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# JIBFL APRIL 2021: THE PENSIONS REGULATOR'S NEW TEETH: HOW MIGHT THEY BITE LENDING TRANSACTIONS?

## 1. Introduction

The Pensions Regulator (TPR) has, since 2004, had relatively extensive rights to intervene in corporate activities that present a "moral hazard" risk of losses to members of underfunded defined benefit (DB) pension schemes. However, recent corporate failures have prompted the Government to examine the efficacy of the TPR, described as "reactive and slow-moving" by the Work and Pensions Committee in the wake of the collapse of BHS and Carillion.

The Government's March 2018 White Paper proposed extensive new powers for TPR to deter and, where necessary, punish wrongdoing in relation to DB pension schemes. These proposals have now been incorporated into the recently passed Pension Schemes Act 2021. The 2021 Act strengthens the existing powers of the TPR and introduces new criminal sanctions and punitive financial penalties for behaviour adversely affecting DB scheme benefits, which can be imposed on parties with no formal connection to the scheme including lenders, investors and advisers. It also imposes new information-providing requirements in relation to corporate activities with the potential to affect DB scheme liabilities.

The new powers are expected to come into force by autumn this year. The Government has said that they will not be retrospective i.e. they will not be exercised in relation to activities taking place prior to their coming into force (although recently-published draft guidance on how TPR proposes to investigate and prosecute the criminal offences indicates that TPR may take into account evidence pre-dating that)

TPR's existing powers have been a relevant consideration in financing transactions involving groups with DB scheme liabilities since 2004. This article outlines how risks relating to DB pension scheme liabilities affect financing transactions, the relevant provisions of the 2021 Act and the extent to which they might result in changes in practice.

## 2. Pensions Act 2004

2.1 Contribution notices and financial support directions: the "moral hazard" powers

The Pensions Act 2004 conferred powers on TPR to require the provision of additional support for DB scheme liabilities in the form of "contribution notices" (CN) and "financial support directions" (FSD). It also imposes requirements on employers and schemes to notify TPR of certain events, to enable TPR greater oversight and engagement in corporate activities that affect the pensions creditor.

The CN and FSD powers are of particular concern, because they can be issued to parties "associated or connected" with the scheme employer. The definitions of "connected" and "associated" are taken from the Insolvency Act 1986 and are extremely wide, potentially extending responsibility for DB scheme liabilities beyond the scheme employer and its corporate group, to directors, shareholders and even, potentially, lenders in certain circumstances. An example is TPR's recently-reported intervention in relation to the Silentnight pension scheme.

A CN can be issued to an employer or a person connected or associated with that employer where TPR believes that:

- the recipient was a party to, or "knowingly assisted" in, a deliberate act or failure to act, the main purpose of which was to prevent recovery of a pension scheme debt (the "main purpose" test), or

- the target's act or failure to act has "detrimentally affected in a material way" the likelihood of accrued scheme benefits

being received (the "material detriment" test).

In both cases, it must be reasonable to require the target to pay the amount specified. These powers can be exercised in relation to behaviour dating back up to 6 years prior to the issue of the CN.

TPR's guidance on the "material detriment" test gives examples of the sorts of events that it considers are likely to be materially detrimental to the ability of the scheme to meet its liabilities. "Employer-related events" include certain types of financings, for example transactions that result in a change in priority (of the pension creditor) which might include the grant of a fixed and floating charge over the employer or the assets of the employer's wider group. The risk of a CN is therefore a relevant consideration in the context of leveraged and other secured financings.

A defence is available where it can be illustrated that:

- the target gave due prior consideration (tested objectively) to the reduction in the hypothetical debt recoveries or reduction in value of employer resources as appropriate, and
- after taking any reasonable steps to eliminate or minimise that effect,
- it was reasonable in the circumstances to conclude that the act did not have that effect.

The CN power is of most relevance to financing transactions such as acquisitions, financings and restructurings because it considers the impact of corporate acts on the pensions creditor. The FSD power is more general. FSDs can be issued to anyone "connected or associated" with a DB scheme employer to provide appropriate "financial support" for the employer's obligations in relation to the scheme where that employer is "insufficiently resourced" and where, in TPR's opinion, it is reasonable to require the target to provide the financial support. However, there is no cap on the amount that TPR can order to be paid under an FSD and failure to comply can lead to the issue of a CN.

A voluntary pre-clearance procedure under the 2004 Act enables parties to obtain a statement from TPR in advance of a transaction, that, in its opinion, it would not be reasonable for it to impose an FSD or CN in the specified circumstances.

