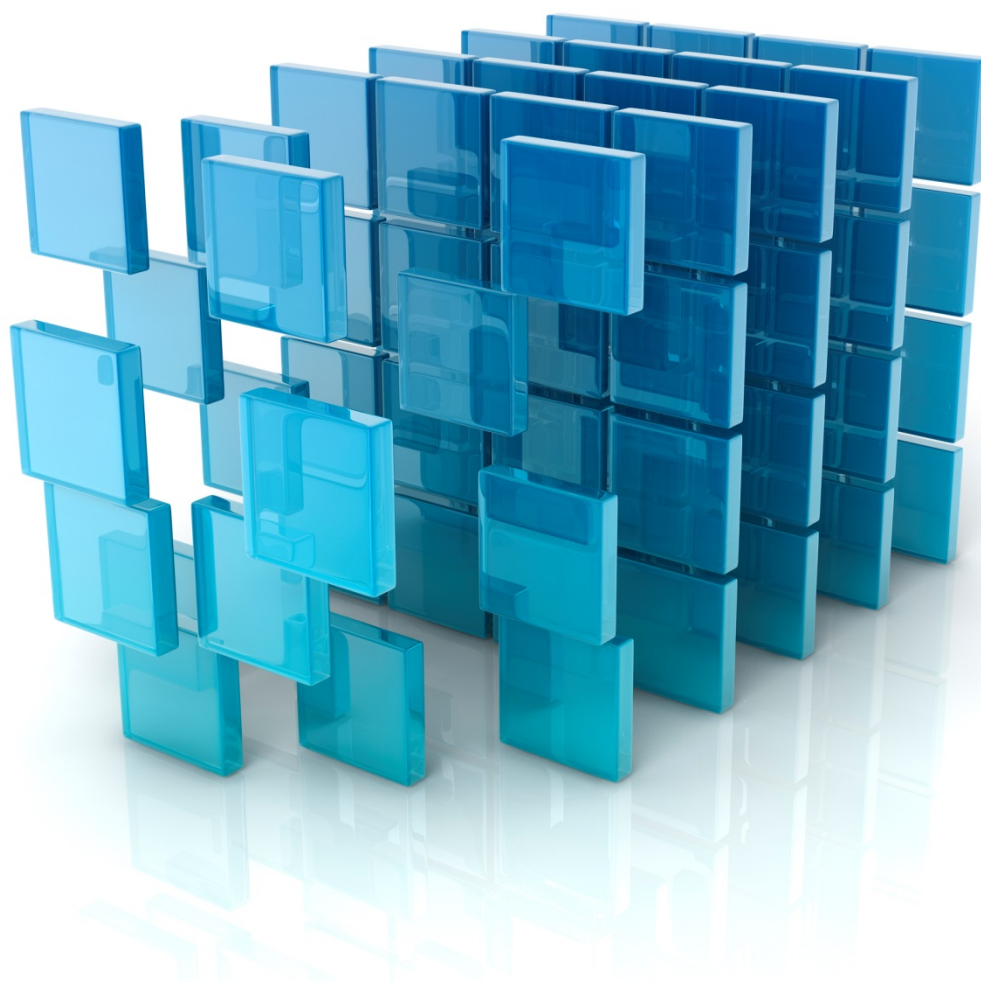


# ALLEN & OVERY



## Financial Support Directions: issues for banks and lenders

January 2017



# Contents

Key points	4
Introduction to FSDs	4
What are the tests for issuing an FSD?	5
When might a Bank be an FSD target?	6
Would it ever be reasonable to impose an FSD on a Bank?	7
What are the consequences of an FSD being issued against a Bank?	8
Other ways an FSD can affect a Bank	9
Procedure for issuing – and challenging – an FSD	10
Annex 1 – Procedural flowchart	11
Annex 2 – ‘Connected’ and ‘associated’	12
Key contacts	14

