ECWG
employer covenant working group

Employer Covenant Working Group

Transactions in a distressed environment
Guidance for practitioners

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1. Introduction and objectives

'Distressed' scenarios : this guidance considers corporate activity where the directors' focus should, or may be about to, switch from optimising the shareholders' position to protecting the creditors.

Overview

This guidance has been developed by the Employer Covenant Working Group to assist practitioners in evaluating the impact of a range of distressed scenarios on the covenant of sponsoring employers, the risks to the security of member benefits and the related advice that they may give to their clients.

It considers what actions could be taken and what, if any, mitigation might be appropriate where material detriment arises, or is likely to arise, as the result of the distressed scenarios and potential solutions considered herein.

This guidance is not prescriptive and experience shows that the impact of any distressed scenario on the covenant afforded to a scheme by its sponsoring employer will be specific to the circumstances of the respective scenario and must take account of the full range of issues 'in the round'. This guidance does, however, try to bring out key issues which may be relevant in different distressed scenarios and potential range of solutions, based on practitioner experience.

The ECWG guidance on 'transactions in a non-distressed environment' considers corporate activity prior to an actual or prospective default on lending arrangements, significant cash flow pressure or an insolvency event.

However, the 'distressed' scenarios considered herein cover corporate activity where one or more of these factors is likely to be evident and the directors' focus should, or may be about to, switch from optimising the position for shareholders to protecting the position of creditors.

These circumstances are characterised by an increased threat of insolvency to one or more employer and/or significant risk that one, or all, of the corporate's creditors, including any defined benefit pension scheme, will not be repaid in full as and when their respective debt falls due.

This guidance seeks to highlight the key issues which a practitioner may have to consider when reviewing 'distressed scenarios', as defined opposite. However, it is not an exhaustive nor prescriptive commentary and as regulatory and market practice evolves, practitioners are encouraged to develop leading practice further.

1. Introduction and objectives (continued)

Points for practitioners to consider

Professional judgement should be based on an integrated assessment of the risks to scheme funding, taking account of broader economic, commercial and financial issues in the context of the employer and respective scheme over all timeframes.

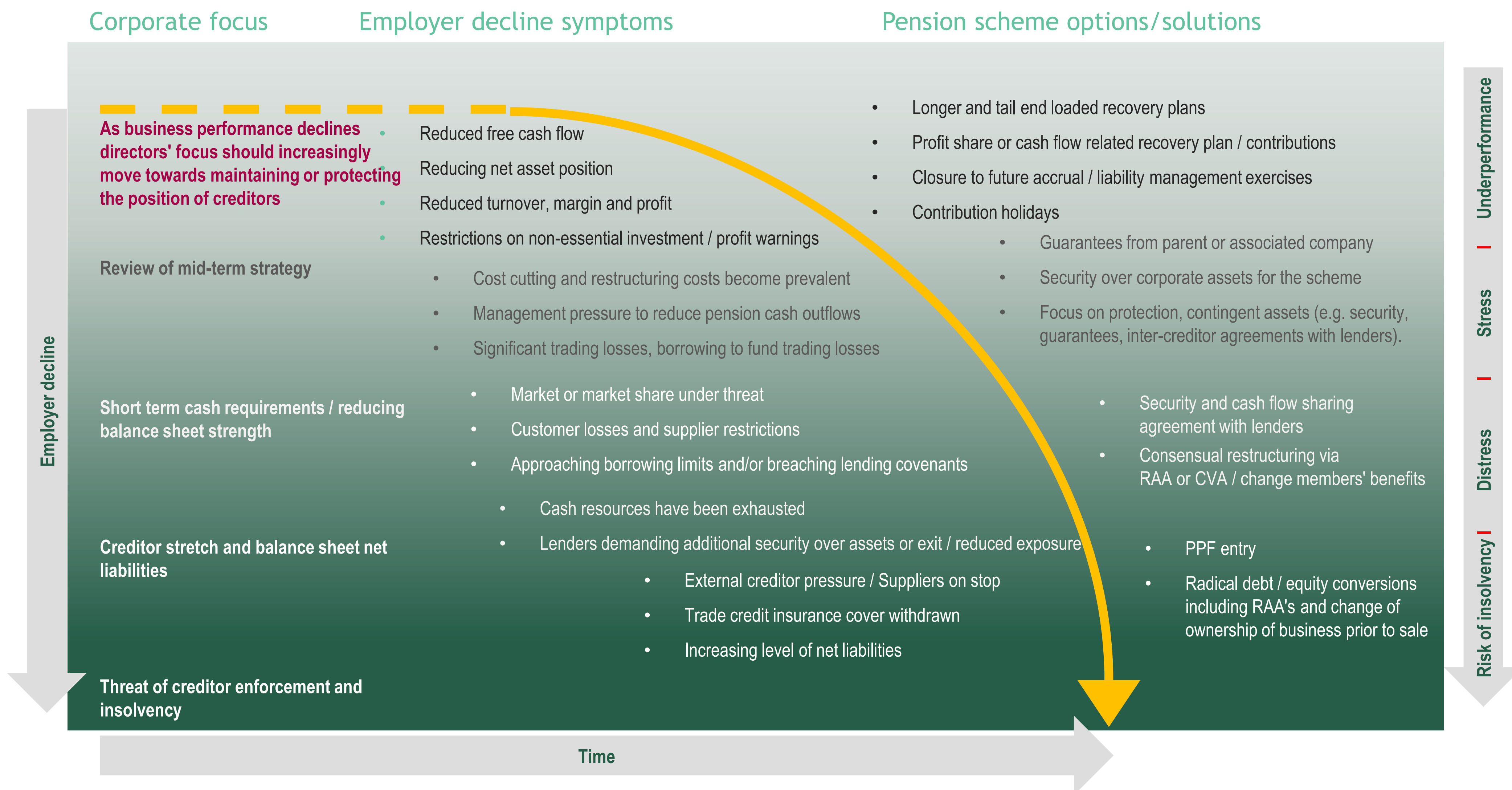
Any situation must be assessed proportionately and the respective scheme size, funding level, recovery plan and investment risk profile need to be considered in conjunction with the possible impact of the different scenarios on the respective employer(s).

A sponsoring employer may support more than one pension scheme and a scheme may also be supported by multiple employers and a practitioner should be mindful of this when evaluating the impact of any distressed scenario.

This document should be considered with the guidance, codes and statements issued by the Pensions Regulator and the Pension Protection Fund and the other guidance notes issued by the ECWG.

2. Overview of distressed scenarios

High level introduction to distressed situations



2. Overview of distressed scenarios (continued)

High level introduction to distressed scenarios

Overview

The aim of this guidance is to consider scenarios where the financial strength of the employer is decreasing and the duties of the respective corporate directors should be more focused on safeguarding the position of the creditors rather than increasing or maintaining shareholder value or the equivalent for 'not for profit' organisations.

The point at which this focus switches is often unclear and will normally be subject to the specific circumstances faced by the corporate entity. It may not occur due to the impact of a single identifiable event but arise as the result of a gradual build up of factors and pressures impacting on the trading performance, cash flow and balance sheet positions of the respective scheme employers.

The diagram of the high level 'decline curve' on the previous page, outlines a number of symptoms of distress, together with possible options and solutions available to restructure pension schemes. It is not intended to imply that these symptoms will all occur in the order summarised, nor that all or any of them may be identified by trustees prior to an insolvency or recovery event impacting on a scheme's employer.

The position of any employer on the decline curve will depend on its specific circumstances. Employers may face a broad range of difficulties including, but not limited to, matters such as market or product decline, customer or contract loss, operational inefficiency, margin or profit decline, over borrowing and even the magnitude of the pension scheme's funding requirements itself.

The respective approach adopted by the employer and the trustees to each other will be dictated by the materiality and maturity of the Scheme's future funding requirements and the employer's current and future trading expectations and solvency position.

The legislative definition of insolvency references s123 of the Insolvency Act 1986 which considers both balance sheet and cash flow solvency. However, typically it is cash flow pressure that brings about most insolvencies.

The relative importance of the scheme in comparison to the employer's other problems will also need to be considered.

