What the UK pensions environment means for acquisitions, sales, restructuring and refinancing.
Corporate transactions and pension liabilities

**UK defined benefit pension liabilities can present considerable challenges for company boards and other decision makers.**

**Pension issues have the potential to trap the unwary**

There may be surprises regarding the nature of some of the issues involved, and the range of situations where pensions funding is a key consideration. In addition to business acquisitions and sales, situations which can involve highly material pensions negotiations include:

- share buy-backs or the payment of special dividends;
- changes in corporate structure;
- business restructuring or refinancing; and
- the optimal structuring of deals undertaken to reduce debt levels and support turnarounds.

Trustees have been given significant powers and responsibilities, and companies have to treat the Trustees as a powerful creditor with the ability to exert leverage over the company. The Pensions Regulator has the power to intervene in some circumstances, and has a proven ability to exert influence on how negotiations are conducted. Cash funding and related issues are a matter for negotiation on a case-by-case basis, making it vital for companies to understand how pensions issues may be seen from the Trustees’ perspective.

The powers of the Pensions Regulator include the ability to impose “Financial Support Directions”, requiring ongoing support of a pension plan from other group companies, or “Contribution Notices”, requiring lump sum payments from related companies or even individuals. Long established principles for limited liability of companies can be over-ridden.

It is crucial for companies and other parties involved in corporate transactions to obtain specialist actuarial and legal advice early in the process.
Pre¬paring for a transac¬tion

Based on our experience of advising corporates and Trustees, we consider a proactive approach to be vital to successful management of pensions issues and their interaction with overall corporate strategy.

Practical ways in which this can be achieved include:

- Early consideration of pension issues where there are corporate changes.
- Obtain specialist actuarial and legal advice up-front on the potential issues arising from corporate changes, and potential solutions.
- Consider the make-up and availability of the Trustee board, including whether any senior executives on the Trustee board may need to stand aside due to conflicts of interest.
- Ensure that the Trustees have suitably experienced advisers in place.
- Understand how the issues and potential solutions may appear from the Trustees’ viewpoint.
- Ask Trustees to sign confidentiality agreements so that the Trustees and their professional advisers can be provided with details of the proposals, and commence consideration of issues which can also be complex from a Trustee perspective, at an early stage.
- Engage with the Trustees on investment strategy.
- Remove or mitigate defined benefit liabilities where feasible, eg by partial or full buyout.
- Consider the long-term strategy for dealing with the pension liabilities beyond the transaction, and how the handling of the transaction can support this.

Overview of key UK pensions legislation affecting transactions

Increasing the security of pension plan members’ benefits has been the overriding driver for a series of changes in legislation over recent years. This followed a number of high profile cases where employees lost most of their pension when their employer went into insolvency leaving an under-funded pension plan.

A pivotal change was the UK Government’s requirement (from 11 June 2003) that solvent employers who put their pension plans into wind-up would be required to pay off the deficit based on the cost of buying out the benefits with an insurer - as a lump sum.

Then, in April 2005, the Government established the Pension Protection Fund (“PPF”), which provides protection for a large proportion of an employee’s defined benefit pension rights should the employer become insolvent. The PPF is funded by a levy on all UK defined benefit plans. Part
of the levy is related to an assessed “risk” that the employer will become insolvent – this can have the effect of complicating recovery situations by imposing extra costs when they are least affordable.

In order to protect the PPF, provisions were introduced to strengthen pension plan funding. Companies and Trustees must now negotiate contribution rates, with the Pensions Regulator being able to intervene in the event of agreement not being reached. Trustees must also take account of the employer covenant, and are encouraged to take independent advice in this regard. These measures have generally been leading to progressively more cautious actuarial assumptions being used, with deficits having to be met over shorter periods, driving higher cash request from Trustees.

Employer pension costs will rise further due to government plans to increase the proportion of employees participating in pension funds. In summary, these will involve employees being enrolled automatically into a defined contribution plan, unless they choose not to join. Some companies are finding it necessary to reduce the benefits offered by their existing pension plans, to prevent increases in overall costs in excess of what is affordable.

“Moral hazard” provisions
In 2004 the Government also introduced what have been called the “moral hazard” provisions to try to protect against:

- corporate structures that do not provide sufficient security for the pension plan; and
- corporate changes that are seen as likely to weaken the ability of the sponsoring employer to support the pension plan.