## Key points

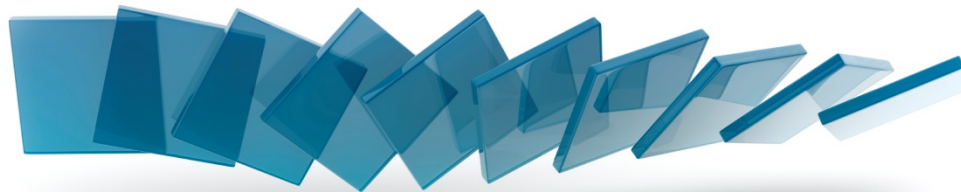
The Pensions Regulator's power to issue a financial support direction (**FSD**) could mean that a bank, lender or other corporate investor becomes obliged to provide financial support to a pension scheme to which it has little, if any, connection. External business activities with third parties could result in the lender being 'connected' or 'associated' with a third-party employer that participates in a defined benefit pension scheme. If such a connection is established, the lender could become a potential target of an FSD in relation to that third party's pension scheme.

In the worst case scenario, failure to comply with an FSD which has been issued in relation to a specified

defined benefit pension scheme could mean the target of the FSD becomes liable to pay the pension scheme deficit in full.

This briefing:

- provides a summary of how and when an FSD can be issued;
- highlights the potential significance of FSDs to banks, lenders and corporate investors; and
- sets out practical checks and safeguards to help protect banks, lenders and corporate investors from these wider FSD risks.



## Introduction to FSDs

FSDs are a key weapon in the Regulator's 'moral hazard' armoury. An FSD is simply an order requiring that financial support be put in place for a defined benefit pension scheme. It is not fault-based: there is no requirement for the Regulator to show that the target of the FSD (the **target**) has breached any rule or caused detriment to the scheme through any deliberate act or failure to act.

Instead, the Regulator must go through a series of tests relating to the scheme, its employer(s), the potential target and the connection between them. If a bank, lender or corporate investor (referred to in this briefing as a **Bank**) falls within scope as a potential target on those tests, it could be vulnerable to an FSD. The Regulator's decision to issue an FSD then depends on a fourth test: whether it is reasonable to impose an FSD.

Once an FSD is issued, the target will be required to put forward proposals for providing financial support for the relevant scheme and agree these with the Regulator. Such financial support could take the form of, for example, providing funding, or a guarantee or other support for the scheme. Annex 1 contains a flowchart setting out the stages of the procedure.

It is unsurprising that a Bank could be a target in its capacity as an employer in relation to a pension scheme within its own group or that it could be required to put in place financial support for that scheme. However, in this briefing we are concerned with a different risk: the risk that a Bank, in its capacity as such, might be a potential target of an FSD in relation to third parties. In such situations, it could be required to put in place financial support for a scheme to which it has little, if any, connection.

## What are the tests for issuing an FSD?

There are four tests that must be satisfied: we look at each of these in turn below.

- (1) **Scheme test:** an FSD can only be imposed in relation to an occupational pension scheme (but not a money purchase scheme) – essentially this means a defined benefit scheme which is not otherwise exempt.
- (2) **Target test:** the target of an FSD must have been, at the relevant time, an employer in relation to the pension scheme or connected with or an associate of a scheme employer.

### RELEVANT TIME:

a time determined by the Regulator that falls within a period of 24 months preceding the date of a warning notice to issue an FSD.

### CONNECTED; ASSOCIATED:

these terms have specific statutory meanings set out in the Insolvency Act 1986 (see *Annex 2*). We explain how they apply below – see *When might a Bank be an FSD target?* below.

- (3) **Insufficiently resourced test:** the employer must, at the relevant time, be either a service company or insufficiently resourced:
  - An employer is a **service company** if its turnover is solely or principally derived from charging for the provision of its employees to other group companies.
  - An employer is **insufficiently resourced** if its resources are less than 50% of the estimated s.75 debt in relation to the scheme, and if one or more of its associates has resources which, when added to the employer's, are at least equal to 50% of the estimated s.75 debt (see box).

**s.75 debt:** referring to section 75 of the Pensions Act 1995, this is the debt due from an employer which participates, or has participated, in a defined benefit pension scheme, to the trustees of that scheme. An employer's s.75 debt can arise where the scheme has a deficit on the buy-out basis (that is, where the assets of the scheme are less than the cost of securing liabilities with an insurer).

