Hogan Lovells

The Pensions Regulator's new powers: what lenders need to know

Updated August 2021 Pension briefing

HIGHLIGHTS

Following the insolvencies of Carillion and BHS and the associated fallout for the pension schemes they sponsored, the Pensions Regulator (tPR) announced it was going to be "clearer, quicker and tougher".

The Pension Schemes Act 2021 (the Act) gives tPR significant new powers to intervene where the security of defined benefit (DB) pensions may be at risk. These new powers include an expansion of the moral hazard powers and an extension of the "notifiable events" framework It also creates new criminal offences and liability for civil fines of up to £1m.

Lenders to corporate groups with DB schemes should understand the potential impact that the new provisions could have for structuring lending and on a borrower's ability to agree to changes to its capital structure or grant new credit support in the context of a restructuring. The changes proposed through the Act have potential for a material impact on financial restructurings and will certainly not make things easier for stakeholders looking to restructure groups with DB schemes. The scope of the new offences is wide and lenders should take careful advice to ensure transactions are structured in a way that takes into account tPR's expectations in relation to the security of DB funding, or that early discussions take place with tPR to reduce the risks of future investigation.

We have updated this note to cover recent consultations on draft regulations and on tPR's draft policy explaining how it will investigate and prosecute the new criminal offences.

NEW CRIMINAL OFFENCES AND FINES

The Act introduces two new offences – conduct risking accrued DB benefits and avoidance of employer debt, as explained below. Each offence is punishable by up to seven years' imprisonment and / or an unlimited fine.

There are specific exemptions from both offences for insolvency practitioners, but not for other professionals. Potentially, an offence could be committed not just by a sponsoring employer but also by its parent company and advisers or other professionals who might have "aided and abetted" the commission of the offence, including, in theory, its lenders.

As an alternative to criminal prosecution, tPR will have power to impose civil fines of up to £1 million, in broadly similar circumstances.

Conduct risking accrued DB benefits

- Risking pension scheme benefits to which members have already built up rights may be an offence.
- A person may commit this offence by doing an act (or failure to act) which "*detrimentally affects in a material way the likelihood of accrued scheme benefits being received*".
- The person must also have known, or ought to have known, that the act, omission, or course of conduct would have that effect; <u>and not have a reasonable excuse</u>.

Avoidance of employer debt

- An employer with a DB scheme may become liable for a debt due under section 75 Pensions Act 1995 in particular circumstances (please see the box below).
- It will be an offence to prevent a section 75 debt becoming due; reduce the amount falling due; prevent the recovery of a section 75 debt; or compromise a section 75 debt.
- Similarly, the person must also have known, or ought to have known, that the act, omission, or course of conduct would have that effect; <u>and not have a reasonable excuse</u>.

What is a section 75 debt?

A DB scheme's section 75 debt is, broadly:

- the value of liabilities to pay benefits built up under the scheme; less
- the value of the scheme assets

calculated as if the benefits were being bought out with annuities from an insurance company.

A section 75 debt will potentially fall due from a sponsoring employer of a DB scheme if:

- the employer becomes insolvent (or goes into solvent winding-up);
- the scheme starts winding up; or
- where a scheme has multiple employers, one of the employer stops employing active members (employees currently earning pension benefits) when the scheme continues to have active members employed by other employers.

New offences: implications for lenders

The circumstances in which the new offences might be committed are wide-ranging. Any action which lessens an employer's ability to fund its DB scheme could affect the likelihood of benefits being paid and so potentially be an offence. This may cause directors concern when considering borrowing new money or giving security and guarantees if it could weaken the financial position of an employer. This could lead to an increase in applications for clearance, more "three-way" negotiations between lenders, borrowers and pension trustees and may ultimately leave lenders in a worse position if concessions need to be made to trustees.

Theoretically, lenders themselves come within the remit of the new offences (they apply to "*any person*"). It is not necessary to be associated or connected with a sponsoring employer which is the case for the tPR's existing moral hazard powers (please see the box below). The Act does not help us with what might amount to a "*reasonable excuse*" but the common sense view must be that lenders would have a reasonable excuse for acting in their own commercial interest (and the interests of their shareholders).

Draft investigation and prosecution policy

tPR has recently consulted on a draft policy setting out its approach to investigating and prosecuting the new offences. tPR makes clear that it expects those it investigates to explain their actions and to put forward evidence of any matters which might constitute a reasonable excuse. In particular, it expects the reasons behind particular action (or inaction) to be well documented, including consideration of alternative approaches and any assessment that no material detriment to the pension scheme would arise.

tRP has stated that it won't generally expect a person to take action which would unreasonably disregard their own interests. When assessing whether a person has a reasonable excuse, tPR will consider three factors in particular:

- Whether the detrimental effect was an **"incidental consequence"** of the act (or omission), or a "fundamentally necessary step to achieve the person's purpose". tPR gives an example of detrimental impact being "incidental" where a lender refuses, revises or terminates a lending agreement, where the purpose of the act was unrelated to the scheme. The **adequacy of any mitigation** to offset the detrimental effect.
- Where there was no (or inadequate) mitigation, was there a "**viable alternative**" which would have avoided or reduced the detrimental effect? For example, there may be no viable alternative where new secured debt is critical to the employer's survival and the continuation of the employer is a better outcome for the scheme than the employer's insolvency.

tPR's moral hazard powers

tPR already has power in specified circumstances to issue:

- a contribution notice (CN) requiring a one-off contribution to be made to a DB scheme; or
- a financial support direction (FSD) requiring financial support for the sponsoring employer's pension liabilities to be put in place.

