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Tax and Employee Benefits Law Update

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PENSIONS ACT 2004

Defined Benefit Pension Schemes – Further Significant Impact on Commercial Life

Introduction

The Pensions Act 2004 will impact many areas of commercial activity (including M&A) in relation to companies providing defined benefit (DB) pensions. The details of the new legislation are now being worked out through regulations and the publication of guidance notes by the Pensions Regulator. This update aims to provide an overview of a rapidly developing and changing area of law.

Without delving into any of the detail, the key message is that if you (or the target company in an M&A transaction) have a defined benefit pension scheme you must take detailed early advice if the topics addressed in this note are remotely relevant.

Protecting Scheme Members' Benefits

The Pensions Act 2004 arms the new Pensions Regulator with far-reaching powers to ensure that employers do not avoid their pension liabilities or fail to support them in a meaningful way. This update concerns the Regulator's new powers (currently in force) to issue the following two orders:

- *Contribution notices* – where there is an act (or failure to act) to avoid pension liabilities; and
- *Financial support directions* – when the employer is a service company or is insufficiently resourced.

It should be noted that the Regulator has many other powers which, although important, are outside the scope of this update.

Contribution Notices

What Are They?

The Pensions Regulator may order an employer, or any person connected or associated with the employer (this includes directors of the employer and other group companies, whether UK resident or not) to contribute to the scheme in question. Depending on the circumstances, the amount to contribute can be substantial.

When Will the Regulator Issue a Contribution Notice?

The Regulator may issue a contribution notice if there is an act, or failure to act, where the main purpose (or one of the main purposes) is to avoid or reduce pension scheme liabilities. Much discretion is vested in the Regulator. Fortunately, some guidance has been issued, indicating that contribution notices may be issued if:

- The pension scheme in question is in deficit; and
- The event in question has a financially detrimental effect on the pension scheme.

How Is a Deficit Calculated?

There are many ways to calculate a pension deficit. Currently, the Regulator is using the accounting standard FRS17. Many schemes will be in deficit on this basis! Furthermore, the Regulator has not ruled out calculating deficits on the even more expensive buy-out basis.

How Is Financial Detriment Determined?

The Regulator focuses on whether the event in question changes the level of security for the pension "creditor" and is particularly concerned with regard to the following events:

- *Changes in the level of security given to creditors* – The pension creditor is usually unsecured. Therefore, creation of a charge ranking ahead of unsecured creditors may adversely affect the security of the pension scheme. Thus, the Regulator will be concerned in relation to the creation of fixed or floating charges over assets that do not specifically and solely relate to new money.
- *Returns of capital* – This is of concern since a return of capital to shareholders will reduce assets available to the pension scheme if the employer were to be wound-up. Examples of

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a return of capital include dividend payments, share buy-backs and dividends in specie.

- *Change in control structure* – A change in the corporate group structure could weaken the employer's ability to meet its pension commitment. Examples given by the Regulator include situations where there is a change in ownership of a parent company of the employer or the ultimate group parent. To be relevant, the change in control structure must be detrimental to the financial strength of the employer. The Regulator suggests considering the impact the change has on the employer's credit rating. An obvious example here is the takeover of the group by a private equity-backed leveraged buy-out vehicle.

Financial Support Directions

What Are They?

When the pension scheme employer is a service company or is insufficiently resourced, the Regulator may order the employer — or any person connected or associated with the employer — to put in place financial arrangements to support the pension liabilities. A financial support direction (FSD) cannot — other than in certain limited circumstances — be given to an individual (unlike a contribution notice). However, FSDs can be given to other group companies even when they have never participated in the pension scheme and when they are incorporated outside the United Kingdom. It is important to note that the Regulator's power to issue an FSD depends on the employer's circumstances, there is no need for there to be an act or omission.

What Is a Service Company?

The Regulator defines a service company as a company where the turnover is principally derived from amounts charged for the provision of the services of employees to other group companies.

What Does "Insufficiently Resourced" Mean?

An employer will be insufficiently resourced if its resources are less than 50% of the estimated pension deficit. This time, the deficit will be calculated on the harsh buy-out basis. Virtually all schemes will be in deficit on this basis, probably significantly.

The way an employer's resources are measured will be important. Regulations will prescribe how this is done. However, it is likely to be based on the fair value of the company on a market value basis. This may entail obtaining a full market valuation.

Conclusions

The world is changing for those groups who operate defined benefit pension schemes. Many commercial activities and group structures will run the risk of becoming embroiled in negotiating with not only the pension scheme trustees but also the Pensions Regulator. The head of the Regulator (David Norgrove, ex-M&S director of clothing) has already suggested that pension scheme deficits are "loans from the [pension scheme] members to the company". If this view is maintained, then the far-reaching powers that the Regulator has are likely to be used. This background will give more negotiating strength to trustees. We have already seen a number of high-profile transactions fall away as a result of the state of the pension fund.

Further information

For more information on this and other tax employee benefits matters, contact your regular Wilmer Cutler Pickering Hale and Dorr contact, or:

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