- (4) **Reasonableness test:** an FSD can only be imposed on a target if it is reasonable to do so, having regard to matters such as the target's relationship with the employer, any benefits the target received from the employer and the target's connection or involvement with the scheme, as well as the target's own financial circumstances.

If tests one to three are (potentially) met, then a Bank will need to establish that it would not be reasonable for the Regulator to issue an FSD. For more on this, see *Would it ever be reasonable to impose an FSD on a Bank?* below.

## When might a Bank be an FSD target?

We've already seen that, if a Bank is **connected** or **associated** with an employer that participates in the relevant pension scheme, it can be a target for an FSD. Determining whether parties are connected or associated for the purposes of an FSD can be complicated. The employer (or a company which has control of it) can be any body corporate, and can be overseas.

A Bank might find itself in scope if it has direct or indirect control of an employer participating in a pension scheme. For example:

- the directors of the employer (or of another company which has control of the employer) are accustomed to act in accordance with the Bank's directions or instructions; or
- the Bank is entitled to exercise (or control the exercise of) one-third or more of the voting power at any general meeting of the employer (or of another company that controls the employer).

Given this control test, a Bank could easily, and possibly inadvertently, find itself associated with a scheme employer and therefore a potential target for an FSD. A Bank might be a target where:

- The Bank has a one-third shareholding of a company following a debt equity swap exercise, or upon exercising security held over shares.
- The Bank owns at least a third of the shares in a joint venture company, and the joint venture company has a subsidiary which is an employer in relation to the pension scheme.
- The directors of the employer (or its holding company) are accustomed to act in accordance with the instructions of the Bank or its employee(s).

### Directorships

If the Bank and the scheme employer have one or more common directors (including non-executive directors) they will be connected to each other. The Bank would also be connected with the employer if a Bank employee is a director of the employer.

### Taking security

Merely taking security, including a legal mortgage, over a company's shares should not make the Bank a potential target of an FSD as long as the borrower continues to direct the Bank as to how it should vote in respect of those shares.

However, sometimes security documentation entitles the chargee to exercise, or control the exercise of, at least one-third of the voting rights in a borrower once an event of default is declared. In this instance, the chargee risks becoming connected with or associated to the employer.

#### Practical considerations

To avoid or manage the risk of being a potential target of an FSD, Banks should consider the following:

- Take less than a one-third shareholding in a company that is an employer in relation to a defined benefit pension scheme, or in a company that has control of such an employer.
- Restructure the voting rights of the shares so the Bank does not control a third of the voting power (even if it might hold more than a third of the actual shares). For example, consider exchanging debt for non-voting shares.
- Where the Bank holds security over the company's shares, avoid voting rights being automatically triggered on the occurrence of an event of default.
- If the Bank is already outside the one-third limit in existing cases, conduct an audit to identify potential risks where a relevant employer is a service company or could be insufficiently resourced.
- Check that processes for employees and directors to declare and clear external directorships are clearly understood and applied; design a process to identify and flag any potential risks.

## Would it ever be reasonable to impose an FSD on a Bank?

This would depend primarily on:

- the Bank’s relationship with the employer;
- the value of any benefits the Bank has received, either directly or indirectly, from the employer;
- any connection the Bank has had with the pension scheme; and
- the Bank’s financial position.

In many cases, the Bank should be able to argue successfully that it is unreasonable to impose an FSD on it as it received no benefit from the employer and has no connection with the scheme or the employer. However, there are situations where the Regulator might consider it reasonable to impose an FSD. For example, if assets were stripped out of the employer and transferred to another member of the group to facilitate loan repayments to the Bank, then there could be an argument that the Bank has received a benefit from the employer.

It is important to note that the Regulator does not just look at ‘end result’ benefits. The Regulator has stated that the benefit the target could have derived from the employer can be wide ranging, including receiving assets or dividends from the employer, sharing common security or cash flow arrangements or gaining tax advantages. For example, as part of a debt equity swap the Bank might become entitled to a dividend payment which could count as a benefit for this purpose. It is also possible that loan interest might be considered a benefit.

### What factors have been used to date?

With a limited number of FSDs issued so far – none in the context we are considering in this briefing – we can only draw parallels from factors used in other cases.

