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An Overview of the New Pension Regulations and their Impact on Restructurings and M&A Transactions in the UK

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Overview

Introduction

A new era dawned in the UK on 6 April 2005 when the Pension Act 2004 ('the Act') became effective. It brings sweeping changes to the ways in which deficits for UK defined benefit (DB) schemes are to be dealt with. The importance of this issue has been highlighted by a number of recent high-profile transactions such as Alders, WH Smith and MG Rover where potential M&A transactions have been forestalled by pension deficits. This article examines the key implications of these changes, mainly from a restructuring and M&A viewpoint.

Historical perspective

The Act is hailed in the Ministerial foreword of the Guide to the Pensions Act 2004 as 'a landmark in securing and strengthening the UK's tradition of private pension provision and a major stepping stone on the road to meeting the demographic challenges posed by an ever healthier, but increasingly ageing, population.' Whilst this may be a very admirable goal from a social point of view, its impact on the corporate world is more uncertain.

The Act itself is lengthy and complicated and a number of guidance notes are not yet published. This article concentrates on 3 key aspects of the Act.

First, the Act creates the Pension Protection Fund ('PPF'), a major new institution that radically transforms the nature of protection offered to members of DB schemes even if their company becomes insolvent and leaves the pension scheme underfunded. Second, the new Pensions Regulator ('TPR' or 'the Regulator') will have a range of new powers designed to protect the interest of scheme members. Third, a new clearance procedure has been set up for those involved with M&A or restructuring transactions and concerned with underfunded schemes and who are worried about being pursued by TPR (to seek advanced clearance from TPR).

Moral hazard

Under the Act, TPR has replaced OPRA as the Regulator of work based pensions. TPR has powers to help reduce risks to members' benefits and to the PPF, helping to limit costs for PPF levy payers.

On 11 June 2003 the Government announced the creation of the PPF and the introduction of a full buy-out debt on scheme windup where the employer is insolvent. The Government subsequently announced that powers were to be given to TPR from April 2005 onwards to act where employers and other companies have avoided their obligations to fund DB liabilities.

Actions or inactions by the sponsoring and other employers may put at risk the employer's ability to fund a deficit on its DB scheme in the event of the scheme being wound up. Sometimes these risks are caused by changes to the sponsoring employer as a result of corporate transactions. In a few cases these changes may be a deliberate attempt to avoid the statutory debt on a scheme's wind-up, in the knowledge that the PPF will after April 2005 compensate members if their employer becomes insolvent when the scheme is underfunded. This represents a risk to the PPF and PPF levy payers.

Pensions Regulator's powers

The Act gives TPR specific powers to help reduce risks to members' benefits caused by employer actions. A summary of these powers is set out below.

Contribution Notices ('CN')

These will allow the Regulator to recover when reasonable an amount up to the full statutory debt from one or more persons who were involved in an act or failure to act after 26 April 2004 which had as one of its main purposes the avoidance of pension liabilities. The amount would be payable to the trustees of a scheme (or to the PPF if it has assumed responsibility for a scheme).

Financial Support Directions ('FSD')

These will require provision of financial support to an underfunded scheme. Financial Support Directions may be issued where the Pensions Regulator concludes that the sponsoring employer of a scheme is either a service company or is insufficiently resourced. In deciding whether it is reasonable to issue a direction the Regulator will have to consider a range of relevant factors.

Restoration orders

These will require money or property that has been transferred out of the scheme at undervalue in the two years before an insolvency event or application for PPF protection (but after 26 April 2004) to be either returned to the trustees or paid to the PPF as appropriate to restore the scheme to the position it would have been in had the transaction not been entered into.

Clearance statements

Anyone who considers they may be subject to a Contribution Notice or Financial Support Direction will be able to seek confirmation from the Pensions Regulator that it will not exercise its powers (either CN or FSD) to issue these. The Regulator must make a decision in relation to clearance as soon as reasonably practicable but will not be bound by the clearance statement if there is a material change in circumstances or if the circumstances described in the application are inaccurate.

Implications on restructurings and other corporate activities

The following is a list of issues which companies, advisers and other stakeholders involved in restructurings and M&A transactions should be aware of.

Notifiable events framework

One of the principal aims of these requirements is to alert TPR to those 'at risk' companies which could potentially be responsible for a claim on the PPF. This is essentially an early warning system modelled on the US Pension Benefit Guaranty Corporation (PBGC) regime in order to prevent losses before they arise, rather than waiting to pick up the pieces when a company goes bankrupt and its financial resources are limited.

The following is a list of proposed employer related events which require notification:

- Any decision to compromise a pension debt
- Any decision to cease business in the UK
- Any decision to dismiss 20 or more employees
- Receipt of notice of wrongful trading
- Any breach of a banking covenant
- A significant change in credit rating
- Change of control
- 2 or more changes in Chief Executive
- Conviction of a senior staff involving dishonesty.

As can be seen above, the list is quite extensive and events such as breaching of banking covenants or credit downgrade affect many companies going through restructuring. This is a good thing as this would create an alert to the potential risk of an insolvency and that the Regulator would have more time to engage in negotiations with the employer and other stakeholders.

