of members of the pension scheme were an important part of their decision-making and actions.

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There has long been political support and pressure to ensure that pensioners' interests are protected, but the work of the Select Committee has acted as a real catalyst for fast-moving and potentially far-reaching changes. The PR battle to be seen as 'doing the right thing' is often as important as any legal rights that classes of creditors may have in any successful restructuring.

It is evident that TPR and the PPF are proactive and engaged both in their support of pension trustees and in dealing directly with companies and key financial stakeholders in ensuring that the interests of the DB Scheme are represented in negotiations and protected. One of the main reasons for this is that they are aware of their new-found leverage created by this current political and PR environment relating to pension schemes. TPR has also set out their new general approach to regulating pensions in their 2018 corporate plan as being 'clearer, quicker, tougher'.

TPR and the PPF are also aware that DB Schemes are often attached to operating companies, which means that insolvency at that level is often unattractive due to the disruption, value destruction and overall cost that often follow. Therefore, in order to preserve the company, an acceptable compromise must be made with the trustees regarding future funding.

Where the preservation of the operating company is a key element of any restructuring plan, but the scale of the DB scheme's liabilities is such that a turnaround plan is not feasible, it is possible to detach a scheme from a company using a Regulated Apportionment Arrangement ('RAA') which effectively places the scheme in a new company, and the original employer is no longer responsible for its funding. An RAA requires the sanction of TPR; unsurprisingly, the criteria which has to be met for a company to be eligible is quite proscriptive and the 'price' is set high both in terms of cash contribution that has to be made to the scheme, and also the fact that the DB scheme (usually through the PPF) will have to be given equity (no less than 10%) in the original employer as part of the compensation package. In essence, TPR's use, or threat of use, of its powers increasingly creates tensions between the economic interests of all relevant stakeholder groups.

For a DB Scheme to reach its 'end game', i.e. the point at which it has enough funds to meet all future obligations and is therefore no longer reliant on the employer, that employer would need to survive up to that point. Therefore, the approach of TPR and the use of its powers are designed to support that goal. Recognising, however, that it is better for a DB Scheme to achieve independence sooner rather than later, there is now greater pressure on companies and DB Scheme trustees to create a plan that enables the DB Scheme to be funded in shorter time frames, which naturally creates a tension in a distressed environment where, by its nature, money is in more limited supply.

All of the above factors have created an additional issue for secured creditors looking to restructure a balance sheet with a debt-for-equity arrangement. The price for avoiding either the costs associated with an insolvency, or the reputational damage caused by acting in a way that is detrimental to the DB Scheme, may require both an upfront compromise with the scheme and an exit price that impacts the timing of an exit and the overall return to the lenders.

But the story does not end here. In October 2019, a new Pensions Schemes Bill was put before Parliament, and then presented again in December following the UK general election, which if passed has potentially far-reaching consequences for restructurings.

The Pensions Schemes Bill 2019

Changes to the system and new powers for TPR, including much-discussed criminal sanctions for directors in certain circumstances, were expected in the proposed Pensions Schemes Bill 2019 (the 'Bill'), but what has been presented has taken many by surprise.

The Bill contains several notable provisions that, if implemented, would introduce:

– **New criminal offences for company directors and other parties who act to avoid or reduce an employer debt or action that jeopardises benefits under a DB Scheme.** Such sanctions include up to seven years' imprisonment, a fine, or both.
– **A new civil penalty of up to £1 million that can be imposed on directors and other parties in a range of circumstances.** Such circumstances include acting unreasonably (or failing to act reasonably) in respect of scheme liabilities; causing material detriment in the scheme's ability to pay benefits; or knowingly or recklessly providing TPR or trustees with false or misleading information.
– **New triggers for issuing contribution notices.** Contribution notices are effectively a demand to make good any shortfall to the scheme that the target of the contribution notice has caused; such notices can be issued against directors. One such trigger is an action taken by a company that would materially impact upon the recoveries of the pension scheme in an insolvency; e.g. where a company takes on additional debt which ranks above a DB Scheme in the event of the company's insolvency or as a result of corporate restructuring, or where dividend payments are made.

A contribution notice may be issued against directors of a pension scheme sponsor and connected and associated parties. This includes other group companies and directors of companies within the same group. Moreover, the criminal and civil sanctions discussed above can be applied to various directors in the same way, as well as investors, persons within banks or other

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financial institutions who have financed a company or a group with a DB Scheme.

In essence, if the Bill is enacted in its current form, there will be a risk of both civil and criminal liability for directors (and other persons) who either act, or fail to act, in a manner where the resulting effect of such action or inaction is a reduction in the return to the pension scheme. This is tested on the hypothesis that the relevant company is placed into an insolvency process immediately following the act (or failure to act) by the relevant directors (or other person).

Although the Bill provides certain defences and requirements as to reasonableness and materiality, its core premise is that, absent reasonable excuse, directors (and other persons involved) will be at risk of both civil and criminal liability if the relevant action or inaction results in a loss to the scheme. The drafting of the Bill raises the prospect that directors who are trying to balance the interests of different creditors may be 'damned if they do and damned if they don't'. The one certainty is the likely increased need for financial and legal advice for directors when contemplating a restructuring, in order to cater for the potential risks created by the Bill, and thus an even greater role for TPR and DB Pension Schemes in restructuring negotiations going forward.

The Bill may also impact upon a company's ability to pay dividends (since a dividend inevitably removes assets from a company) or grant security (which impacts upon assets available to pay unsecured creditors). If TPR takes a stance upon enactment of the Bill that dividends should be restricted in some way whilst pension deficits exist, or that new security could not be granted, this may also reduce the restructuring options available to a company as it may limit its ability to raise capital in the equity markets or maintain its debt capital.

The scope of TPR's proposed new powers is significantly broader than what many within the industry expected, and the threshold which would need to be met in order for the new criminal sanctions to be applied is significantly lower than indicated by the Government previously. In addition, TPR has demonstrated in the past that, where appropriate, they will pursue its powers against persons or corporates in jurisdictions beyond the UK.

All of these factors will greatly increase the risks and complexity associated with transactions involving (or the restructuring of) a company or group with a DB Scheme.

Conclusion

We have seen how the political and regulatory landscape for UK DB Schemes and its impact on restructurings have developed over the last 20 years, but with snowball-like intensity in recent years.

An emboldened regulatory body with a clear political mandate and mission statement to be 'tough' on behalf of scheme members creates a very new dynamic in the art of negotiating an acceptable and deliverable restructuring plan.

Moreover, the reach and impact of TPR is designed to extend to jurisdictions beyond the UK. This can have a material influence on foreign companies, the directors of these companies and even their shareholders, either in relation to a UK-based restructuring or foreign proceedings which impact on a UK scheme.

Nevertheless, it is important to remember that ultimately, it is in the interests of all the stakeholders (including the DB Scheme) that the employer company can continue as a going concern. On that basis, there is scope for sensible negotiation and imaginative solutions to accommodate all.

The key is to engage with the DB Scheme trustees, the PPF and TPR as appropriate and work with them at the early stages of a restructuring. A greater spirit of openness and dialogue can at best lead to a 'win-win' consensus, and at the very least avoid heavy fines and an unwelcome period in jail!

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