Likewise, the severity of the impact of the symptoms on an employer increases the further down the decline curve you travel. This typically leads to greater complexity in the potential options or solutions needed to address the underlying issues and an increase in the level of specialist advice required by all parties.

As the likelihood of insolvency becomes greater, creditors tend to focus on their own short term position. Creditors with security may seek to crystallise that security to ensure full recovery. The timing of this decision could have a detrimental impact on the position of the unsecured creditors, which usually includes the scheme.

The potential severity of the impact of these changing circumstances on an employer, reinforce the need for the trustees to continuously monitor the covenant, investment and liability management strategies and funding risks being faced by a scheme.

As the employer's issues become increasingly complex, the appointment of an Independent Professional Trustee to support the lay trustees may be beneficial.

2. Overview of distressed scenarios (continued)

High level introduction to distressed scenarios

Symptoms

The decline in the financial strength of a sponsoring employer may be demonstrated through changes in its on-going profitability and cash generation and/or in its underlying balance sheet position.

Reducing turnover and net profit are relatively simple to observe by comparing a company's statutory results over time, albeit the impact of exceptional or extraordinary events should be identified and understood to ensure short term temporary reductions are not misinterpreted as an indication of a longer term underlying decline.

Cash trends are more difficult to monitor. Although earnings before interest, tax, depreciation and amortisation ('EBITDA') can often be calculated from a company's statutory results and may act as a proxy for operational cash generation, there are a number of limitations to solely using this metric to understand the underlying strength of the business.

For example, a mismatch between depreciation and capital expenditure can enhance profitability while materially impacting underlying free cash flow.

Likewise a shrinking business may temporarily demonstrate increased cash generation in the short term as assets and stock are sold, albeit this can mask longer term viability issues.

The use of statutory accounts is helpful but they are backward looking and forecasts and narrative regarding future trading expectations can be a more effective indicator of potential decline. For example, market contraction, the expected loss of large contracts, restrictions on capital expenditure and investment, reduced margins and dividend expectations can be informative.

An understanding of the balance sheet is also important, given that the underlying asset position of an employer and the size of the scheme's deficit and priority relative to other creditors may impact the level of potential recoveries in an insolvency scenario.

The potential insolvency outcome can become increasingly complex where an employer is supported by a wider group which is, in turn, funded by secured loans, bank debt or shareholder loans which attract significant interest.

The deterioration in the trading, cash generation and the underlying asset position of an employer could have a significantly adverse impact on the trustees' view of the underlying covenant strength afforded to the scheme by the employer.

As the strength of the underlying covenant weakens, the length of associated recovery plans normally increase, exposing the scheme to greater investment, covenant and funding risk over an increasing time span.

Contributing factors in many distressed scenarios are the magnitude of a scheme's deficit, its volatility and the size of the deficit repair payments due under the terms of the agreed Schedule of Contributions.

Even where an employer is profitable and cash generative, the magnitude of its future obligations to a scheme could lead to, or play a part in, its insolvency, if not immediately, then in the longer term.

2. Overview of distressed scenarios (continued)

High level introduction to distressed scenarios

Potential investors and lenders may be wary of providing funds to a corporate entity where there is a material scheme deficit due to concerns that the trustees and the Pensions Regulator may seek higher deficit repair payments on the back of the employer's increased liquidity, rather than allowing the funding to be used to support growth, future profitability and dividends.

The interplay between a scheme's funding requirements and the ability of an employer to meet these needs, whilst also supporting the growth and profitability of its own business, reinforces the requirement for trustees to understand and closely monitor the relationship between the scheme's investment strategy, risk appetite and maturity of its membership.

The interplay between these respective factors for schemes and employers who are not facing distress are considered further in the ECWG's guidance on covenant assessments.

2. Overview of distressed scenarios (continued)

High level introduction to distressed scenarios

Options / solutions

Where the principal issue facing the employer is cash flow orientated, and perceived as temporary, there are a number of potential solutions that could be considered, including:

- Temporary recovery plan holiday
- Lengthening recovery plans
- Tail end loading the contributions to match higher contribution levels against expected future improvements in the employer's trading profile.
- If the scheme remains open to new members and/or future accrual the employer should normally be expected to consider the merits of closing the scheme to safeguard benefits that have accrued to date and reduce potential volatility which could otherwise arise as the result of detrimental movements in gilt yields and investment returns.
- Where businesses are asset rich, rather than cash rich, contingent assets can be used to provide trustees with the security needed to support long term or tail end loaded recovery plans.

Any alteration to recovery plans will require an amendment to the agreed Schedule of Contributions and any advisor might expect either tPR or the PPF to take a close interest in any or all of them.

Where a scheme's deficit and funding requirement are disproportionately large when compared to the employer's funding ability, even after taking account of extended recovery plan options, then the potential solutions become significantly more complex and the involvement of tPR, and potentially the PPF, should be expected to increase.

The profile of the scheme could have a major impact on the level and structure of the solutions being considered. The age profile of the members, the scheme's investment strategy and its underlying funding level all potentially impact on the options available to trustees as they seek to balance the scheme's covenant, investment and funding risks with the employer's ability to afford an appropriate solution.

As an employer's position on the decline curve falls, the options and solutions facing both the employer and the scheme become increasingly complex, requiring greater interaction and discussions between the trustees, the management of the employers, and, ultimately, with tPR and the PPF. This may even extend to interaction with the employer's other major stakeholders including shareholders, banks, bond or loan note holders and other major creditors.

In consequence the need for advice and assistance to be provided to all parties will increase.

2. Overview of distressed scenarios (continued)

High level introduction to distressed scenarios

Summary of key relationships and roles

In any distressed scenario the initial interaction should always be between the trustees and the employer. These discussions should consider the extent of the issues facing the employers and seek to identify a range of potential solutions.

Although not necessarily involved during these initial discussions, tPR will expect all options which do not involve compromising members' benefits to have been fully explored before more complex or radical options are considered.

It is, therefore, important that both the employer and trustees obtain relevant advice and evidence the process being undertaken to demonstrate that all possible solutions have been reviewed and why certain solutions could not be progressed, before other, more radical options are considered.

Given that these discussions will increasingly focus on the financial position of the employer, it is the corporate advisors who will normally lead the documentation of the issues, with the scheme's advisors typically providing a critique to the trustees of the corporate proposals/advice.

Trustees should seek to be as proactive as possible in their dealings with the employer, particularly as an employer's position becomes increasingly distressed. They should act robustly to ensure that they are not viewed as an easy solution to the employer's solvency issues, whilst also ensuring any detrimental impact to the scheme's position is proportionate to that of other key stakeholders (for example, equity holders, secured lenders and/or unsecured creditors) after taking account of the priority of their claims.

Initially the corporate's proposals/advice should focus on explaining the short term trading and funding issues facing the employer. However, as the employer travels down the decline curve this advice is likely to extend to reviewing:

- key relationships and contagion issues between the employer(s) and any wider group,
- potential outcome scenarios under various insolvency processes; and
- possible regulatory intervention seeking to attach liabilities to associated or connected parties.

