Freshfields Bruckhaus Deringer

Pensions Alert - Pensions Regulator to have stronger powers in corporate transactions

Highlights

- The government has issued its first consultation paper on proposals set out in the Pensions White Paper (see our alert for further details) to strengthen the Pensions Regulator's powers in relation to corporate activity.

- The online consultation includes further details of proposals in the White Paper as well as some new proposals to strengthen the Pensions Regulator's powers which, if implemented, will impact on corporate activity for groups which operate defined benefit pension schemes.

- The proposals, somewhat light in detail, are aimed at deterring behaviours by pension scheme sponsors and their corporate groups that could detrimentally impact on a defined benefit pension scheme. The consultation paper includes proposals to give the Pensions Regulator powers to impose new criminal and civil sanctions for a lack of compliance with the new/improved regime.

- As a result of the proposals in the consultation paper and the Pensions Regulator's mantra to be "clearer, quicker, tougher", it will be more important than ever for corporate groups to ensure that the impact of corporate activity on their defined benefit pension schemes is carefully considered and appropriately mitigated.

- Key proposals that will impact on corporate activity include:

  - New criminal penalties to punish "wilful or grossly reckless behaviour" of directors in relation to a defined benefit scheme, failure to comply with a contribution notice (issued under the Pensions Regulator's anti-avoidance powers) and failure to comply with the new framework for notifying the Pensions Regulator about corporate activity.

  - A new civil penalty of up to £1m to be imposed by the Pensions Regulator for any non-compliance with existing and new legislative requirements, with the most serious breaches attracting the highest level of penalty.

  - Expanded requirements to notify the Pensions Regulator of certain corporate events, with an obligation to notify some events earlier than is currently the case, along with potential civil and criminal penalties, including custodial sentences, for failure to comply.

  - Corporate groups being obliged, before proceeding with any material corporate transaction, to provide scheme trustees and the Pensions Regulator with a "declaration of intent" statement on the impact of the transaction. The declaration would need to include details of the transaction, any mitigation proposed in relation to the pension scheme and whether the trustee has agreed to the proposed transaction and the mitigation package. Failure to provide this statement could result in a civil penalty up to £1m.

Introduction

With the Pensions Regulator still under intense scrutiny following the high profile insolvencies of BHS and Carillion, the government has published an online consultation "Protecting Defined Benefit Pension Schemes – A Stronger Pensions Regulator" seeking views on proposals to strengthen the Pensions Regulator's powers. These proposals were outlined in the pensions White Paper "Protecting Defined Benefit Pension Schemes", published in March this year. For further details of the government's proposals in the White Paper, see our alert "Pensions White Paper: Increased scrutiny for corporate transactions".

The proposals, which support the Pensions Regulator's new aim to be a "clearer, quicker, tougher" regulator, could mean that corporate groups that sponsor defined benefit schemes are subject to additional scrutiny and reporting requirements when undertaking corporate transactions.

The consultation focusses on three areas:

- enhancing the role of the Pensions Regulator and trustees role in scrutinising corporate transactions;
- strengthening the sanctions that can be imposed by the Pensions Regulator to deter, and where necessary, punish, "wrongdoing" in relation to a defined benefit pension scheme; and
- expanding the Pensions Regulator's existing anti-avoidance powers.

The consultation closes on 21 August. Further details of the proposals are discussed below.

Scrutinising corporate transactions

Proposals to enhance the role of the Pensions Regulator and trustees in scrutinising corporate transactions include:

- expanding the list of events that need to be notified to the Pensions Regulator in order to give the Regulator earlier warning of events which could potentially have a detrimental impact on a pension scheme.
- requiring some events to be notified at an earlier stage in the transaction timetable;
- requiring employers to engage with the Pensions Regulator and trustees before a transaction takes place by providing them with a declaration of intent statement to provide "meaningful information" about certain transactions and details of mitigation offered to pension scheme trustees.

Notifying corporate events – strengthening the framework

(i) Significant expansion of trigger events requiring notification

- There is already a requirement on employers and trustees to notify the Pensions Regulator on the occurrence of certain events. The consultation paper proposes to extend this regime to the following additional events:
  - the 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;
  - granting security to a creditor to give it priority over the debt to the pension scheme. More detail on this is expected from the Pensions Regulator in a revised code of practice on notifiable events but it would exclude financing for specific chattels such as hire purchase financing for company vehicles;
  - a significant restructuring of a scheme employer's board of directors and other senior management appointments such as the appointment of a chief restructuring office, and changes to two out three of the chairman, chief executive office and chief financial officer within the previous 6 months;
  - the sponsoring employer taking independent pre-appointment insolvency/restructuring advice (such as an independent business review). This is aimed at alerting the Pensions Regulator to potential distress situations and would enable the Pensions Regulator to be satisfied that the interests of the pension scheme are taken into account during the early stages of an insolvency process e.g. for pre pack administrations; and
  - deferral or waiver of a banking covenant (breach of a banking covenant is already a notifiable event). This would allow the Pensions Regulator to receive earlier notification of circumstances indicating that a sponsoring employer is struggling.
- In order to minimise the additional burden on businesses, only transactions exceeding a certain risk threshold (to be prescribed by the Pensions Regulator) would require mandatory notification to the Pensions Regulator.
- Although dividend payments have been a significant issue in the recent high profile insolvencies, the consultation paper doesn't propose to make

dividend payments a notifiable event as the framework surrounding dividend payments is being considered as part of a separate consultation by BEIS on corporate governance and insolvency.