At present, tPR may issue a CN if it is of the opinion that:

- the *"material detriment"* test is met in relation to the target's act or failure to act; or
- the main purpose or one of the main purposes of the act or failure to act was to:
    - prevent the recovery of the whole or part of a section 75 debt; or
    - prevent a section 75 debt becoming due, compromise or settle a section 75 debt, or reduce the amount of a section 75 debt which would otherwise become due.

Broadly, the material detriment test will be met if tPR considers that the target's act (or failure to act) has "*detrimentally affected in a material way the likelihood of accrued scheme benefits being received".*

A person who *"knowingly assists"* in an act or failure to act may also be subject to a CN.

CONTRIBUTION NOTICES: EXTENDED POWERS

The circumstances in which tPR may issue a contribution notice (CN) (please see the box on moral hazard powers above) will be extended. A recipient of a CN still needs to be associated or connected with a sponsoring employer of a DB scheme (for an explanation of these terms please see the box below) and tPR may only issue a CN where:

- it believes it is reasonable to do so, taking into account specified considerations; and
- it issues a warning notice in respect of the CN within six years of the act or failure to act.

Who is associated or connected with a sponsoring employer?

Who is associated or connected with an employer is set out in insolvency legislation.

A person (A) (which may be a company, an individual or a body of unincorporated persons) is *connected* with a company if A is:

- a director (or shadow director) of the company;
- an associate of a director (or shadow director) of the company; or
- an associate of the company.

Broadly, a company (B) is *associated* with another company (C) if:

- B controls or is controlled by C;
- the same person controls both B and C;
- a person (D) has control of either B or C, while associates of D (or D together with his associates) have control of the other of B or C; or
- B and C are both controlled by the same group of persons (or by their associates).

For this purpose, a person (E) has *control* of a company (F) if, broadly:

- the directors of F are accustomed to act in accordance with E's instructions; or

- E is entitled to exercise, or control the exercise of, at least one-third of the voting power at a general meeting of F (or at a general meeting of a company which controls F).

A new **"employer insolvency test"** and an **"employer resources test"** will be introduced, and tPR may issue a CN where either of the new tests is met in relation to a person's act or failure to act.

New employer insolvency test

The employer insolvency test will be met if tPR considers that immediately after the target's act or failure to act (the *"relevant time"*):

- the value of the scheme assets was less than the amount of the liabilities (as estimated by tPR, on the section 75 debt basis); and
- if a section 75 debt had fallen due from the employer, the target's act (or failure to act) would have materially reduced the amount of the debt likely to be recovered by the scheme.

The new test may also be met by a series of acts, or failures to act.

Employer insolvency test: defence

tPR must not issue a CN in relation to the employer insolvency test where the target meets Conditions A to C below or, alternatively, can rely on Condition D.

- **Condition A:** before becoming a party to the act (or failure to act), the target gave *"due consideration"* as to how, if a section 75 debt became due from the employer immediately after the relevant time, the act or failure to act might materially reduce the amount of a section 75 debt likely to be recovered. Giving "due consideration" for this purpose means taking such steps as a reasonably diligent person would have done;
- **Condition B:** the target took all reasonable steps to eliminate or minimise the potential for the act (or failure to act) to have such an effect (where relevant); and
- **Condition C:** having regard to all relevant circumstances, it was reasonable for the target to conclude that the act (or failure to act) would not materially reduce the amount of section 75 debt likely to be recovered.

The target will also have a defence if tPR is satisfied that immediately after the relevant time the value of the assets was at least equal to the value of the liabilities (**Condition D**). (The Act does not set out on what basis the values of the assets and liabilities are to be determined for the purposes of Condition D but it is likely to be the section 75 debt basis).

New employer resources test

The employer resources test will be met if tPR considers that:

- the act (or failure to act) reduced the value of the sponsoring employer's resources (determined in accordance with regulations); and
- that reduction was a "*material reduction*" relative to the amount of the estimated section 75 debt which would be due from the employer on a winding up, calculated as at the time immediately before the act (or failure to act).

The new test may also be met by a series of acts or failures to act.

Following consultation, the DWP has confirmed that an employer's resources for the purposes of this test will be its profits before tax, adjusted to exclude the effect of non-recurring or exceptional items. It will be for tPR to decide whether an item is non-recurring or exceptional, its value and the effect of the act (or failure) on the employer's resources.