For example, the following issues might put the Bank at risk:

- Any non-arm’s length arrangements, for example charges in relation to services provided by the employer, where the value gained by the Bank is greater than the value on paper
- Control of funding and investment decisions in relation to the pension scheme
- Stripping out of cash, for example from a joint venture vehicle as payment for contributed assets or loans
- Secondments from the employer in question to the Bank

#### Practical considerations

To limit the risk that the Regulator could find it reasonable to issue an FSD, Banks should consider the following:

- Take less than a one-third shareholding in a company that is an employer in relation to a defined benefit pension scheme, or in a company that has control of such an employer.
- Limit integration/interdependency between the Bank and the employer. This would include secondments and the use of facilities/services.
- Ensure that arrangements between the Bank and the employer are on arm’s length terms.
- Ensure that strategic decisions – for example, on funding and investment – are made by the trustees under normal principles, not at the direction of the Bank.

## What are the consequences of an FSD being issued against a Bank?

- **Cost** If an FSD is issued, it is up to the target to propose the amount and type of financial support that it will put in place for approval by the Regulator. The level of support required is determined by reference to the employer's pension liabilities (its estimated s.75 debt plus any liabilities due under a schedule of contributions). This could be significant: in the Nortel case it was approximately GBP2.1 billion and in the Lehman case GBP184 million.
- **Litigation** With high costs at stake, FSDs to date have involved complex, multi-stage and multi-party legal challenges with associated time and expense.
- **PR** So far, the Regulator has issued only a handful of FSDs, and none against Banks which had no direct connection to the pension scheme. Each new FSD issued attracts a significant amount of press coverage which could be unwelcome by a Bank.
- **Non-compliance contribution notice** If the target does not put the appropriate financial support in place, the Regulator can, where it believes it is reasonable to do so, issue a non-compliance contribution notice requiring it to pay a sum up to the full amount of the employer's pension liabilities. However, the amount which group companies can ultimately be ordered to pay under

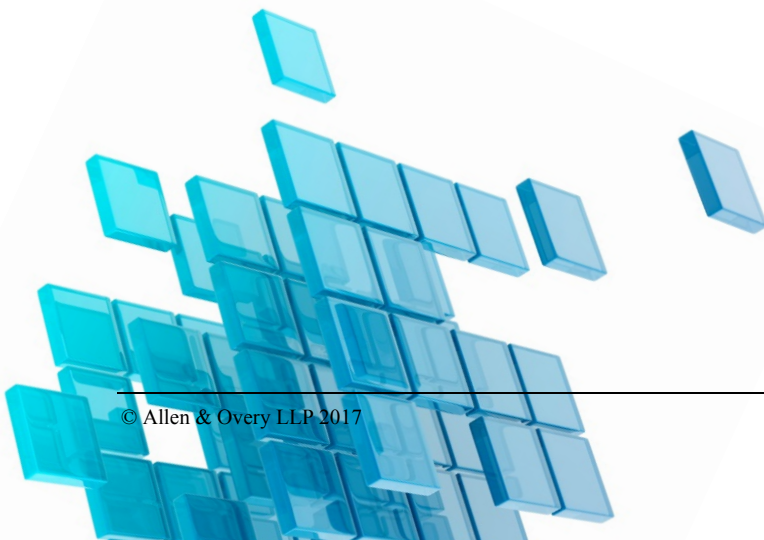
contribution notices enforcing the FSD can in aggregate exceed that amount, subject to the requirement of reasonableness.

### Enforceability overseas

Overseas enforcement is proving a problem for the Regulator. In the Sea Containers and Nortel cases, the targets were already subject to bankruptcy proceedings under Chapter 11 of the U.S. Bankruptcy Code or its equivalent when the Determinations Panel decided to issue the FSDs. Those proceedings trigger an automatic stay on further judicial, administrative or other proceedings against the debtor. The Canadian and U.S. courts have blocked the Regulator's attempts to pursue Nortel in their jurisdictions, on the grounds that the Regulator's action breached this stay.