But there are some concerns:

(a) As the list is deliberately widely drafted, the Regulator is bound to get a large number of 'notifiable' events reported. The concern is that given the limited resources available to the Regulator whether they are able to quickly sift through those which are genuinely at risk and those which have much lower risk but the trigger is only of a minor or technical nature.

(b) It is not clear how the Regulator intends to handle sensitive information reported to them for which the market may not be generally aware.

Credit risk

Lenders and investors will want to know if a borrower or investee company is subject to Contribution Notices or Financial Support Direction, or that any events have been reported to the Regulator. In addition, very often the quantum of the buy-out deficit is not disclosed and it is important that additional due diligence is done to establish this number and the basis on which it is calculated. It should be noted that while for most companies with a going concern assumption FRS 17 is probably an appropriate basis for measuring the size of the deficit, this is not so when the company is close to insolvency. This is because in an insolvency the pension liability will be based on its buy-out deficit rather than FRS 17 deficit. The buy-out deficit, which is usually significantly higher than the FRS 17 deficit, is not disclosed in the accounts.

Situations that might require a clearance statement

The clearance statement framework is designed to catch transactions that are 'financially detrimental' to the company and thus weaken the credit covenant. Such transactions, which are often seen in restructurings, include:

- *Change in priority* – a change in the level of security given to creditors, with the consequence that the pension creditor might receive a reduced dividend in the event of insolvency. This could include substitution of secured debt for a significant

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amount of previously unsecured debt.

– *Return of capital* – any payment of large dividends, share buy backs, dividend strips could affect the overall assets base of the company.
– *Change of control* - The concern here is that any change of control could affect the employer's ability to meet its pension obligations.
– The break-up of a group or spin-off of a subsidiary.
– A major divestiture by an employer which retains underfunded pension liabilities.
– A transfer of significantly underfunded pension liabilities as part of a business transfer.

The Regulator has recently issued some clearance procedure guidance notes but the rationale is not too clear in some cases and it remains to be seen how they will apply in practice. To avoid over-reporting, clearance procedures will only initially apply to those schemes with a FRS 17 deficit at the time of the clearance application. There is a concern that this cut-off is superficial but in practice prudent deals should still go for clearance even with a modest FRS 17 surplus. This surplus could swing into a deficit over time and also the buy-out deficit is very often higher in any case.

Special Purpose Vehicles

One of the unique features of the Pension Act is the piercing of the 'corporate veil' because the definition of 'connected parties' includes those which are only indirectly connected with the employer even though it does not have a direct shareholding relationship. For example, the Regulator has the power to issue Contribution Notices or Financial Support Directive to fellow subsidiaries, joint ventures or even special purpose vehicles which have common sponsors if it believes it has the reason to do so. Likewise, investors and funders of special purpose project companies may also be exposed to the pension deficits of project sponsors who provide staff to work on the projects. Lenders and other stakeholders in these situations should take extra care in their due diligence to ensure there is no potential pension liability 'contamination risk'.

Debt–equity swaps

Many restructurings include a debt-for-equity swap where the control of the company will pass from the shareholders to the lenders. Under the new Pension Act definition, any equity investor with 33.33% or more of the voting rights will be an 'associate' of the company and thus could be a target for a Contribution Notice or Financial Support Direction of a company with a defined benefit deficit. Lenders considering debt–equity swaps are well advised to seek advice to consider alternative structures which could mitigate the risks.

Internal group reorganization

Whilst the procedures contemplate that normal commercial transactions carried out at arms' length do not require clearance, it should be noted that if these transactions involve one of those triggers mentioned above, they would still require clearance. For example, moving assets from one company to another involving pension deficits could be viewed as being 'financially detrimental.'

Leveraged transactions

In theory, any leveraged transaction could weaken the company's credit covenant especially as the new debt is often secured which puts the lenders ahead of the unsecured pension creditor. Such transactions should be structured carefully and in a number of these cases the Regulator's clearance will be required.

New stakeholder

Finally as mentioned above, the mission of the Pension Regulator is to seek to get involved with 'at risk' situations earlier thus reducing the likelihood of a claim against the PPF as a result of companies going into insolvency. This means, if the process is to work as anticipated, as a major unsecured creditor, the Pension Regulator will get involved in restructuring negotiations a great deal earlier with other stakeholders. However, the Regulator's hands are relatively tied as the trustees would not be too sympathetic to accepting any proposal which gives them less than what they could otherwise get from the PPF. Looking at the US experience, this proactive involvement has been helpful in rescuing companies – either pre or in Chapter 11 situations. It remains to be seen in a UK context with its limited resources and powers how successful it would be.

Conclusions

It is clear that the impact on M&As, restructurings and other corporate activities will be far-reaching. Potential bidders for companies with large pension deficits should be very careful in analysing the situation and any impact arising from the pension deficit should be factored into the price negotiation. The regulations are designed to make sure that the pension liability cannot be dumped. The consequence is that buyers of businesses with pension deficits will either have to pay more, walk away or wait until the company has gone into an insolvency process where there is less control over the outcome. As for restructurings, it is clear that the Regulator will be a major stakeholder going forward.

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