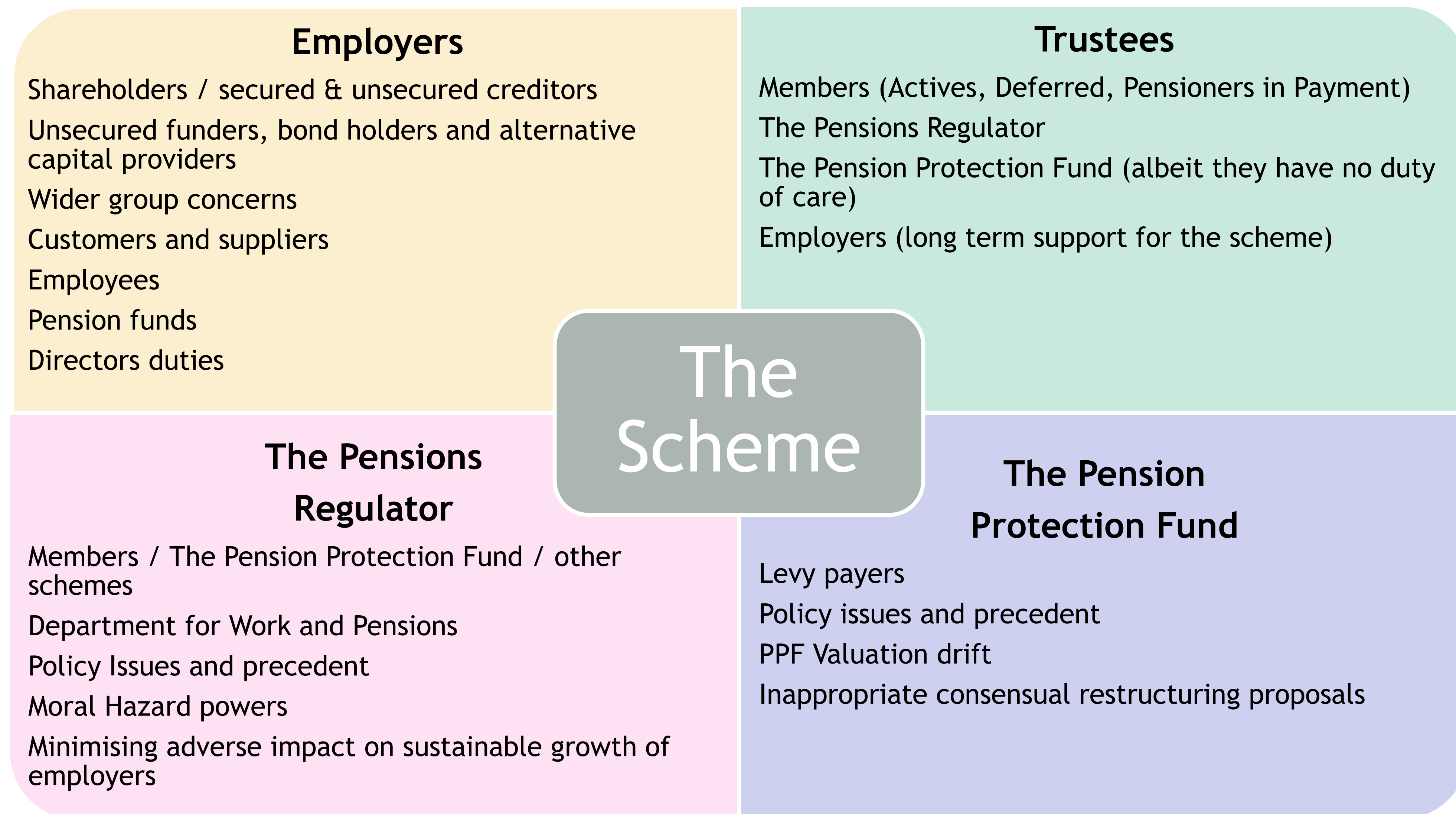
Although the trustees and tPR may initially appear to have similar objectives in seeking to safeguard members' benefits, as scenarios become more complex and the insolvency of the employer appears more likely absent a restructuring, these objectives may diverge.

As employers approach insolvency, trustees become increasingly focused on maintaining the support of the employer to meet members' benefits in the short to medium term, while tPR is likely to become increasingly focused on reducing the risk to, or size of a call arising on, the PPF.

In extreme scenarios this can lead to tensions between the trustees, the employer, tPR and the PPF, which a covenant adviser might be expected to provide some analysis or assistance in navigating.

2. Overview of distressed scenarios (continued)

Summary of key stakeholders, their constituencies and considerations



3. Temporary reduction in profit and cash flow

Businesses from time to time face short term trading issues, which should not impact on their long term solvency or underlying financial strength; for example the unexpected loss of a material contract, the insolvency of a significant customer, commodity price fluctuations or the timing of major capital expenditure or rationalisation.

Although these events can have a material short term impact on profit and cash generation, the longer term existence of the business should not necessarily be in jeopardy.

Where these circumstances impact on a business which supports a defined benefit pension scheme, trustees may consider it appropriate to provide support to the employer by reducing, flexing or suspending deficit repair contributions for a short period of time, albeit they should be aware that these changes could have a detrimental impact over time on the scheme's future funding position including one estimated on a PPF basis.

If the employer has unencumbered assets, trustees may seek charges over these assets as security for agreeing to these temporary changes in any on-going funding agreements.

Alternatively, trustees may seek to agree a ratchet mechanism or back end loaded recovery plan profiles to ensure that deferred payments are recovered as the performance of the underlying business improves.

In these circumstances the employer may seek assistance from a practitioner to prepare short and medium term cash flow forecasts to demonstrate the size and nature of the issues being faced.

In the same situation, trustees will require advice from a practitioner critiquing the forecasts provided by the employer to confirm that the expected impact to the covenant will be only short term, as longer term under-performance may require more radical solutions.

Potential areas where advice could be required from a practitioner

- Preparation and explanation of trading and cash flow forecasts, including material movements
- Critique of trading and cash information provided to the trustees by an employer
- Updating previous covenant assessment for either the employer or the trustees
- Ongoing monitoring of performance and results of remedial action
- Review of impact of short term issues on all key stakeholders
- Options review considering the implications of alternative strategies on the employer's position
- Short term mitigation options
- Review of potential moral hazard issues

4. Longer term reduction in profitability and cash generation

Where the financial performance of an employer is undergoing a longer term decline, for example due to structural changes arising from globalisation or product substitution, a reassessment of the strength of the scheme's covenant may be necessary, together with a re-evaluation of the employer's longer term ability to support its future funding requirements.

Where a scheme remains open to new members and/or future accrual, tPR may expect the option of closing the scheme to be considered on the basis that it may be in the best interest of all parties.

This would focus an employer's limited financial resources on meeting the benefits that have already accrued, rather than exacerbating the problem by continuing to increase the on-going funding requirement.

In line with tPR's recent guidance on Integrated Risk Management, any reduction in the longer term view of the covenant strength should lead to a re-evaluation of the funding and investment risks being faced by the scheme.

This, in turn, may give rise to the consideration of strengthening the assumptions underlying the Technical Provisions and/or a de-risking of the investment strategy.

Any increase in the overall estimated funding requirement may lead to a longer recovery plan, unless additional support can be secured either from the employer or a third party.

This additional support could take the form of

- direct obligations to provide funding should the employer be unable to do so;
- guarantees covering the scheme's current and/or future funding obligations;
- subordination of intra-group balances behind the claims of the scheme.

Ideally guarantees should be 'evergreen' in nature and cover the full Section 75 deficit and preferably be supported by charges over readily accessible and realisable assets. Although guarantees which are restricted by value or duration may be considered to have a lower covenant impact, they can still be of commercial value and provide some additional support to the scheme, over and above that obtained solely from the employer(s).

The terms of the guarantee together with the position of the guarantor in the overall group structure, its underlying purpose (holding or trading company) and its own financial strength, should have an impact on the trustees' view of the guarantee.

Whereas a guarantee from a parent or holding company could provide security not only against the contributions due from the employers but also against future operational and/or financial restructurings, one provided by an operating business should remove the possibility of structural subordination, which could impact on a holding company.

4. Longer term reduction in profitability and cash generation

Although any type of guarantee from an entity which is not an employer should provide a scheme with support over and above that available directly from the employer(s), a review should be undertaken to assess the financial strength of the guarantor and to evaluate its realistic capacity to meet a call under the guarantee.

Regular monitoring of the guarantor may also be appropriate to highlight any changes which could lead to structural or contractual subordination, which may potentially reduce its future value as security.