The Canadian courts also rejected a separate claim brought by the trustee of Nortel's UK Plan for proof of debt based on the contingent FSD liability as being too remote and speculative.

The Regulator had more success in relation to Sea Containers, because the trustees of the two UK schemes reached an agreement with Sea Containers in the U.S. over its obligations to fund its UK schemes. The U.S. Bankruptcy Court approved a settlement agreement based on that deal, rather than the FSDs themselves.





## Other ways an FSD can affect a Bank

A Bank may also be affected if it is a creditor of a recipient of an FSD and that recipient enters UK insolvency proceedings.\* In these circumstances the ranking of a claim in respect of the FSD relative to the Bank's claim in such insolvency proceedings will be key.

If a determination in respect of an FSD (see the flow chart in Annex 1) is issued before insolvency proceedings begin, it is clear that the FSD liability and any subsequent contribution notice to enforce that FSD will be a provable unsecured debt, ranking below all secured and preferential liabilities. Following the Supreme Court decision in *Nortel* and

*Lehman Brothers*, if a determination is issued after insolvency proceedings have begun, the FSD will usually also be a provable unsecured debt: see this bulletin for more detail on the case. Therefore, if the Bank has a secured claim, it will rank ahead of the FSD claim (subject to rules on floating charge realisations). In contrast, if the Bank has an ordinary unsecured claim, it will rank alongside the FSD claim and will compete for the same pot of money.

The Supreme Court decision gives clarity to Banks and creates a level playing field with unsecured creditors.

*\*As mentioned above, overseas enforcement of FSDs has been difficult in practice to date.*



## Procedure for issuing – and challenging – an FSD

The flow chart at Annex 1 sets out the procedure that the Regulator must go through to issue an FSD.

The first step of the process is an investigation by the Regulator to determine whether or not the relevant tests for the issuing of an FSD have been satisfied. An investigation may be triggered by, for example, an employer insolvency, concerns expressed by the trustee, or the occurrence of a notifiable event.

As part of the investigatory process, the Regulator will often interview relevant personnel and seek copies of documentation. It has the power to compel parties to produce this information; failure to do so carries possible criminal sanctions.

If the Regulator believes that the relevant tests have been satisfied, it will issue a warning notice. The Regulator's case and all the non-privileged evidence it has collated to demonstrate that the tests have been met (or not) will be set out in the warning notice, which must be frank and transparent. That warning notice will be sent to directly affected parties and to the Panel. The parties will have an opportunity to respond to the warning notice and the Regulator may decide to withdraw the case before it is considered by the Determinations Panel.

The Determinations Panel will decide whether to hold an oral hearing or to make a decision on the basis of the papers alone.

Once the Determinations Panel has reached a decision, it will issue a determination notice. The Regulator may decide to publish the determination notice on its website, in accordance with its policy on publishing information about cases.

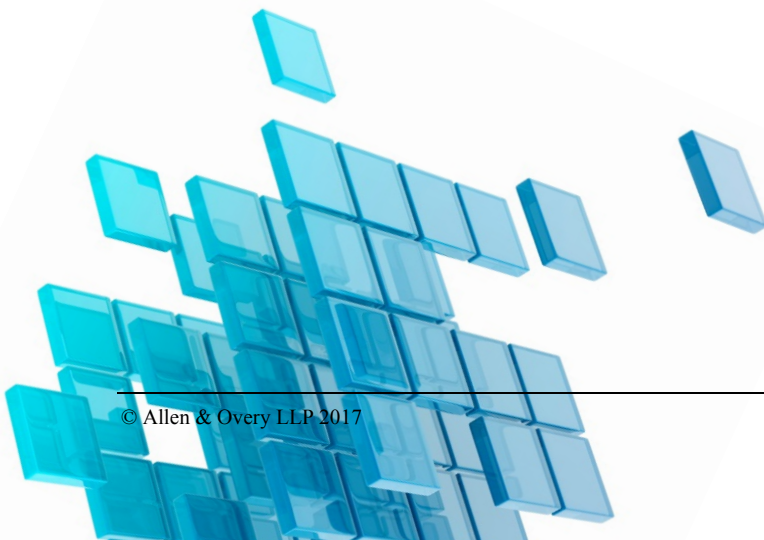
If the Determinations Panel issues a determination notice, the parties have 28 days from notification of the determination to make a reference to the Upper Tribunal objecting to the determination. No action can be taken on the determination notice while a reference to the Upper Tribunal (or any subsequent appeal) is pending.

