# Insolvency and restructuring of employers - issues for trustees of defined benefit pension schemes

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Pension briefing

## HIGHLIGHTS

The credit crunch caused problems for businesses at the same time as the value of pension scheme assets plunged, adding ballooning defined benefit pension deficits to the woes of struggling companies.

Company insolvencies, and attempts at restructuring to avoid insolvencies, can have a significant impact on the pension schemes sponsored by those companies. The pensions issues can also act as a significant obstacle to restructuring.

This note considers the issues that face trustees of defined benefit pension schemes in such circumstances. It does not, however, give any detail on entry into the Pension Protection Fund (the "PPF") (see box below).

## INITIAL QUESTIONS FOR TRUSTEES

Here are some initial questions that trustees may need to ask when faced with employer insolvency or restructuring proposals. Depending on the answers, the trustees may have to consider much more complicated issues.

### Insolvency

- What do the rules of the scheme say about the impact of employer insolvency? Is a winding-up of the scheme triggered? In the case of a multi-employer scheme, is a partial winding up of the scheme triggered?
- Is a Pension Protection Fund (“PPF”) assessment period triggered for all of the scheme (or, in the case of a multi-employer scheme, part of the scheme)?
- Is a section 75 debt triggered (see box on next page)? Can any of it be recovered?
- Can the trustees seek more contributions from the employer before the employer goes insolvent?

### Restructuring

- What exactly is the restructuring proposal and how does it affect any scheme employers?
- Will the proposals lead to a section 75 debt being triggered (see box on next page)? If so, how does the group propose to deal with it?
- Will the strength of the scheme's sponsoring employer (the "employer covenant") and the security of members' benefits be weaker after the restructuring is completed, compared with before? Would the trustees have legally enforceable recourse to at least the same level of assets if the pension scheme employers went insolvent? An independent covenant review may be needed to answer these questions.
- If the employer covenant or the security of members’ benefits will be worsened, what mitigation is being offered?
- Will the proposals have any adverse consequences under the rules of the pension scheme (such as triggering a wind up of the scheme)?

### The Pension Protection Fund

The PPF was set up as a lifeboat for defined benefit schemes in deficit where the pension scheme employers become insolvent.

Various conditions must be satisfied in order for the pension scheme to be transferred to the PPF. First, a qualifying insolvency event must have occurred to the pension scheme employer, and this will trigger an “assessment period”. During the assessment period the scheme's eligibility or otherwise will be determined.

One of the key eligibility conditions is that the scheme's assets must be less than the level of the scheme's "**protected liabilities**". The protected liabilities are the compensation that would be paid to the scheme members if the scheme goes into the PPF (in many cases, less than the benefits that would have been paid under the scheme rules). If the scheme has sufficient assets to meet these liabilities, then the PPF will cease to be involved with the scheme and it is likely to wind up outside the PPF.

If a pension scheme is transferred to the PPF, the scheme assets are transferred too and it assumes responsibility for paying the PPF level of benefits to members of the scheme.

## IMPACT OF EMPLOYER INSOLVENCY

### Single employer scheme

For a pension scheme with a single sponsoring employer, insolvency of that employer is likely to have the following consequences:

- the pension scheme will probably go into an assessment period to determine whether it is eligible for entry into the PPF (see box on previous page).
- a “section 75 debt” is likely to be triggered from the employer to the pension scheme (see box). The trustees will be an unsecured creditor unless they have some formal security in place. This means they will rank behind secured creditors, such as mortgage holders or often banks, in getting their debts paid in an insolvency. In

practice, trustees may be unlikely to recover much, if any, of the section 75 debt on an insolvency.

### Multi-employer scheme

Where several companies participate in a pension scheme, the impact of the insolvency of one or more group companies may be similar as for a single employer scheme, with the whole scheme likely to enter the PPF (depending on its funding level), or the impact may be more subtle where solvent sponsoring employers remain.

**Who is the employer under pension legislation?**

Trustees sometimes assume that the "employers" of their pension scheme are the companies listed as the employers in their trust deeds – the principal employer under the scheme, and any participating employers who have participated under a deed of participation or adherence. However, pension legislation defines "employers" (for scheme funding, PPF entry, section 75 debts and other purposes) without reference to a scheme's trust deed and rules.

Definitions in the legislation vary slightly and case law has confused the application but, broadly, "statutory employers" are those employers that have at some point employed active members of the pension scheme. When they stopped employing actives they may or may not have ceased to be employers – this can be complicated to determine.

The key is to appreciate who your statutory employers are.

**An example**

- A company is the principal employer under a pension scheme's rules, but is not a statutory employer as it has never employed active members.
- The one additional participating employer is a statutory employer.