The pension industry has raised concerns about the lack of clarity about how the employer resources test will be applied. Given the objective of protecting pension benefits, it would make sense for assets subject to a charge (and which would not be available to the pension trustees on the employer's insolvency) to be excluded.

Employer resources test: defence

tPR must not issue a CN in relation to the employer resources test where the target can demonstrate that it meets Conditions A to C above, except that *"due consideration"* must be given to the extent to which the act or failure to act might reduce the value of the employer's resources relative to the amount of the estimated section 75 debt.

There is no Condition D defence in relation to the employer resources test.

Code of practice

tPR will be required to explain the circumstances in which it expects to issue a CN in relation to the employer resources test or the employer insolvency test in a code of practice. A draft code and code-related guidance was issued for consultation in May 2021.

New CN tests: implications for lenders

These new grounds may cause difficulties in employer restructurings as they focus on the strength of the employer's covenant. While defences are available to the target, these rely on the target evidencing that the act or failure to act would not materially reduce the amount of the debt likely to be recovered by the scheme or reduce the value of the resources of the employer relative to the estimated section 75 debt in relation to the scheme. Accordingly, they may not provide much help if priority new money or additional credit support are needed. Given the risk of stakeholders incurring criminal and civil liabilities if the new grounds do arise, where a structural workaround cannot be found we may see an increase in parties seeking assurances, via the existing voluntary clearance regime, that tPR will not exercise its powers.

As far as lenders themeslves are concerned, in 2005 the Financial Markets Law Committee raised concerns with tPR that a lender could be deemed to have control of a company to which it had lent money (bringing it in scope for moral hazard powers as a connected or associated party), where the terms of the debenture provide for control of the company to vest in the lender if the company defaults on its obligations.

tPR responded that in circumstances where either:

- control has not vested in the lender; or
- control has vested in the lender but has not been exercised,

the lender would not be party to an act (or deliberate failure to act) with a main purpose of avoiding the company's pension liabilities – meaning that the lender would not be in scope of a CN. tPR added that in these circumstances it

would also not be reasonable for tPR to issue an FSD to the lender.

The material detriment test was subsequently added, to apply in relation to any act or omission from 14 April 2008. The material detriment test – and the new employer insolvency and employer resources tests – are concerned with the *effect* of an act or omission, not the *purpose* behind it. To be within scope for a CN, the target must be connected with or an associate of the sponsoring employer "*at any time in the relevant period*". The relevant period begins with the date of the act or omission and is ended when tPR gives a warning notice that it is considering issuing a CN. As the legislation is drafted, if a lender gains control of an employer following an event of default, it will potentially be in scope for a CN, even if it was not associated or connected with the employer at the time of taking security. However, the comfort from tPR around what it means for a lender to have control still holds good.

Lenders to groups with DB sponsoring employers should think carefully and take advice before enforcing rights which could cause them or a newly incorporated purchasing vehicle to become associated or connected to the employer and therefore within scope of tPR's moral hazard powers. This has always been the advice but given the enhanced tPR powers, it is now more important than ever.

EXTENSION OF THE NOTIFIABLE EVENTS REGIME

Sponsoring employers already must notify tPR of certain events. However, in our experience, notification can sometimes be an afterthought or even forgotten entirely.

The list of notifiable events will be extended and is expected to include giving security to creditors ahead of the DB scheme trustees and any sale of a material proportion of the business or assets of a scheme employer which has funding responsibility for at least 20% of the scheme's liabilities. Notification must include analysis of the impact on the pension scheme and steps taken to mitigate any adverse effects.

The obligation to notify applies to both the employer and any person connected or associated with the employer. Failure to comply could give rise to a fine of up to £1 million.

WHEN WILL THE CHANGES COME INTO FORCE?

The Pensions Act 2004 (the 2004 Act), which introduced CNs, allowed tPR to issue a CN in respect of an act that took place before the 2004 Act became law.

The Pensions Minister has recently told Parliament that provisions in the new Act will not be retrospective – but this is not explicit on the face of the new provisions. It would be helpful for the commencement orders (which will bring the provisions of the Act into force) specifically to prevent retrospective application.

In tPR's draft prosecution policy, it states that evidence predating the commencement date of the legislation (expected to be 1 October 2021) may be relevant to its investigation or prosecution of actions after that date, for example if it indicates a party's intention.

HOW WE CAN HELP

Through our active participation in the pension industry and involvement in some of the highest profile cases involving DB schemes, we can give you an informed view on tPR's approach and how that develops in light of these new powers.

Our pension and business restructuring and insolvency teams can support you in structuring and restructuring lending to groups with DB schemes to achieve the best possible outcome for lenders whilst avoiding any members of the group (or indeed the lenders themselves) falling foul of the new regime.

This note is written as a general guide only. It should not be relied upon as a substitute for specific legal advice.

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