The proceedings before the Upper Tribunal involve a fresh hearing of the matter and making of the decision – the Court of Appeal has ruled that the Regulator may, depending on the circumstances, be able to rely on grounds before the Tribunal that were not raised in the warning notice sent to the Determinations Panel. The Upper Tribunal will determine the appropriate action for the Regulator to take and will make directions to the Regulator. It can confirm, vary or revoke a determination.

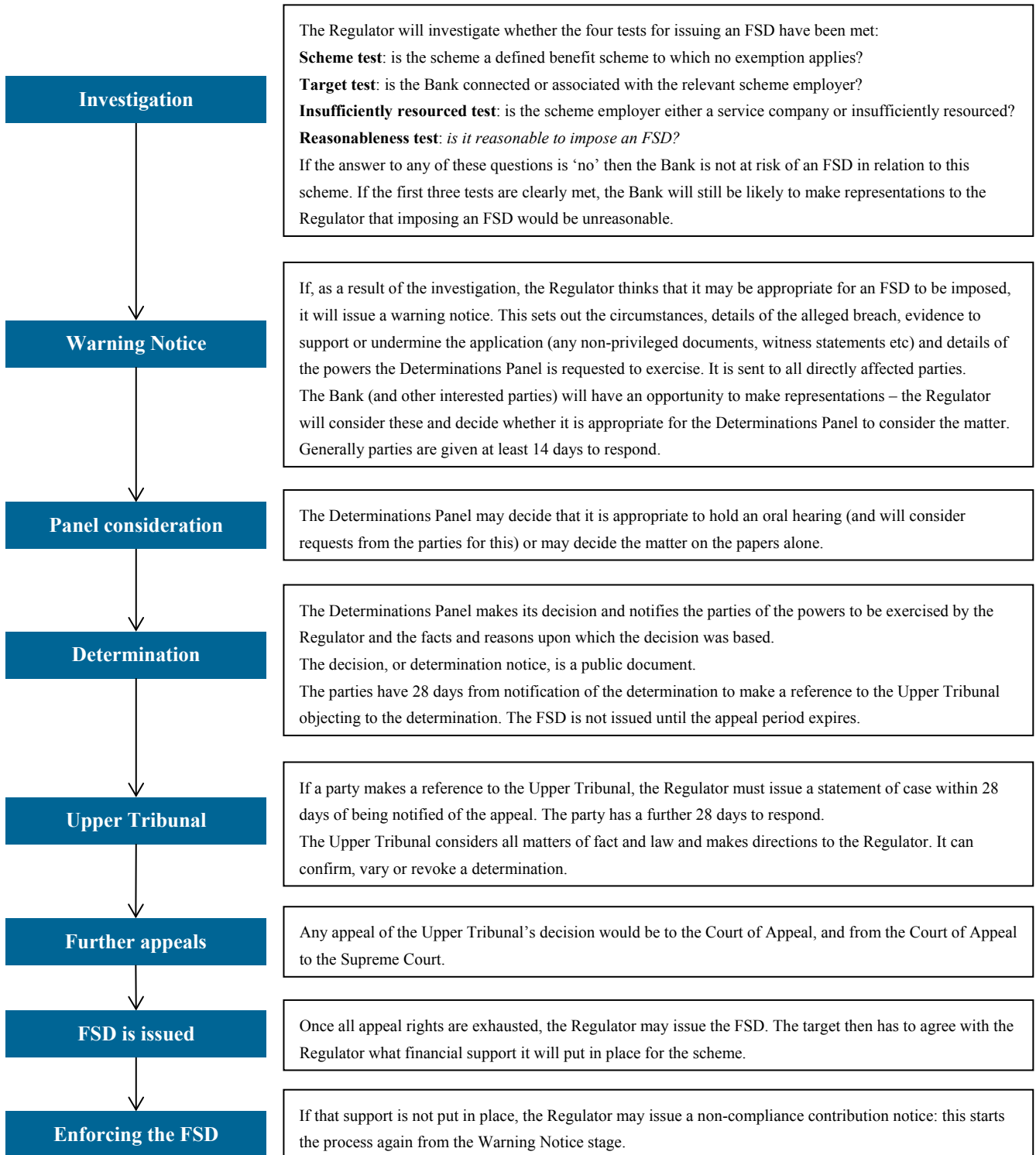
If the Determinations Panel has decided against issuing an FSD to a particular target, the trustees can at this stage appeal against that decision, so that a potential target which appeared to be off the hook can be put at risk of an FSD once again.