(ii) Early notification of some events

- To address issues in the current legislation about when a notification should be made to the Pensions Regulator, the consultation paper proposes that the following events would require early notification to the Pensions Regulator:

  – sale of controlling interest in a sponsoring employer;
  – sale of the business or assets of a sponsoring employer; and
  – granting security to a creditor in priority to pension scheme debt.

- These events would need to be notified to the Regulator “no later than when negotiations have led to agreement in principle of its main terms” and suggests that this would be when a heads of terms agreement is first put in place. More detail is needed to understand how this early notification requirement would apply to transactions which proceed without a heads of terms agreement or agreement in principle.

- The government expects that new regulations, and guidance from the Pensions Regulator, will clarify the timing of notifications for those transactions and extend the obligation to make a notification to “other parties”, which would include the parent company directors of a sponsoring employer.

Declaration of intent statements relating to the impact of corporate transactions

- Whilst the White Paper stopped short of proposing mandatory clearance by the Pensions Regulator of certain corporate transactions, the consultation paper expands on the initial proposal in the White Paper to require companies to prepare a “declaration of intent” statement for certain transactions. Such statements would show the Pensions Regulator and trustees that companies have appropriately considered the impact of a transaction on their defined benefit pension scheme.

- A declaration of intent would be addressed to trustees, and come from the board of directors planning the transaction, and shared with the Pensions Regulator. It will need to:

  – explain the nature of the planned transaction;
  – confirm that the company planning the transaction has consulted on its terms with the trustees and confirm the trustees’ agreement (or otherwise) to the planned transaction; and
  – explain any detriment to the scheme and how this is to be mitigated.

- Declarations of intent are intended to work alongside the notifiable events regime, and will be required later in the transaction timetable after a notification is made. The consultation paper envisages that companies will need to provide the declaration of intent after due diligence is completed and financing for the transaction has been finalised but before the sale agreement is signed. Engagement with the trustees is expected at the earliest opportunity.

- Failure to provide a declaration of intent statement for a relevant transaction could result in a civil penalty of £1m under the new proposals (see below). The consultation paper does not suggest that a transaction would be unwound if the statement is not provided. However, companies who failed to comply would be at risk of the Pensions Regulator exercising its moral hazard powers if the transaction resulted in a material detriment to the pension scheme.

Which transactions will require a declaration of intent statement?

The White Paper proposed that only “relevant business transactions” which pose the highest potential risk to the pension scheme should trigger the requirement to prepare a declaration of intent statement. The consultation paper proposes that the requirement should apply to those events which require early notification (see above), such as the sale or takeover of the sponsoring employer and granting security to a creditor in priority to pension scheme debt.

Clarifying the Pensions Regulator’s existing voluntary clearance regime

The Pensions Regulator will review its clearance guidance to “clarify” its expectation as to how employers and trustees should approach clearance. Proposals include clarifying the definition of “material detriment”, revising the definition of types of events and circumstances in which clearance is given in relation to financial support directions, and providing more information on the clearance process and expectations around timing of a clearance application (which is expected to be made as early as possible).

New criminal and civil penalties

- The consultation paper proposes to introduce a range of new criminal and civil penalties. Some of these penalties are intended to deter non-compliance with the expanded regime relating to corporate transactions and notifiable events, but an entirely new, stand-alone criminal sanction is also proposed.

- The proposed civil penalties include:
  - punitive fines of up to £1m where corporate activity has detrimentally impacted a pension scheme;
  - new criminal offences for failure to:
    - comply with a contribution notice, i.e. a requirement to make a payment to the pension scheme that is imposed by the Pensions Regulator under the existing moral hazard powers regime;
    - failure to notify the Pensions Regulator about a prescribed corporate activity; and
  - a new criminal offence to punish "wilful or grossly reckless behaviour" of directors in relation to a defined benefit scheme. This offence was proposed in the White Paper but no further details are provided in the consultation paper.
- The level of penalty imposed would be determined by the seriousness of the breach/non-compliance. More serious offences, for example, reckless behaviours in relation to a pension scheme, could attract criminal sanctions, including custodial sentences.
- The consultation proposes that possible targets of the new civil and criminal sanctions should include all of those who have responsibility to the pension scheme – directors, sponsoring employers and any associated or connected persons (and in some circumstances, trustees).

Improving the Pensions Regulator's existing anti-avoidance powers

The consultation proposes a number of changes to "strengthen" the existing contribution notice ("CN") and financial support direction ("FSD") regimes. The proposals include broadening the range of targets of FSDs and CNs to allow FSDs to be issued agaisnt individuals associated with, or connected to, the sponsoring employer and CNs to be issued against any person associated or connected with the recipient of an FSD. The government is also considering whether to increase the current 'lookback' period for FSDs beyond two years, and what appropriate protections would need to be put into place for businesses brought within scope by a longer lookback period.

What action should companies be taking?

These proposals to strengthen the Pensions Regulator's powers would add to the potential exposure for companies and their directors if pensions issues are not appropriately addressed in corporate transactions. Corporate groups will therefore need to put even more thought and time into managing pension scheme risks when planning corporate activity. As a result, it will be more important than ever for employers to ensure that the impact of corporate activity on their defined benefit pension schemes is carefully considered and appropriately mitigated if necessary, and that such steps are properly documented, with the aim of both reducing the risk of future regulatory action being instigated and being in the best possible position to defend any such action if it arises.

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