Potential areas where advice could be required from a practitioner

- Preparation and explanation of a trading and cash flow forecasts
- Critique of trading and cash information provided to the trustees by an employer
- Consideration of inter-company creditor and debtor positions and the impact of the repayment of these positions under 'going concern' or distressed circumstances
- Updating previous covenant assessment for either the employer or the trustees
- Review of the commercial value of contingent assets and/or guarantees
- Evaluation of a guarantor's ability to meet a call under a guarantee as and when called, to enable trustees to consider its certification for PPF levy purposes
- Regular monitoring of guarantors and/or employers financial positions
- Review of potential moral hazard issues
- Assisting employers or trustees in negotiations related to the impact of changing employer circumstances on the covenant and/or the affordability of recovery plans

5. Corporate restructuring and turnaround strategies

Should the ability of an employer to support the future funding requirements of the scheme be considered remote, due to a material deterioration in the financial performance of the employer and/or a significant increase in the scheme's funding requirements, or both, it may be appropriate for more radical options to be considered, such as corporate restructuring or formal insolvency procedures.

While a corporate entity remains solvent, the directors' focus should be on the future and, in particular, how they can preserve, if not improve, the underlying value for shareholders.

However, as a corporate entity's financial position becomes increasingly stressed, the directors' focus should change with greater emphasis on protecting the position of creditors, which should include any pension scheme.

As such, directors may need to spend greater amounts of time in monitoring and managing the position of creditors. This process becomes increasingly complex where creditors have security over some, or all, of the corporate's assets or where there are significant contingent creditors, such as contracts, landlords and contingent pension scheme s75 deficits

Where assets have been secured, directors will need to balance the need to ensure secured creditors do not take pre-emptive action to recover value under their security, thereby potentially compromising a strategy that could restructure the business for the benefit of all creditors, against the fact that without their continued support a longer term turnaround strategy may not be feasible.

The retention of the secured creditors' support is likely to depend on the credibility of any turnaround plan. This should also be the case for other major unsecured creditors such as a pension scheme. As such, a set of detailed, credible forecasts and/or strategic plans are key when outlining any restructuring proposal to creditors.

These forecasts should clearly detail the reason for the current issues facing the corporate entity and the depth and breadth of the restructuring requirements; including costs, the sources of any additional funding and the impact on all creditors.

Where there is an apparent disproportionate impact on different classes of creditors, the restructuring plan should clearly explain the rationale for the different outcomes and seek to demonstrate that all creditors are being dealt with equitably.

This will help evidence to the trustees and tPR that the directors are not pursuing a strategy designed simply to abandon the employer's obligations to the pension scheme.

This is a key tenet of both tPR and the PPF's requirements when considering any consensual restructuring proposal that involves the entry of the scheme into the PPF.

Finally, when considering a restructuring plan which could have a materially detrimental impact on a scheme, trustees should expect to have evidenced that appropriate consideration has been taken of all possible scenarios, including the advantages, disadvantages, deliverability and risks of each of the possible scenarios, to demonstrate that all options to mitigate any potential detriment to the scheme have been considered

5. Corporate restructuring and turnaround strategies

Regulated Apportionment Arrangement ('RAA')

RAA's involve transferring an employer's future scheme funding obligations to another party (a new employer), which will enter into an insolvency, allowing the original employer to continue to trade solvently while the scheme enters into a PPF assessment period. Regulatory clearance is needed as the scheme's funding obligations are to be apportioned to an entity which is expected to enter into an insolvency process within 12 months,.

When being provided to support such a consensual scheme restructuring proposal, forecasts/restructuring plans will need to clearly demonstrate the inevitability of insolvency absent an agreement being reached with the trustees.

Where it is clear that an employer is not able to support the future funding requirements of a scheme but, removed of this obligation, should be able to continue to trade profitably, it may be possible to agree a consensual scheme restructuring where the scheme enters the PPF. The hurdles which have to be met, before obtaining tPR's and the PPF's agreement are high and relatively prescriptive.

Although different organisations, tPR and the PPF work closely together when considering such extreme scenarios. Until such time that the cash flow insolvency of the employer is an issue, tPR will lead the discussions with the trustees and the employer, albeit the PPF may be kept informed if insolvency is a longer term possibility.

However, as insolvency becomes more likely, the PPF's involvement in the discussions should be expected to increase, in particular with regard to the level of any mitigation to be offered in return for any consensual PPF entry via an RAA.

The PPF's *'Guidance for Insolvency Practitioners'* summarises the circumstances behind its participation in pre-insolvency discussions and sets out a number of hurdles which must be met for it to agree to a scheme restructuring proposal which involves the consensual entry of the scheme into the PPF. These are as follows:

- Insolvency has to be inevitable
- The mitigation must be significantly better than the dividend the scheme would receive on the insolvency of the employer and will be viewed in light of the s75 deficit
- The proposal must be deemed to be fair taking account of any 'gain' to other stakeholders following the agreement
- Equity will be provided in an appropriate surviving business
- tPR confirms it would not generate more funding for the scheme from the use of its 'moral hazard' powers and is prepared to clear the RAA
- All costs associated with the process, including professional advice, are to be met by the employer

In addition to the criteria noted above (which are considered further later in this guidance note) both tPR and the PPF are wary of concluding a consensual restructuring proposal that could set an inappropriate precedent in the wider pensions market, leading to a grater number of schemes entering a PPF assessment period.

Advice from covenant advisors is generally required by both employers and trustees to address these hurdles.

5. Corporate restructuring and turnaround strategies

Inevitability of insolvency

The main hurdle that has to be cleared to meet the PPF's criteria is to evidence that absent the agreement of the proposed restructuring, the insolvency of the employer is inevitable.

Insolvency is defined in the Insolvency Act 1986 as when a company is not able to pay is debts as and when they fall due or its liabilities, including contingent and prospective liabilities (i.e. the scheme), are in excess of its assets.

If a pension scheme has a future funding requirement materially greater than the employer's current profitability or cash generation, the directors should consider on the balance of probability whether the employer is insolvent, irrespective of the size of the scheme's accounting deficit reported on the balance sheet.

Insolvency usually manifests itself through cash flow issues, either due to a cash flow crisis or a build up of issues because of a general decline in the underlying trading performance of the employer, including but not necessarily limited to the funding needs of the pension scheme.

Although legislation provides no clear definition as to when insolvency should be considered to be 'inevitable', Regulation 7A of the Employer Debt Regulations notes that to progress an RAA the trustees should be of the opinion that it is reasonable likely that a PPF assessment period will occur within the following 12 months.

Where an employer appears uncertain to be able to meet the long term future funding requirements of a scheme but insolvency is not considered likely within the next 12 months, the scheme’s internal dynamics should be reviewed to ensure there is a reasonable probability that its own cash flows will remain positive and it can pay members’ benefits as and when required.

If a review of this nature indicates that a scheme will not be able to maintain a positive future cash flow without a material increase in the support provided by the employer, then the employer’s own long term solvency should be considered in this context.

Where there is uncertainty as to an employer's ability to meet a long term recovery plan, matters can be brought to a head if the trustees have a unilateral power to set contributions and/or the unilateral power to wind up the scheme.

In these circumstances the trustees could in theory set a contribution rate that was unaffordable by the employer or agree to wind up the scheme, the outcome of which is likely to be the insolvency of the employer.

However, this is an action that trustees are likely to be extremely reluctant to take as it would effectively crystallise members benefits at PPF levels. It is also such a radical option that, absent the agreement of key stakeholders, it has the potential to come under criticism.

Likewise, tPR could use its powers to set an unaffordable contribution level but it is obviously wary of the criticism such an action would raise, in particular given the conflicting nature of its statutory objectives.

5. Corporate restructuring and turnaround strategies

Inevitability of insolvency (continued)

This lack of clarity can leave employers and their directors vulnerable, where long term support of an appropriate recovery plan profile is not considered affordable and there are no clear triggering events in the shorter term.

Directors' concerns may be exacerbated if the discussions with the trustees and/or tPR take place over an extended period of time. In these circumstances they are potentially at risk of wrongful trading if the negotiations break down and they do not act to place the employer into insolvency, given that the inevitability of its insolvency absent a deal is a key criterion for commencing the discussions in the first place.

An option for directors in these circumstances may be to use a Company Voluntary Arrangement (CVA) to restructure the employer and address the risks arising from the scheme’s future funding requirements. Although this is a formal insolvency process, and is discussed in more detail in section 6 of this guidance note, it is generally considered by the market as a positive restructuring tool which can be used by an otherwise viable business to address a historical funding issue.