2.2 "Notifiable events"

The 2004 Act also introduced the concept of "notifiable events", obligations to notify TPR of certain events affecting the scheme or the employer, intended as a means of policing the moral hazard provisions. These include a series of events that might be viewed as potentially detrimental to the pensions creditor, such as a breach by the employer of its banking covenants and certainchanges of control.

TPR must be notified "as soon as reasonably practicable" upon the employer becoming aware of the notifiable event. Non-compliance with notification obligations can lead to TPR imposing fines and is a factor that TPR may consider when deciding whether to issue a CN.

## 3. Pension Schemes Act 2021

3.1 New CN gateways

The 2021 Act introduces new gateways for the issue of CNs. In addition to the existing "main purpose" and "material detriment" tests, TPR will be able to issue a CN if the "employer insolvency" test, or "employer resources test" are satisfied. Defences are available in relation to both, and both are subject to the existing "reasonableness" test whereby TPR must be of the opinion that it was reasonable to impose a CN. As with the existing tests, CNs may be issued against employers and those associated or connected with them.

The "employer insolvency" test is satisfied where, in TPR's opinion, if an employer debt had been triggered at the time of the particular act to which the target was party, that act would have materially reduced the amount of the debt likely to be recovered by the scheme i.e. the return to the scheme on a hypothetical employer insolvency is measured before and after the act in question.

The "employer resources" test is satisfied where, in TPR's opinion:

- the particular act to which the target was party reduced the value of the "resources" of the employer (what constitutes "resources" will be set out in regulations), and

- that reduction was material, relative to the amount of the employer debt which would have been triggered if the scheme had begun to wind up at that time.

The same defences are available as outlined above in relation to the existing "material detriment" test.

3.2 New criminal and civil penalties

The 2021 Act also introduces new criminal and civil penalties, perhaps the aspect of the Act that has given rise to most concern as a result the breadth with which they are cast.

The new criminal offences, avoidance of an employer debt to a DB pension scheme, and conduct risking accrued DB pension scheme benefits, apply in broadly the same circumstances as the existing CN "main purpose" and "material detriment" tests. Importantly, in relation to lending and restructuring transactions, they extend to any person, regardless of whether there is any connection to or association with the pension scheme or its employer (although there is a limited exemption for insolvency officeholders).

Avoidance of employer debt is committed where a person does an act or engages in a course of conduct which prevents the recovery of or compromises an employer debt, where the person intended this to be the outcome. Conduct risking accrued scheme benefits comprises any act or course of conduct that "detrimentally affects in a material way" the likelihood of accrued scheme benefits being received where the person knew, or ought to have known, that it would have that effect.

A defence is available in relation to both offences, if the person had a "reasonable excuse" for their actions. TPR is consulting on its policy for investigating and prosecuting the new criminal offences, including what is a "reasonable excuse". It says that evidence pre-dating the powers coming into force (expected to be 1 October this year) may be relevant to its investigation (for example if it indicates a person's intention. Anyone found guilty of these offences faces up to 7 years imprisonment and/or unlimited fines.

New financial penalties of up to £1 million apply to broadly the same circumstances but are potentially of wider reach in that there is no "intention" requirement and they are subject to a lower burden of proof. A further new criminal offence (punishable by an unlimited fine) applies to failure to pay a CN without reasonable excuse.

3.3 New notification requirements

The 2021 Act confers a new duty on the employer and/or a connected or associated person to give notice to TPR of events relating to that employer, building on the existing "notifiable events" regime. The notice, to be given to the pension scheme trustees at the same time, must give details of any adverse effect on the scheme, any proposed mitigation, and what communication there has been with the trustees and members. More detail (including on timing) will be in regulations but it is expected that this notification will be required at an earlier stage than under the current notifiable events regime.

In addition, there are expected to be changes to the events that must be notified to TPR under the existing regime, with the addition of two new employer-related 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 scheme liabilities, and

- the granting of security on a debt to give it priority over the debt to the scheme.

These changes are expected to be in regulations that will be put out for consultation later this year.

Existing civil penalties for failure to notify are replaced by a new financial penalty of up to £1 million. The existing criminal offence of knowingly or recklessly providing false or misleading information to TPR (punishable by up to 2 years imprisonment and/or unlimited fines) is expanded to include information on notifiable events, and there are new financial penalties for knowingly or recklessly providing information to TPR or to DB scheme trustees.