The Pensions Regulator can, if it thinks it reasonable - and subject to complex controls - take three key actions:

1. Issue a Financial Support Direction
This can be issued where the sponsoring employer is a service company or is insufficiently resourced (the latter being defined as having net assets on a fair value basis of less than 50% of the buyout deficit) subject to various criteria. A Financial Support Direction (“FSD”) requires financial arrangements to be put in place to support the pension liabilities. An FSD can be imposed on a retrospective basis for up to 24 months from ceasing to be a connected party.
2. Issue a Contribution Notice
The Regulator can use a Contribution Notice to require that a company or individual pays a pension plan or the PPF an amount that could be up to the full statutory debt on winding up. The Regulator can look back at events that took place up to six years previously in deciding whether or not to issue a Contribution Notice. Contribution Notice powers were initially applicable just to situations where a specific action, or failure to act, was deliberately aimed at avoiding a statutory debt to a pension plan.

This was expanded by enabling the Regulator to issue Contribution Notices under the “material detriment test”, introduced with effect from 14 April 2009. This covers situations where an act, or failure to act, has the effect of materially weakening the security of pension benefits, and reducing the likelihood of members receiving their full benefits. If the material detriment test is used, the Regulator is crucially not required to prove that the detriment was caused deliberately.

3. Appoint and remove pension fund Trustees
The Regulator can disqualify individuals from being Trustees of pension plans, and can also appoint Trustees in addition to – or in place of – existing Trustees. A high profile case of the Regulator using this power was in connection with telent’s pension fund in October 2007. Following this, the threshold for the Regulator having the power to appoint Trustees was lowered, from situations where it is “necessary” to appoint Trustees to protect members’ benefits, to situations where it is “reasonable” to do so. (Note: the Pensions Regulator’s powers to appoint and remove pension plan Trustees are also relevant to other situations not involving “moral hazard” considerations, for example where it is considered necessary to supplement the knowledge and experience of the existing Trustee board).

A Contribution Notice or FSD can potentially cover the plan’s sponsoring employers as well as employers and persons who are “connected” or “associated” with the sponsoring employers. It therefore includes major shareholders, not just group companies. In effect the limited liability status of a company can be overturned. There is, however, some uncertainty as to the extent to which Contribution Notices and FSDs are effective outside of the European Union. So far, the Pensions Regulator has exercised its transaction-related powers directly in only a handful of cases. However, we understand that there have been other cases settled “on the courtroom steps”.

Material detriment test
Key circumstances seen by the Pensions Regulator as relevant:
- Pension plan transferring out of UK jurisdiction
- Sponsoring employer transferring out of the UK jurisdiction, if this results in a material reduction in protection
- Severing or substantially reducing employer support for the plan
- Transfer of liabilities to another plan that does not have sufficient employer support and/or funding
- Business model seeking a financial benefit to the sponsor of the plan, without adequate regard to the interests of and risks to members

Statutory defence framework
A statutory defence framework enables a company to defend against a Contribution Notice if it can demonstrate that:
- due consideration was given to the extent to which the act or failure to act might put benefit security at risk;
- all reasonable steps were taken to eliminate or minimise detriment; and
- taking the above steps into account, it was reasonable to conclude that there is no material detriment to the likelihood of full accrued benefits being received.
Clearance statements – how to get comfort from the Regulator

The risk of receiving a possible future Contribution Notice or FSD can make it more difficult for companies to restructure or carry out normal corporate transactions.

The Regulator can, however, issue Clearance Statements in relation to a corporate transaction. Applying for clearance is a voluntary procedure. Assuming that a Clearance Statement is granted and the underlying facts and circumstances are described accurately and have not changed materially, parties to a corporate transaction have certainty that a Contribution Notice or FSD will not be issued as a consequence of the corporate transaction.

The Regulator expects parties to consider applying for a Clearance Statement where the prospective corporate transaction is a Type A event. Type A events are those which the Regulator considers would reduce the security of pension benefits, for example by prejudicing the pension plan’s position as a creditor in the event of the plan employer becoming insolvent.

The Regulator’s timescales for processing Clearance Statement applications are variable, depending among other things on the size and nature of the corporate transaction in question and the overall volumes of deals and Clearance Statements at the time. The Regulator has indicated that in certain cases, such as those where jobs are at risk, the process can be accelerated. The Regulator is also encouraging parties that may need to apply for clearance to involve the Regulator as early as possible.

When Clearance Statements were originally introduced in 2005, there was a flurry of applications. Subsequently the number of applications reduced as players and professional advisers in the mergers and acquisitions market became familiar with the Regulator’s requirements and views. However, the material detriment test, where the Regulator is not required to prove that the detriment was caused deliberately, has led to parties to corporate transactions proceeding more cautiously including renewed emphasis on clearance applications.
Section 75: New solutions to a thorny problem

The debt on the employer legislation, or “Section 75” of the Pensions Act, requires broadly that any employer leaving a multi-employer plan must pay its share of the deficit. Since September 2005, this deficit has been calculated on a buyout basis – and includes the employer’s share of any “orphan” liabilities arising from employers than have already left, which can be substantial. We have seen situations where there would have been a severe risk of insolvency in otherwise sound businesses if Section 75 exposures had not been managed effectively.