Demonstrating the inevitability of insolvency where facilities are provided by a third party funder can be more straightforward, in particular, where the funder refuses to provide additional facilities as required or where the terms of existing lending facilities or covenants are breached or, in extremis, demand for repayment is made.

However, this position can be complicated for groups where funding is provided on a group-wide basis and individual operating companies are financed through a web of inter-company debt. In these circumstances it may be more difficult to evidence the inevitability of insolvency, if there is no third party trigger event and insolvency hinges on the group's indication that it is no longer willing or able to continue funding the employer.

A group's ability to robustly communicate the rationale for the withdrawal of its support, will be vitally important for both the trustees and tPR. This may be particularly the case where support has previously been provided over a significant period and/or the insolvency of the employer could have a material impact on the rest of the group.

Where directors are preparing forecasts which demonstrate the inevitability of insolvency in support of a consensual scheme restructuring proposal, they must also be aware of their wider duties as directors including their potential personal exposure under the terms of the wrongful trading requirements of the Insolvency Act 1986.

The directors will, therefore, need to keep the status of the negotiations and the trading of the business under constant review as, if at any time it appears that the required agreement may not be forthcoming, the directors are likely to require advice as to their prospects of avoiding insolvency or alternatively the need to bring about the most effective insolvency procedure.

5. Corporate restructuring and turnaround strategies

Significantly better outcome than insolvency

Any mitigation offered to the scheme/PPF must be significantly better than the scheme would have received through the insolvency of the employer, or by tPR exercising its 'moral hazard' powers.

Although 'significantly better' is not defined on the PPF's website, it is clear that the magnitude of the improvement together with the overall level of mitigation, will be viewed against a combination of the theoretical insolvency return, the magnitude of the overall s75 deficit and the professional costs to be incurred to achieve the expected outcome for the scheme.

Detailed insolvency analysis should, therefore, be provided to demonstrate the potential level of recoveries which might be available to the scheme following the assumed insolvency of the employer.

This analysis should ideally be based on the most recent balance sheet information, albeit amendments and provisions may be needed to reflect the potential impact of the insolvency on the value of the underlying assets and liabilities. In turn, this may require the support of appropriate professional third party valuations. Practitioners should anticipate that the PPF will focus on the nature of the assumptions underlying these estimates.

In a group scenario, outcome analysis becomes increasingly complex, as the position of inter-company balances and investments in subsidiaries will need to be addressed, together with the impact of group-wide funding agreements, security structures, inter creditor agreements. This will, normally, require some form of Entity Priority Model ('EPM') to be prepared.

Where there is a material web of inter-company debtor and creditor balances, the insolvency of the employer may have a material impact on the solvency of other entities within the wider group. In these circumstances, the materiality of any potential contagion arising from the insolvency of the employer may need to be considered, in particular, if it impacts on the employer's ability to achieve recoveries from inter-company debtors.

The potential impact of guarantees and contingent creditor claims, will also need to be considered, together with the treatment of cash balances, in particular, if composite pooling, group security and inter-creditor priority arrangements are in place, which is not unusual in group scenarios.

The group position is further complicated for multi-employer schemes or multi-scheme employers. Stakeholders will need to consider the potential level of recovery available from all the employers and whether this could be materially impacted by the timing of the appropriate insolvency processes. Marshalling options and scenario planning may therefore have to be undertaken to demonstrate a full range of possible outcomes for the scheme. This may also be impacted by the nature of the trust deed, in particular if there is segregation on insolvency and whether this is automatic or discretionary.

Although potentially expensive, absent this evidence being provided, both tPR and the PPF are unlikely to agree to a consensual restructuring process.

5. Corporate restructuring and turnaround strategies

Equitable treatment of creditors

The issue for the PPF here is to ensure that the mitigation that is being offered to the scheme is fair when compared to the impact the transaction is expected to have on other key stakeholders (both creditors and shareholders).

This is particularly an issue where the return expected by non-scheme stakeholders is expected to be materially better, either due to a significantly higher return or reduced detriment.

To reach a conclusion on this will normally require the preparation of an insolvency outcome statement to demonstrate the change in outcome for the different classes of creditors and shareholders pre and post the proposed transaction.

If the PPF considers that the detriment being suffered by the scheme is disproportionate to the movement in the outcome for the other creditors, however this is achieved, it will expect the mitigation due to the scheme to be improved whilst other creditors take a more equitable portion of the downside impact of the proposal.

Equity will be provided in an appropriate surviving business

The PPF also normally requires equity in the surviving entity to be provided to the scheme, as follows :

- At least 10% where the future shareholders are not currently involved with the surviving company
- At least 33% if the parties are currently involved.

If the PPF considers that the scheme fundamentally owns the economic benefit of the employer given the magnitude of its liabilities/funding requirements, it may seek an equity holding greater than 33%.

This equity stake is taken as 'anti-embarrassment' protection to ensure the shareholders do not obtain a windfall gain by disposing of their shares immediately following the transfer of the pension liabilities to the PPF.

Despite arguments to the contrary often put forward by the respective management teams, the PPF assumes the equity provided has no value, on the basis that absent a deal the company is insolvent and its shares are therefore worthless. Accordingly, the PPF will not place either current or future value against these shares when evaluating the mitigation being offered.

Notwithstanding this, the PPF recognises that this equity may obtain value in the future and it may, subsequently be willing to enter into discussions with the surviving companies' management teams to sell the shares at some stage in the future, after an appropriate period of time has lapsed.

The shares obtained by the PPF through this process normally have dividend and non-dilution rights, together with other protective measures included in a shareholder agreement.

5. Corporate restructuring and turnaround strategies

'Moral hazard' issues

One of the hurdles to be cleared when proposing a consensual scheme restructuring involving an RAA or CVA is to evidence that the proposal provides greater mitigation to the scheme than it would otherwise receive should tPR seek to use its 'moral hazard' powers.

Accordingly, both the directors of an employer and the trustees are likely to require advice as to whether the employer, or any connected parties are potentially at risk from the use of these powers by tPR. Details of tPR's 'Moral Hazard' powers are considered further in Appendix B.

In essence, a 'Moral Hazard' review should consider whether any associated or connected parties have received benefit from the employer, which has caused detriment or compromised the employer's ability to support the funding requirements of the scheme and, if it has, whether it would be reasonable for tPR to use its powers against such connected parties.

Scheme amendments / restructurings

A very small number of recent scheme restructurings have progressed with members agreeing to transfer to a new scheme, which provides them with benefits lower than those to which they were originally entitled but above those payable by the PPF, for example the restructuring of the Halcrow pension schemes.

These proposals involved complex legal, financial and actuarial analysis. Ultimately they required individual member consent to be obtained, together with tPR and PPF approval.

In addition, the trustees will be concerned to ensure that the new scheme's future PPF entry eligibility is not compromised.

The main tenets of these proposals were:

- All classes of members were capable of being better off than if the scheme had entered into the PPF
- The ability of the successor scheme to enter into the PPF at a later date was preserved
- The successor scheme had a sponsoring employer that was capable of supporting it or the scheme had a high probability of being self-funding
- Provision was made for those members that did not want to transfer or who could not be located to enter into the PPF via a RAA

Given the required involvement of tPR and the PPF in these processes, the various options and outcomes still need to be evidenced by both the employer and the trustees to ensure regulatory agreement is received. This may include provisions relating to the cessation of these arrangements in certain pre-determined circumstances.

5. Corporate restructuring and turnaround strategies

Both tPR and the PPF will also be concerned to ensure that by agreeing to a consensual scheme restructuring proposal it does not set an inappropriate precedent which other employers could leverage to transfer the funding of their schemes into the PPF. This may give rise to tPR taking account of policy or non-commercial considerations.

The implications and importance of this should not be underestimated. Employers and trustees alike should expect this to be a particular area of focus for both tPR and PPF.

Both the employers and the trustees should be aware that although they may agree on the terms for a potential consensual scheme restructuring, based on a commercial view of the risks impacting on both the employer's business and the scheme future funding requirement, tPR and/or the PPF may not share that view.