Any appeal of the Upper Tribunal's decision would be to the Court of Appeal, and from the Court of Appeal to the Supreme Court. Once the appeals process has been exhausted (or if there has been no appeal) the Regulator may issue the FSD. The target then has to agree with the Regulator what financial support it will put in place for the scheme.

If that support is not put in place, the Regulator may issue a non-compliance contribution notice: this starts the process again from the Warning Notice stage.



## Annex 1 – Procedural flowchart



## Annex 2 – ‘Connected’ and ‘associated’

In the moral hazard regime under the Pensions Act 2004, the terms ‘connected’ and ‘associated’ have specific statutory meanings taken from the Insolvency Act 1986. These are set out below.

### Insolvency Act 1986 section 249

“**Connected**” with a company

For the purposes of any provision in this Group of Parts, a person is connected with a company if –

- (a) he is a director or shadow director of the company or an associate of such a director or shadow director, or
- (b) he is an associate of the company;

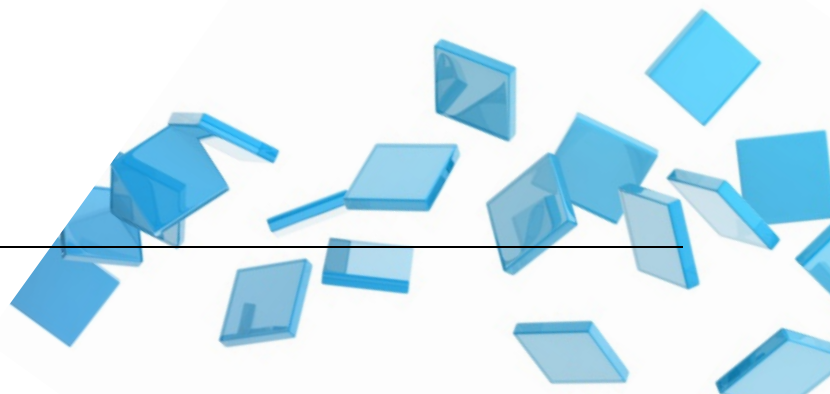
and “associate” has the meaning given by section 435 in Part XVIII of this Act.

### Insolvency Act 1986 section 435

#### Meaning of “associate”

- (1) For the purposes of this Act any question whether a person is an associate of another person is to be determined in accordance with the following provisions of this section (any provision that a person is an associate of another person being taken to mean that they are associates of each other).
- (2) A person is an associate of an individual if that person is –
  - (a) the individual’s husband or wife or civil partner,
  - (b) a relative of –
    - (i) the individual, or
    - (ii) the individual’s husband or wife or civil partner, or
  - (c) the husband or wife or civil partner of a relative of –
    - (i) the individual, or
    - (ii) the individual’s husband or wife or civil partner.

- (3) A person is an associate of any person with whom he is in partnership, and of the husband or wife or civil partner or a relative of any individual with whom he is in partnership; and a Scottish firm is an associate of any person who is a member of the firm.
- (4) A person is an associate of any person whom he employs or by whom he is employed.
- (5) A person in his capacity as trustee of a trust other than –
  - (a) a trust arising under any of the second Group of Parts [Insolvency of individuals; Bankruptcy] or the Bankruptcy (Scotland) Act 2016, or
  - (b) a pension scheme or an employees’ share scheme is an associate of another person if the beneficiaries of the trust include, or the terms of the trust confer a power that may be exercised for the benefit of, that other person or an associate of that other person.
- (6) A company is an associate of another company –
  - (a) if the same person has control of both, or a person has control of one and persons who are his associates, or he and persons who are his associates, have control of the other, or
  - (b) if a group of two or more persons has control of each company, and the groups either consist of the same persons or could be regarded as consisting of the same persons by treating (in one or more cases) a member of either group as replaced by a person of whom he is an associate.