The scheme is a single employer scheme for statutory purposes and insolvency of the participating employer may trigger PPF entry for the whole scheme, even if the principal employer is in fine financial health.

**Section 75 debts**

Broadly, section 75 of the Pensions Act 1995 requires the sponsoring employer of a defined benefit occupational pension scheme to pay an additional contribution (the section 75 debt) to the scheme trustees if:

- the employer becomes insolvent or enters voluntary winding up
- the scheme goes into winding up, or
- where the scheme is a multi-employer scheme, one of the employers ceases to have any employees who are active members of the scheme when another employer continues to employ active members (an "employment cessation event").

The third circumstance may occur when a participating employer is sold out of a corporate group (or all its workforce transfers to a new employer under a TUPE transfer) or when the last remaining active member employed by that employer leaves pensionable service or dies.

The section 75 debt will be, broadly, the cost of buying annuities with an insurance company to provide the accrued scheme benefits, less the value of the assets. On an employment cessation event, the section 75 debt will be the cessation employer's share of the cost of buying annuities, unless the trustees agree to a statutory alternative option being used.

## WHAT DO TRUSTEES NEED TO KNOW?

### What is happening to your sponsoring employer?

It is important to understand exactly what has happened to the employer. The events that count for the purposes of pension legislation as insolvency events leading to section 75 debts or PPF entry are not exactly the same as what an insolvency practitioner might consider to be insolvency. An event that triggers the wind-up of the pension scheme under the scheme rules may be different again. The exact timing of events is also important for determining how the pensions legislation applies.

### Multi-employer schemes - is a partial winding-up triggered?

For multi-employer schemes, the impact of the insolvency of one employer will depend very much on the rules and structure of the pension scheme. The insolvency of an employer while the others continue may trigger a "partial winding-up" of the scheme. This means that part of the assets are set aside for some or all of the members who relate to that employer, and that part of the scheme may be wound-up (or continued as, in effect, a separate scheme with segregated assets and liabilities). There are many variations on exactly how this might happen. Rules that provide for partial winding-ups can raise difficult questions on what to do next when they are triggered, as there will generally be power for the trustees to decide to continue the part of the scheme that would have been wound up.

A partial winding-up rule can also mean that the segregated part of the scheme may end up going into the PPF.

If a partial winding-up is not triggered, the remaining scheme employers will be responsible for funding the benefits for employees attributable to the insolvent employer.

## EMPLOYER RESTRUCTURING - GENERAL ISSUES

Corporate groups may restructure for general business reasons, or to avoid insolvency of the whole group. If any of the affected group companies participate in a defined benefit pension scheme, one or more section 75 debts may be triggered by the restructuring. Attempts to compromise debts due to the pension scheme can lead to ineligibility for the PPF. In addition, the employer covenant in relation to the pension scheme may be adversely affected.

The impact on the pension scheme is not always considered when restructuring proposals are put together. Trustees who hear of restructuring should contact the group, ask for more information and seek to engage with the group on any potential issues. Employers should be aware of the Pensions Regulator's "moral hazard" powers (see box).

### Moral hazard powers

- The Pensions Regulator has anti-avoidance powers to issue contribution notices (CNs) and financial support directions (FSDs) against persons who are associates of or connected with pension scheme employers. CNs and FSDs may require additional contributions to the pension scheme or additional support, such as a guarantee.
- CNs can be issued where there is an act or omission the main purpose of which was to prevent a section 75 debt becoming due or being paid (or reduce its amount) or that was materially detrimental to a scheme's ability to pay members' benefits.
- FSDs can be imposed if the sponsoring employer is a service company or is otherwise "insufficiently resourced".

Concerned parties can seek "clearance" from the Pensions Regulator that it will not use its powers against them in particular circumstances.

## ISSUES FOR TRUSTEES

The trustees need to consider:

- Will the proposals trigger any section 75 debts?
- Will the proposals trigger a winding up of the pension scheme under the rules (or have any other consequences under the rules)?
- How will the employer covenant be affected? Understanding who the employer actually is will be important here – see box.

## RESTRUCTURING EXAMPLE – SINGLE EMPLOYER SCHEME

A corporate group is transferring all its operating businesses into one company, Newco, currently not a pension scheme employer. As a result, the pension scheme employer (Oldco) will be left as a shell, to be wound-up. Oldco is the only statutory employer of the pension scheme (see box on previous page).

### Issues for the trustees:

- Once Oldco's business is transferred to Newco, Oldco will be a company with no substance. The employer covenant will be materially worsened.
- The transaction may result in a section 75 debt being triggered from Oldco to the pension scheme (for example, if a winding up of the scheme is triggered, or if Oldco is wound up after the business transfer). Oldco will have no money to pay the debt.
- Winding up Oldco could also trigger the scheme entering a PPF assessment period.