Given that a scheme will enter the PPF's assessment process provided its employer is insolvent and the scheme meets the required entry criteria, the PPF board adopts a risk averse stance in its evaluation of consensual scheme restructurings proposals and will reject any where it considers that its involvement could be criticised, or the marginality of the benefit on offer financially is outweighed by the wider precedent.

If the commercial terms of a proposal are such that they just exceed the return through a normal insolvency, exclude any 'anti-embarrassment' equity mitigation, could be perceived to be unfair to the scheme when considered against the return to other stakeholders and there is a reasonable likelihood that the employer will be insolvent irrespective of the deal, then the PPF is likely to conclude that the marginal gains it may receive from agreeing to the proposal are outweighed by broader considerations.

As with tPR, the PPF will consider the potential impact that approval could have on its levy payers and wider pensions landscape. It would not wish to set a precedent which could provide employers with latitude when seeking to avoid their future funding responsibilities to their pension schemes.

Whereas there is usually a consensus as to approach between tPR and the PPF, in exceptional circumstances advisors should recognise that there is potential for them to disagree, since their objectives may be different.

5. Corporate restructuring and turnaround strategies

Potential areas where advice could be required from a practitioner

- Preparation and explanation of long term trading and cash flow forecasts
- Preparation and explanation of contagion reports, summarising intragroup relationships and the impact thereon of an employer's insolvency
- Preparation of insolvency outcome analysis, clearly demonstrating the outcome to all creditor classes
- In more complex group structures, Entity Priority Modelling and Marshalling analysis
- Consideration of the 'Economic benefit' ownership between stakeholders
- Review of reasonableness of 'Moral Hazard' actions
- Critiquing the above documents as prepared by the employer, if not directly prepared for the trustees
- Updating previous covenant assessments for either the employer or the trustees
- Reviewing contingent assets and/or guarantees and evaluating a guarantors' ability to meet a call under a guarantee / Monitoring of guarantors' and/or employers' financial positions
- Project management and liaison with other advisers
- Providing negotiation assistance to employers and trustees in their discussions with key stakeholders
- Reviewing and advising on options and associated mitigation structures, including equity / loan notes / cash and other wider consideration
- Advice to directors / stakeholder management

6. Insolvency options

If a consensual scheme restructuring is proposed but not progressed, the insolvency of the employer should be the next logical step, given that insolvency is supposed to be inevitable absent the agreement of a consensual restructuring proposal.

Under the terms of Section 123 of the Insolvency Act 1986, insolvency occurs when an entity, in this case the employer, is unable to meet is debts as and when they fall due.

Provided a qualifying insolvency event is triggered and the scheme meets the PPF's entry requirements, an assessment process for the scheme's entry into the PPF should commence.

Qualifying insolvency events principally include the insolvency processes outlined in the 1986 Insolvency Act 1986 and the 2002 Enterprise Act; being administrations, receiverships, liquidations and CVAs. For the sake of clarity, these do not include fixed charge receiverships or schemes of arrangement.

However, during the period prior to the commencement of an insolvency process, the directors of the employer should seek advice to ensure they are not exposed to potential action in relation to antecedent transactions i.e. transactions at an undervalue, preferences, validity of recently granted floating charges, wrongful trading etc.

6. Insolvency options

Pre-pack insolvency processes

Pre-pack administrations allow the rapid transfer of an insolvent company's underlying business and assets to new ownership, minimising disruption to trading. The main benefit is to avoid a significantly adverse impact on the underlying value of the business and assets and hence on the return to creditors from an extended sale process

However, given the nature of this process, there are frequently strong links between the new and old entities, either in the form of management, owners or investors.

Accordingly, it is important that the appointed insolvency practitioner fully discloses the circumstances of, and rationale behind, the sale, to demonstrate that the process has not been undertaken with the principal aim of 'dumping' existing liabilities, including any pension scheme.

This is addressed by the Statement of Insolvency Practice 16 (SIP16), which not only requires the insolvency practitioner to provide information on the transaction but also requires major creditors to be consulted prior to the sale being concluded.

In addition, the PPF has recently issued guidance in respect of pre-pack insolvencies as it remains concerned that in some cases appropriate consultation is not being undertaken. Where it forms this view, the PPF has resolved to appoint an alternate insolvency practitioner to manage the exit from the administration, either as a joint administrator, a supervisor to a CVA or as a liquidator, to ensure the actions of the original administrator are appropriately reviewed.

The PPF's guidance, issued in August 2016, indicates the factors it will take into account in making this decision include, but are not limited to, the following:

- The level of consultation undertaken with the pension scheme trustees/PPF prior to the pre-pack being undertaken
- The nature of the underlying business and the risks to it from an insolvency marketing period
- The underlying causes of the insolvency (including the prior conduct of the scheme and of the company/directors) and the rationale for the pre-pack
- Any interaction with tPR
- The method used to market the business and the outcome achieved
- The ongoing involvement of the original shareholders and/or management in the business post administration

Normally a clearance application would not be made in support of a ‘pre-pack’ sale which means that tPR retains its ability to utilise its ‘moral hazard’ powers if it considers the transaction would have a materially detrimental impact on the position of the scheme.

6. Insolvency options

Company Voluntary Arrangements ('CVA')

As noted in section 5 of this guidance note, recently the use of CVAs has become more prevalent in scenarios where an employer could be returned to solvency following the removal of its obligations to a scheme, but where tPR and/or PPF has indicated that it would, or could, not support a RAA.

The advantage of this process is that a CVA does not require a RAA and, therefore, does not need Clearance to be provided by tPR. However, the agreement of the PPF is required as it controls the scheme's voting rights as a creditor in any insolvency process and, therefore, holds the power to agree to or seek a revision of the terms of the CVA proposal.

Even in these circumstances the PPF has indicated that it will generally apply the same decision making process and criteria to CVA proposals as it does when a RAA and consensual restructuring is being proposed.

Potential areas where advice could be required from a practitioner

- Strategic options review / pre-Insolvency planning, in particular with regard to Pre-pack insolvencies
- Advice to the directors in respect of their duties and responsibilities in an insolvency and on antecedent transactions
- Preparation of insolvency outcome analysis, clearly demonstrating the outcome to all classes of creditors
- In more complex group structures, Entity Priority Modelling and Marshalling analysis
- Preparation and explanation of contagion reports, summarising intragroup relationships and the impact thereon of an employer's insolvency
- Moral hazard reviews
- Assisting corporates present restructuring or CVA proposals from a pension perspective taking account of the regulatory requirements

7. Mitigation

All potential actions and transactions discussed in this guidance could impact on the view of the strength of the covenant afforded to a scheme and on its future funding requirements.

Accordingly, the potential impact of the transaction should be carefully considered to understand whether mitigation may be required to address any perceived detriment.

When considering the nature and extent of the possible mitigation the financial strength of the employer and the materiality of any detriment will need to be taken into account. In addition, the funding position of the scheme should be considered together with the longevity of any expected future support.

The circumstances under which mitigation is to be provided may also impact on its perceived value, as cash or other liquid assets will have greater perceived value, than a guarantee if the scheme is likely to enter into a PPF assessment period as the result of a consensual restructuring arrangement.

In many circumstances, the optimal mitigation for trustees is likely to be the provision of cash consideration, as this gives the scheme immediate access to funding to offset any expected detriment.

However, if cash can't be immediately provided, which is often the case, a proposal under which mitigation can be provided over a period of time may be considered. This may expose the scheme to an extended period of funding risk and expose the PPF to drift (see Appendix C), but may be the only option based on the financial position of the employer.

The provision of appropriate security to support any deferred payments, may be required when considering this type of mitigation, or where funding is to be provided by a third party.

This additional security may be a charge over currently unencumbered assets, a second ranking charge over already encumbered assets or a guarantee.

Where guarantees are offered it is important to be clear as to the terms of the guarantee, its amount, how it is triggered and any limitations there may be as to the guarantor's ability to make good its obligations, should the guarantee be called.

Where the guarantor is already an employer of the scheme, the incremental benefit that will be received by taking the guarantee, over and above that already provided by the guarantor in its capacity as an employer, must be clear.