(7) A company is an associate of another person if that person has control of it or if that person and persons who are his associates together have control of it.

(8) For the purposes of this section a person is a relative of an individual if he is that individual's brother, sister, uncle, aunt, nephew, niece, lineal ancestor or lineal descendant, treating –

(a) any relationship of the half blood as a relationship of the whole blood and the stepchild or adopted child of any person as his child, and

(b) an illegitimate child as the legitimate child of his mother and reputed father;

and references in this section to a husband or wife include a former husband or wife and a reputed husband or wife and references to a civil partner include a former civil partner and a reputed civil partner.

(9) For the purposes of this section any director or other officer of a company is to be treated as employed by that company.

(10) For the purposes of this section a person is to be taken as having control of a company if –

(a) the directors of the company or of another company which has control of it (or any of them) are accustomed to act in accordance with his directions or instructions, or

(b) he is entitled to exercise, or control the exercise of, one third or more of the voting power at any general meeting of the company or of another company which has control of it;

and where two or more persons together satisfy either of the above conditions, they are to be taken as having control of the company.

(11) In this section “company” includes any body corporate (whether incorporated in Great Britain or elsewhere); and references to directors and other officers of a company and to voting power at any general meeting of a company have effect with any necessary modifications.



## Key contacts



**Maria Stimpson**  
Partner  
Corporate Pensions  
Tel +44 20 3088 3665  
Mob +447899 063 396  
maria.stimpson@allenoverly.com



**Dana Burstow**  
Partner  
Corporate Pensions  
Tel +44 20 3088 3644  
Mob +44 788 7754980  
dana.burstow@allenoverly.com



**Neil Bowden**  
Partner  
Corporate Pensions  
Tel +44 20 3088 3431  
Mob +44 7973 601 609  
neil.bowden@allenoverly.com



**Jane Higgins**  
Partner  
Corporate Pensions  
Tel +44 20 3088 3161  
Mob +44 7825 384 786  
jane.higgins@allenoverly.com



**Jason Shaw**  
Senior Associate  
Corporate Pensions  
Tel +44 203 088 2241  
Mob +44 7823 530 809  
jason.shaw@allenoverly.com



**Helen Powell**  
PSL Counsel  
Corporate Pensions  
Tel +44 20 3088 4827  
Mob +44 7920 271 006  
helen.powell@allenoverly.com



**London**

Allen & Overy LLP  
One Bishops Square  
London  
E1 6AD  
United Kingdom  
  
Tel +44 20 3088 0000  
Fax +44 20 3088 0088

---

GLOBAL PRESENCE

---

Allen & Overy is an international legal practice with approximately 5,200 people, including some 530 partners, working in 44 offices worldwide. Allen & Overy LLP or an affiliated undertaking has an office in each of:

Abu Dhabi	Frankfurt	Paris
Amsterdam	Hamburg	Perth
Antwerp	Hanoi	Prague
Bangkok	Ho Chi Minh City	Riyadh (cooperation office)
Barcelona	Hong Kong	Rome
Beijing	Istanbul	São Paulo
Belfast	Jakarta (associated office)	Seoul
Bratislava	Johannesburg	Shanghai
Brussels	London	Singapore
Bucharest (associated office)	Luxembourg	Sydney
Budapest	Madrid	Tokyo
Casablanca	Milan	Warsaw
Doha	Moscow	Washington, D.C.
Dubai	Munich	Yangon
Düsseldorf	New York	

**Allen & Overy** means Allen & Overy LLP and/or its affiliated undertakings. The term **partner** is used to refer to a member of Allen & Overy or an employee or consultant with equivalent standing and qualifications or an individual with equivalent status in one of Allen & Overy LLP's affiliated undertakings. This document is for general guidance only and does not constitute definitive advice. | CO:28807923.1