The group may propose to mitigate the effect of the restructuring on the scheme. If it does not, or if the trustees do not accept the proposals, the trustees should consider involving the Pensions Regulator, as it is likely to be concerned about scheme abandonment.

### Mitigation

The group offers to substitute the current pension scheme employer with Newco. This raises additional issues. For example:

- How will the substitution take place? Newco must become a statutory employer as well as an employer under the pension scheme rules. This can be complicated to achieve. Will Newco take responsibility for Oldco's liabilities?
- How will the employer covenant after the restructuring compare with that before?

  Superficially, given that all the assets of Oldco are going to Newco, along with assets from other operating companies, it might be assumed that the covenant should be better. However:

  - What other liabilities will Newco have?
  - Will any of the assets of Newco be secured after the restructuring and so be unavailable to the pension scheme on an insolvency?
  - Will Newco be responsible for other pension schemes from any other group businesses that are transferred to it?
  - If Newco went insolvent immediately after the restructuring, how much would the pension scheme recover compared with what it would have recovered on an insolvency of Oldco as its previous pension scheme employer?

If the covenant is adversely affected, the Pensions Regulator would expect the trustee to ask for appropriate mitigation from the corporate group to offset the disadvantage to members, and this may be the subject of a clearance application by the group. If the group does not cooperate, trustees should consider speaking to the Pensions Regulator.

## RESTRUCTURING AND SECTION 75 DEBTS - MULTI-EMPLOYER SCHEMES

If the restructuring proposals will result in a section 75 debt being triggered, the group may propose to use mechanisms available in legislation to avoid paying the buy-out deficit immediately, such as a scheme apportionment arrangement, a flexible apportionment arrangement, an approved withdrawal arrangement or a withdrawal arrangement. The trustees' agreement is needed, otherwise the section 75 debt will be calculated on the buy-out basis.

Amendments to the section 75 legislation made in 2010 were intended to make it easier for groups to deal with section 75 debts triggered by a restructuring. However, the form of the new exemptions and the detailed conditions that must be met to fall within them mean that these exemptions have been of very limited use in practice.

If a group wishes to restructure purely for business efficiency reasons, it may be reasonable for the trustees to agree to minimise the section 75 debts that have to be paid at the time. However, the trustees must be convinced that the overall employer covenant is not worsened, and there is no detriment to the security of members' benefits (or that appropriate mitigation is offered).

## RESTRUCTURING WHEN IN DIFFICULTY: PRE-PACKS

If a scheme employer is in difficulty and likely to go insolvent, there may be attempts to save some of the business. There might be a pre-packaged sale (or "pre-pack"), with the sale of the company's business or assets being negotiated with a buyer before the appointment of an administrator. The administrator carries out the sale immediately on or shortly after he is appointed.

### Unsecured creditors

Unsecured creditors, including the pension scheme trustees, are not given an opportunity to consider the sale before it takes place, although they can expect administrators to disclose a significant amount of information about the sale. If trustees do not receive detailed information explaining what has happened and why, they should ask for it from the administrator, as it will be important in understanding the effect of the sale on the pension scheme, and also, potentially, whether there are grounds for challenging the sale.

### Impact on pension scheme

Pre-packs can raise significant problems for the pension scheme: they involve selling the assets of the sponsoring employer on to a new company, leaving the sponsoring employer as an empty shell. If the pension scheme's funding level is lower than necessary to provide PPF benefits, the scheme is likely to end up going into the PPF. This "dumping" of the pension scheme on the PPF is likely to be unacceptable to the Pensions Regulator, which may take action against companies seeking to offload their pension liabilities in this way.

However, the Pensions Regulator and the PPF recognise that in some circumstances it may be desirable for a pre-pack to go ahead as with their support as:

- it may be the only chance of saving any jobs; and
- otherwise, the pension scheme, as an unsecured creditor, may not receive any money from the company in trouble anyway.

The PPF and the Pensions Regulator will sometimes participate in a restructuring or rescue of insolvent businesses that allow for the pension scheme to be separated from the business and left to wind up, normally in the PPF.

Trustees may be expected to participate in negotiations with the sponsoring employer, the PPF and the Pensions Regulator to allow rescue of the business. It is likely that the companies involved will seek clearance from the Pensions Regulator (see box on previous page), and the trustees' input will be expected (for example, by commenting on the clearance application or confirming their support for it).

### PPF's attitude to pre-packs

The PPF will participate in the restructuring or rescue of an insolvent business such that the pension scheme debt is removed from the company or compromised only where the pension scheme will be better off than if the business had simply been left to fail.

In particular, the PPF expects that the pension scheme be given an equity stake in the restructured business, of 10% equity where the future shareholders are not currently involved with the company and 33% if the parties are currently involved (this is a form of "anti-embarrassment" protection).


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