In multi employer schemes that are not 'Last Man Standing' schemes, where individual employers do not have joint and several liability for the overall scheme deficit, a guarantee may provide significant mitigation, provided it materially improves the potential return to the scheme in the circumstances when it could be called.

However, if the employers, including the guarantor, already have joint and several liability, or the guarantor is not financially strong, then it may be less clear as to the additional benefit being obtained when considered in light of the detriment.

7. Mitigation

Trustees may consider additional funding arrangements which are triggered by certain future events, for example, a material change in the employer's financial strength or the funding requirements of the scheme.

However, triggers and pre-determined ratchets need to be carefully defined to avoid ambiguity and ensure there is certainty for both the employer and the trustees as to both the magnitude and timing of the expected impact.

Potential areas where advice could be required from a practitioner

- Preparation and explanation of long term cash flow forecasts to outline potentially affordable funding scenarios
- Reviewing contingent assets and/or guarantees and evaluating a guarantors' ability to meet a call under a guarantee as and when called
- Regular monitoring of guarantors and/or employers financial positions
- Assisting employers or trustees in their discussions with all other key stakeholders
- Critiquing the above documents as prepared by the employer if not directly prepared for the trustees
- Liaison with other advisers

Glossary of terms and abbreviations

Glossary of terms and abbreviations

Term	Definition
ALM	Asset Liability Model
CoP3	Code of Practice no.3 'Funding Defined Benefits' published by tPR
CVA	Company Voluntary Arrangement
DB	Defined Benefits
EBITDA	Earnings before interest, tax, depreciation and amortisation
ECWG	Employer Covenant Working Group
EPM	Entity Priority Model
JV	Joint venture
LMS	Last Man Standing
Marshalling	Allocation of realisations under a group guarantee structure
P&L	Profit and Loss account
PIK	Payment In Kind – interest is fully or partially rolled up rather than cash paid
PPF	Pension Protection Fund
RAA	Regulated Apportionment Arrangement
Section 75 debt	References Section 75 and 75a of the Pension Act 1995. Also see 'Solvency' below
Solvency	A measure of liabilities alternatively referred to as the 'Section 75' or 'Buy Out' level of liabilities
TP	Technical Provisions – a measure of liabilities under the scheme specific pension funding regime
tPR	The Pensions Regulator
Type A Event	An event which has a materially detrimental impact on the covenant or funding of a DB pension scheme

Trustees – Key objectives and powers

B

Trustees - Key objectives and powers

The duties and responsibilities of a trustee are outlined on tPR's website and the key duties are summarised below:

Act in line with the trust deed and rules

The trust deed and rules, together with pensions legislation, outline for trustees what their powers are and the procedures they must follow.

Act prudently, responsibly and honestly

Trustees must act in a way that an ordinary prudent person of business would act in managing their own affairs. They must consider circumstances impartially, having taken account of all the relevant facts, and seek professional advice if necessary.

Trustees must not make any unauthorised personal profit at the expense of the fund or profit from it in any way.

Act impartially

Trustees must act in the interest of all the classes of beneficiary covered by the trust deed and rules, and act impartially between them. This extends to acting fairly between individual beneficiaries, weighing the interests of a particular individual against the need to protect the security of the beneficiaries as a whole.

It is understood that, with the exception of Independent Trustees, lay trustees may have potential conflicts given that they may have some direct or indirect, past or present relationship with the employer. It is therefore important to identify and address potential areas of conflict, in particular as conflicts will become increasingly severe as the position of the employer deteriorates

Act in the best interests of your beneficiaries

Trustees must act in the best interests of the scheme's beneficiaries; which is anyone who is entitled to, or who might receive, a benefit from the scheme, now or in the future.

Consider what powers you may have

Usually the trust deed will include the following powers to:

- accept contributions into the scheme
- decide the investment strategy
- invest the scheme's assets
- amend the rules of the scheme
- admit members on special terms
- increase (or 'augment') members' benefits
- deal with a funding surplus (defined benefit only)
- wind up a scheme

Some of the powers provided to trustees are discretionary, some will require the agreement of the employer and some can only be used if the employer asks the trustees to do so.

Where the power is discretionary the trustee must follow the procedures set out in the trust deed and rules. Trustees can't usually delegate their powers, including the discretionary powers, unless the trust deed and rules allow them to do so. An exception to this is the power to delegate investment decisions

Trustees - Key objectives and powers (continued)

As an employer's position deteriorates, whether trustees have a unilateral power to undertake certain actions can become increasingly important; for example the power to set contributions or to wind up the scheme.

Likewise, as the financial position of an employer worsens the requirement for trustees to act in the best interest of their members will come under increasing scrutiny.

Although trustees are usually focused on ensuring members' full benefits can be met as and when they fall due for payment, as an employer's position becomes increasingly distressed, trustees' focus can move to securing the best outcome possible for all members given the circumstances of the employer.

Likewise, although the existence of the PPF cannot be ignored by trustees, they should not take excessive investment risk, seek to prejudice the position of one member class at the expenses of another or expose the scheme to the risk arising from an excessively long recovery plan, merely due to the existence of the safety net provided by the PPF in respect of a minimal level of members' benefits which would be payable to members should the employer become insolvent.

Where these types of decisions arise, the trustees will need to take appropriate legal, actuarial and financial advice to ensure that they are acting within their powers and undertaking their duties appropriately.

The Pension Regulator – Key objectives and powers

The Pensions Regulator – Key objectives and powers

tPR's statutory powers

tPR is the UK regulator of work-based pension schemes established under legislation passed in 2006. Its principle objectives are as follows:

- to protect the benefits of members of pension schemes, both occupational and personal pension schemes
- to promote and to improve understanding of the good administration of work-based pension schemes
- to reduce the risk of situations arising which may lead to compensation being payable from the PPF
- to maximise employer compliance with employer duties and the employment safeguards introduced by the Pensions Act 2008
- to minimise any adverse impact on the sustainable growth of an employer. [Note : This most recent objective, which came into force on 14 July 2014, only applies for scheme funding purposes and may not, therefore, be relevant to all of the scenarios included within this guidance note.]

Although these objectives all have equal weighting, there is clearly potential for conflict between these aims; for example between reducing calls on the PPF, protecting members benefits and minimising any adverse effect on employers where an employer's financial strength is declining and the likelihood of a distressed transactions increasing.

- The Pensions Act 2004 provides tPR with a range of powers to allow it to meet its objectives. These fall broadly into three categories, being:
  - Investigating schemes and gathering relevant information
  - Putting things right where problems have been identified
  - Acting against avoidance to ensure employers meet their obligations to schemes

Investigating schemes

In addition to the annual return which each scheme is required to provide to tPR, employers and trustees are required to provide information about 'notifiable' events and changes to 'registrable' information as detailed in tPR's guidance.

There are also 'whistleblower' provisions to deal with information provided by parties about potential actionable events which have not been formally reported to tPR and the regulator itself has extensive powers to demand information and documents which it considered relevant to its work as a regulator.

These powers can be served on a wider range of parties including the employer, its directors, the trustee and their respective advisers; albeit in many cases some advice from the legal advisers will be covered by privilege restrictions.

The Pensions Regulator – Key objectives and powers (continued)

tPR's statutory powers (continued)

Putting things right

tPR has a range of powers which can be used to protect the security of members' benefits, including but not limited to the following:

- Improvement notices issued on individuals or companies requiring specific action to be taken within a certain time;
- Recovery of unpaid contributions from the employer if the due date for payment has passed;
- A freezing order to temporarily halt all activity within the scheme, so that issues can be investigated and appropriate discussions/negotiations undertaken;
- Replacement of trustees who are not considered to be fit and proper persons for the role;
- Where breaches occur, fines can be imposed and prosecutions can be sought for certain offences through the criminal courts.