An increased range of options is available whereby alternatives to the statutory default provisions can be agreed with the Trustees. This is a major topic in its own right, which we do not seek to cover here. An important point to note is that some of the options – in particular those most likely to be relevant to distressed situations – can only be adopted if first approved by the Pensions Regulator through a Clearance Statement.

It is important that the value and scope of a Clearance Statement is not over-estimated. In particular, it does not override the Trustees’ powers regarding cash contributions, summarised below.

Scheme Funding in a nutshell

In contrast to most countries’ use of prescribed minimum funding rules, pension funding in the UK is now a matter for (often complex) negotiations. The value placed on liabilities, the “Technical Provisions”, must be calculated using prudent actuarial assumptions. Legislation does not define what assumptions would be prudent, although guidance from the Pensions Regulator may influence negotiations. The weaker the “employer covenant”, the employer’s ability and willingness to pay, the more cautious the Pensions Regulator would expect the actuarial assumptions to be.

Deficits should be paid off as quickly as the employer can “reasonably afford”. The Regulator would normally expect this period to be no more than 10 years. However, this is only a ‘trigger point’ for possibly greater Regulator scrutiny rather than a rigid rule.

Companies and Trustees are expected to negotiate the assumptions and recovery plan for any deficits, and agree these within 15 months of the effective date of the actuarial valuation. The results and process are open to Pensions Regulator scrutiny.

If agreement is not reached within 15 months of the valuation date, the Pensions Regulator can impose actuarial assumptions and a recovery plan, although this is very unusual.

Valuations will normally be undertaken every three years. Trustees can bring the next actuarial valuation forward, an “out of cycle” valuation, if they consider this to be in the plan members’ interests and have the power to do so.
Approach of Trustees to scheme funding

Trustees have been encouraged to take a more active role in managing the deficit, including being prepared to negotiate robustly with the company. Well informed and advised Trustees are likely to take a similar approach to a prudent lending bank, looking carefully into the company’s structure and financial covenant, the impact of changes to it, and the ability of the company to generate cash to pay off the pension deficit. It is increasingly common for Trustees to commission specialist employer covenant reports to help them assess this.

In relation to a transaction, Trustees are encouraged to assess the impact of the transaction on the security of members’ benefits. If there is a material reduction, then Trustees are expected to seek mitigation such as accelerated deficit contributions or contingent assets. Where no or inadequate mitigation is offered, Trustees are encouraged to contact the Regulator for guidance.

Furthermore, many Trustee boards see a transaction as a one-off opportunity to negotiate additional funding to clear an otherwise intractable deficit.

Companies will need to involve the Trustees at an early stage in corporate transactions, to make sure that the Trustees and the Trustees’ actuaries and other advisers are satisfied with the transaction from a benefit security perspective. If an application for a Clearance Statement is made, the Regulator expects that this will only be done after the Trustees’ views have been taken into account. The Regulator seldom issues a Clearance Statement without Trustees’ support for the application (although there have been a few exceptions). Situations where a transaction is likely to lead to a reduction in the security of member benefits and where one of the parties wishes to apply for clearance – or where parties wish to be confident that they can reasonably proceed without clearance – will often require a significant lump sum contribution to the pension plan and accelerated payment of the balance of the deficit, in return for the Trustees’ co-operation.

Deleveraging transactions – special considerations

Much of the current legislation is centred around protecting pension plans in scenarios where debt levels in companies are being increased, in particular in leveraged buyouts. It is now quite common to see situations where debt levels are being reduced - for example by rights issues, or a leveraged company merging with or being acquired by a group with a more conservative balance sheet. Providers of capital will need reasonable comfort that their investment can give them an acceptable return, and will not simply be absorbed by an under-funded pension plan.
Where there is potential to inject capital on a sound basis, measures to protect this investment include:

- agreeing contributions with the Trustees for a period, as one of the conditions for injecting capital into the business;
- performance-linked deficit recovery plans, such that pension contributions are automatically adjusted downwards if the full rate would imperil the business, or upwards if upside opportunities are realised; and
- injecting capital in forms other than traditional equity, for example convertible debt.

In our experience, complex pensions issues that have become increasingly challenging in the UK pensions environment can still be addressed effectively, to the mutual benefit of companies and shareholders, and their employees and pension plan members.
Next Steps
For further details regarding the services provided by the LCP M&A Consulting Practice, please contact David Lane or Michael Berg or visit our website www.lcp.uk.com.

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