## 4. Impact on financing activity

4.1 The current position

The 2004 Act resulted in increased scrutiny by lenders of DB scheme liabilities within borrower groups. Engagement with DB scheme trustees became a routine part of preparations for acquisition or secured financings and

restructurings. In some transactions, obtaining voluntary clearance from TPR is a condition precedent to funding. However, clearance is a time- consuming process and impacts on transaction timetables. It can also impact the terms – or even in some cases, the viability - of a financing. The process of considering whether to seek clearance will involve a negotiation with the scheme trustees, who may impose conditions to mitigate the effect of the transaction on the pension creditor, which can include rights to share in the security package and intercreditor controls.

In addition, following the 2004 Act, contractual provisions began to appear in facility agreements, to enable lenders to monitor the DB scheme over the life of the facility. Such provisions include confirmatory representations regarding the existence and extent of DB scheme liabilities, undertakings with regard to the group's compliance with its obligations to the pensions creditor, restrictions on new pensions liabilities and the inclusion of specific Events of Default, should a CN or FSD be issued in relation to a DB scheme. Framework provisions feature in some of the Loan Market Association's recommended forms of facility agreement, for example, its leveraged facilities agreement for senior/mezzanine transactions[1].

4.2 Will the 2021 Act result in changes in practice?

While the changes introduced by the 2021 Act are wide-ranging, the Government's intention is to tighten the rules against abuse of pension schemes and wilful / reckless behaviour in light of high profile corporate failures of recent years. Genuine corporate transactions are not its intended target: "We do not want to stop legitimate business activity, such as lenders taking security for normal financing activities." (Baroness Stedman-Scott (Parliamentary Under Secretary of State for the Department of Work and Pensions in the House of Lords) commenting on the Bill's second reading).

Nonetheless, the changes to the CN regime introduced by the 2021 Act considerably strengthen TPR's powers when dealing with corporate transactions. This is expected to have an impact on day to day corporate activity (such as raising finance). The defences will have to be carefully considered when assessing the risk of the use by TPR of its moral hazard powers in future transactions. As the existing 6 year lookback period applies to the new tests, it is arguable (notwithstanding Government assurances on retrospectivity), that they will be capable of being applied to activities that took place in the 6 years before they take effect.

The impact of the new criminal and civil offences is also likely to be felt in terms of a renewed and more intense focus on due diligence and risk assessment processes (and the scope of any contractual protections) in relation to DB pension schemes. Further, the new criminal/civil sanctions will mean that information provided to TPR and/or trusteeswill have to be carefully verified to ensure it is not misleading, which will involve greater preparation for, and management of, transactions involving DB schemes.

Particularly difficult judgments may arise in distressed scenarios where a wide range of actions intended to procure the rescue of a company may now have the potential to expose some stakeholders to criminal or civil liability. To take one example, emergency or rescue funding is likely to trigger a notification requirement, as well as present grounds for issue of a CN (for example, if secured debt is to be created in priority to the scheme). In such scenarios, it is also possible that the provision of the financing, such as super senior or other secured rescue debt, could bring potential liability as the lenders may rank in priority to and/or the existence of the financing may well have the potential to reduce recoveries for a DB scheme. In the absence of more detailed guidance on CNs (which is expected to be published before the changes take effect), this may result in an increase in clearance applications. However seeking clearance raises a number of challenges in a distressed context, and it does not fully mitigate the risks.

TPR has said that it anticipates that parties may be more likely to apply for formal clearance in future, and that it will be revising its clearance guidance to reflect its new powers. What is not yet clear is whether TPR will be increasing the resources available to manage its expected increase in workload. In distressed or (potentially) competitive situations where swift turnaround times are critical, this is an important concern.

[1] Available to members at www.lma.eu.

The Government has stated that the introduction of these new offences will not be with retrospective effect, but where an offence is under consideration, it will inevitably be considered with the benefit of hindsight. This is likely to be particularly true of restructurings or other distressed refinancings, which may take place over a prolonged period of time with many different factors influencing the outcome. The risk for all parties is that a course of conduct may not turn out as intended and could then be subject to retrospective review under 2021 Act. For example, a well-planned and well-intentioned rescue effort can sometimes fail and result in creditors being worse off than if the company had simply entered an insolvency process at an earlier stage. Could stakeholders be deterred from pursuing rescue efforts by the risk of criminal and civil penalties?

The application of the offences to "a person" (and the (limited) exclusion for insolvency office-holders only) means that a wide range of entities, including lenders (and their advisers), could potentially be caught. Careful advance preparation and advice will be necessary to mitigate the risk of the new provisions being applied by TPR to any case.

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