Acting against avoidance

Where it is considered that an employer is deliberately attempting to avoid its pension obligations, tPR has powers to protect members' benefits and reduce possible calls on the PPF. These powers are frequently referred to as the 'Moral Hazard' powers

'Moral hazard' powers

There are three main 'Moral Hazard' powers available to tPR and these are, in summary:

- Contribution notices ('CN') : these focus on transactions which are considered to be designed to avoid a statutory debt. CNs require those who are considered to have obtained benefit as a result of the transaction to pay an amount up to the full statutory debt either to the scheme or to the board of the PPF;
- Financial support directions ('FSD') : where an employer is either a service company or considered to be 'insufficiently resourced', tPR can issue a FSD requiring a connected party to put appropriate financial support in place to support an underfunded scheme;
- Restoration orders ('RO') : if scheme assets have been transferred at an undervalue, tPR can issue a RO requiring that the relevant assets or their equivalent value are restored to the scheme.

The legislation has also put in place a process whereby companies which consider that they could be at risk from tPR's 'moral powers', can seek to gain protection by 'clearing' a proposed transaction.

The Pensions Regulator – Key objectives and powers (continued)

tPR's statutory powers (continued)

Clearance process

PA 2004 introduced a statutory clearance procedure to give greater certainty to those who were considering transactions involving companies with defined benefit schemes.

Clearance applications for transactions are optional but do provide some certainty to those who may be liable to the imposition of a CN or FSD following a relevant transaction, although tPR will not be bound if circumstances are found to be materially different from the contents of the application.

tPR expects clearance to be sought only in relation to 'Type A' events. These are events which are considered to be materially detrimental to the ability of a scheme to meet its pension liabilities.

Type A events are divided between employer-related events, where there must be a relevant deficit, and scheme-related events which occur irrespective of whether or not there is a relevant deficit.

As a general rule the relevant deficit will be the highest of the scheme's deficits according to the following bases:

- the FRS17/IAS19
- s179 (PPF levy basis)
- Technical Provisions under the Scheme Specific Funding regime

However, the relevant deficit can be based on alternate methodologies depending on the circumstances of the transaction. If there are "going concern" issues or the scheme is to be wound up or abandoned, tPR has indicated that the s75 basis should be used

Examples of scheme-related events include

- compromise agreements
- apportionment of a scheme's deficit
- non-payment of all or any part of a relevant s75 debt or
- any arrangement that has the result of preventing a s75 debt from triggering

Examples of potential employer related Type A events are;

- the granting or extending of a fixed or floating charge
- return of capital, including dividends, share buybacks, dividend strips, distribution in species, de-mergers
- change of an employer
- sale and leaseback of assets
- business or asset sales
- granting or repayment of intra-group debts
- "phoenix events"
- a corporate event that would substantially reduce cash flow cover, for example a significant increase in debt within the group

The Pensions Regulator – Key objectives and powers (continued)

tPR's statutory powers (continued)

Clearance process (continued)

The process will involve the completion of a Clearance Application which outlines the circumstances of the employer and the details of the transaction / event for which clearance is being sought.

Once a Clearance Application is received tPR will usually discuss the position with the trustees to understand their concerns and whether they support the Clearance Application before deciding whether to grant Clearance.

If Clearance is to be granted, a Warning Notice will be issued to all interested parties stipulating the details of the proposal as provided to tPR, together with tPR's decision to provide Clearance and a time frame, which can be as little as 24 hours if the nature of the events justifies it, in which any objections must be raised.

If no objections are raised, the Clearance Notice will be issued. However, if the basis of the transaction alters materially from the circumstances outlined in the Clearance Application, the Clearance Notice may be void and tPR could seek to impose its "moral hazard" powers.

The Pensions Regulator – Key objectives and powers (continued)

tPR's statutory powers (continued)

Other powers available to the Pensions Regulator

In addition to the powers already noted, tPR is granted certain statutory powers under previous legislation.

tPR can exercise the powers granted to it under Section 11 of the Pension Act 1995 to wind up a scheme on the petition of the trustees, the employer or any other party that has the power to alter the rules of the scheme and where this is considered to be necessary to protect the interests of the generality of the members of the scheme, albeit to date, tPR has not utilised this power.

In addition, tPR has extensive powers to change a scheme's valuation basis or set a schedule of contributions under Section 231 of the Pensions Act 2004.

These powers can be used in the following circumstances :

- the trustees have not obtained an actuarial valuation or prepared a statement of funding principles, an appropriate recovery plan or a schedule of contributions;
- the actuary has not been able to calculate a scheme's technical provisions or certify a schedule of contributions;
- the employer has not made relevant payments to scheme in accordance with the current schedule of contributions; or
- the trustees and the employer have not been able to reach an agreement as to the future funding requirements of the scheme within the prescribed time.

If any of these circumstances are met then tPR may:

- Modify the scheme as regards the future accrual of benefits;
- Give directions as to how the scheme’s technical provisions are to be calculated or the period within which, and manner in which, any failure to meet the statutory funding objective is to be remedied;
- Impose a schedule of contributions specifying the rates of contributions payable by the employer and when these payments are to be made

The Pension Protection Fund – Key objectives and powers

The Pension Protection Fund – Key objectives and powers

PPF Statutory objectives

The PPF is a public corporation set up by the Pensions Act 2004 to deal with the defined benefit pension scheme whose employers are insolvent, provided the scheme meets the required entry criteria.

It is funded by a combination of:

- A levy payable by all UK pension schemes, with the amount payable partly based on the level of the scheme's liabilities to its members and partly on the risk of the sponsoring employer becoming insolvent
- Investment returns from the assets of the schemes which have been admitted to the Fund
- Realisations achieved from the claims of the schemes in the respective insolvency processed of their former employers.

Key considerations in a distress scenario

The legislation which set up the PPF does not provide it with any formal powers to intervene in any processes prior to the commencement of an employer's formal insolvency process.

Although it does become involved in consensual scheme restructuring proposals, on the face of it, engaging in such discussions are not specifically included in the legislation which set up the PPF. This lack of legal imperative to undertake consensual discussions leaves the PPF understandably risk averse in its decision making.

The PPF's 'Guidance for Insolvency Practitioners' details the circumstances in which it will partake in pre-insolvency discussions.

This sets out a number of hurdles which must be met for it to agree to a consensual scheme restructuring proposal.

These are as follows:

- Insolvency has to be inevitable so that the PPF can demonstrate that it will have to deal with the scheme whatever happens
- The mitigation must be significantly better than the dividend that the scheme would received if the employer entered insolvency and such consideration is deemed appropriate given the Section 75 deficit
- The proposal to the scheme is deemed to be fair taking account of the 'gain' to other creditors and shareholders following the agreement
- The scheme will receive at least 10% of the equity where the future shareholders are not currently involved with the company and at least 33% if only the same parties are involved pre and post the proposal. This shareholding will be subject to a standard form shareholder agreement and articles of association which will protect the scheme's interests. This shareholding is taken for anti-embarrassment reasons rather than as added value to the mitigation offered
- tPR confirms that it would not generate more funding for the scheme from the use of its 'moral hazard' powers and is prepared to clear the transaction if an RAA is proposed
- Bank fees are reasonable, where the transaction involves a refinancing, and the PPF's and the trustees' fees and costs for considering the proposal will be met.

The Pension Protection Fund – Key objectives and powers (continued)

Other considerations for the Pension Protection Fund

Although the funding requirements of a scheme are only actually measured at the point that the employer enters a formal insolvency process, the potential movement in this position is often a consideration for the PPF when considering the outcome of a restructuring proposal. The potential change in this calculated position is referred to as 'PPF drift'.

'PPF drift' occurs when the funding requirements of a scheme under the PPF valuation methodology potentially increases due to the impact of pension benefit increases and the transition of deferred members to pensions in payment (who receive their full benefits), thereby avoiding the 10% discount and benefit cap.

The extent of the potential 'PPF drift' is an important measure for the PPF and tPR and should therefore be taken into account when considering the viability of a restructuring proposal which maintains an on-going scheme.

In particular, tPR is more likely to agree to a restructuring proposal which provides for the continuation of the pension scheme where the level of contributions being made offset the estimated PPF drift, as this means that the funding burden which could be picked up by the PPF from a future insolvency of the employer should be no greater than the current position.

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Practitioners are expected to be conversant with the body of Guidance, Codes and statements from the Pensions Regulator and the Pension Protection Fund.

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