Employer Covenant Working Group

Transactions in a non-distressed environment

Guidance for practitioners

December 2016

Contents

Appendices

1. Introduction and scope

Overview

This Guidance has been developed by the Employer Covenant Working Group to assist practitioners in evaluating the impact of a range of non-distressed transactions on the covenant of sponsoring employers and the risks to the security of member benefits; and in considering what mitigation (including, potentially, adjustments to scheme funding) might be appropriate where material detriment to covenant arises, or is likely to arise, from the transaction.

The Guidance is not prescriptive: experience shows that the impact of any transaction on the covenant of a sponsoring employer will inevitably be highly specific to the circumstances of the transaction taking account of a range of issues "in the round". However, the Guidance does seek to bring out key issues which may be relevant to different transaction types based on practitioner experience; and, with examples, to provide suggestions as to when a transaction might be covenant-enhancing; covenant-neutral; or detrimental to covenant.

For context, on the spectrum of business stress, references to the "non-distressed" environment cover corporate activity up to the point of an actual or prospective default on lending arrangements; significant cash flow pressures; or an insolvency event. In this environment, no stakeholder is forced to take an immediate loss as a consequence of the transaction – including the pensions creditor.

However, if the employer is non-distressed but is showing signs of decline (e.g. falling profitability / cash generation or rising creditor pressure), the potential future pressures and issues for the scheme should be taken into account when considering the transaction.

The case studies and commentary in this Guidance consider how practitioners might look at the pre- and post- transactional impact, particularly in the context of obligations to pension schemes, but these are not designed to be exhaustive or prescriptive. Regulatory and market practice continues to develop in this area and practitioners are encouraged to develop best practice further.

Specific practitioner points to consider

- Professional judgement should be based on an integrated assessment of the risks to scheme funding, taking into account the broader business, financial and scheme context over the short, medium and longer term.
- When assessing whether a transaction has a material impact on the employer covenant, it is paramount to consider the situation in a proportionate manner relative to the pension scheme(s). The scheme's size, funding level, recovery plan and investment risk profile need to overlaid against the impact of the transaction.
- A number of sponsoring employers sponsor more than one pension scheme: in evaluating the impact on covenant of any transaction, practitioners should be mindful of the implications of multiple pension schemes in their work.
- Insolvency analysis - including estimated outcome statements - will often be prepared. The importance of this analysis will vary depending on the employer's proximity to insolvency.

Linkage to other ECWG guidance

- This guidance should be reviewed alongside other ECWG guidance, in particular "Principles of covenant assessment for scheme valuations".

1. Introduction and scope (continued)

The Guidance considers transactions in four groups:

Transaction Group	Example transaction types
Transactions involving changes of share or asset ownership	• Mergers & acquisitions • Demergers • Disposals of business • Disposals of assets • Joint Ventures
Internal Reorganisations	• Corporate entity “streamlining” exercises and /or divisional activity realignments • Shared service arrangements
Refinancings	• Refinancings of existing debt • Introduction of a new capital structure
Value Distributions	• Dividends • Share buybacks • Other distributions and transfers of value

In addition to commenting on the covenant dynamics of different transaction types, the Guidance suggests possible routes to mitigation which might be considered when material detriment to covenant is considered to have arisen – again, subject to the specific circumstances of each case.

Finally, the Guidance comments on a number of practice matters including arrangements with confidential information and inter-acting with trustees.

Asset Backed Financing structures

The Guidance does not seek to comment on Asset Backed Financing structures which are typically used for ongoing scheme funding purposes. These arrangements can be highly complex and should be considered based on the specific circumstances of the employer(s) and pension scheme involved.

Scheme-related transactions

Whilst the transactions covered by this Guidance substantially cover matters directly affecting the covenant of sponsoring-employers, certain scheme-related transactions may also have a bearing on the employer covenant. For example, “sectionalising” or merging an existing scheme(s) may have a bearing on the covenant supporting the scheme(s).

Although specific reference is made to Flexible Apportionment Arrangements on Page 15, in general this Guidance does not seek to provide specific comment on scheme-related transactions. We recommend that scheme-related transactions should be considered based on the specific circumstances of the employer(s) and pension scheme involved.

2. Linkage to the Pensions Regulator’s Guidance on Clearance

The Pensions Regulator's (“TPR”) Clearance Guidance, published in March 2010, sets out the basis by which employers and other parties may seek clearance from TPR that, essentially, TPR will not exercise its powers in relation to an otherwise materially detrimental (“Type A”) event on the basis that appropriate mitigation has been provided to a scheme in relation to that event.

Clearance is a voluntary protective measure for employers and connected parties but the process will involve trustees and advisers who need to assess the position and indicate their stance towards a transaction or event as part of the application.

Key matters arising from the Clearance Guidance include:

- The Clearance Guidance should be brought to all parties’ attention.
- Clearance will follow a principles-based approach and is highly case-specific.
- Clearance is normally only sought for “Type A” events (employer-related events where there is a “relevant deficit” or scheme-related events) which are materially detrimental to the scheme's ability to meet its liabilities.
- Assessment of any “material detriment” is central to the analysis – does the event weaken the covenant or affect recovery of the Section 75 debt i.e. does it affect the security of members’ benefits?

Key points relevant to Clearance applications include:

- They are made by parties potentially subject to a Contribution Notice or Financial Support Direction (i.e. employers and parties connected or associated with them).
- They are made on TPR’s application form with a detailed supporting information pack (see Clearance Guidance).
- Clearance statements provided by TPR are based on the circumstances disclosed to TPR - and so applications usually need detailed legal and covenant advisory input and discussions or meetings with the relevant TPR case team.
- A formal Clearance statement is preceded by “a warning notice” upon which the parties can comment.

This document should be considered alongside, and not in substitution for, the Clearance Guidance. Practitioners should also be aware of TPR’s Code on Funding (2014) and their “Assessing and monitoring the employer covenant” guidance (2015).

Parties should consider what mitigation may be appropriate to the extent that detriment to covenant arises on a transaction.

3a. Commentary and examples on various transaction types

Transaction Group 1: Transactions involving changes of share or asset ownership

Practitioners may see a variety of transactions involving a change of ownership of either assets or shares. These types of transaction include the following:

- Mergers & acquisitions
- Demergers
- Disposals of business
- Disposals of assets
- Joint ventures

Examples of some of the issues which practitioners may face on acquisitions, disposals and joint ventures are set out on the following pages. The issues noted are not exhaustive and the general principles may also be applicable more widely to other situations.

3a. Transactions involving changes of share or asset ownership

Acquisitions

Overview

Where transactions include a corporate acquisition, consideration should be given to the commercial rationale and materiality of the transaction both to the sponsoring employer, its group (if relevant), and to the Scheme. A minor acquisition by a sponsoring employer for fair value may not be material; whereas a major acquisition for a full price – built on challenging growth or synergy assumptions – may place considerable strain on the employer's financial and other resources (including management time).

In addition to the commercial rationale and price paid for an acquisition, specific consideration should be given to the financing structure used to effect the acquisition; the post-transaction ownership structure of the entity to be acquired; and the mechanics of the transaction. Furthermore, it should be determined whether the employer has helped fund the acquisition and if it will have recourse to the value and cash flows generated by the acquired business.

The overall impact assessment would include a comparison of the "pre" and "post"-acquisition covenant on an historical and *proforma* forecast basis, focussing on P&L, cash flow, balance sheet and – to the extent appropriate - a theoretical insolvency outcome. The review should also analyse and comment on security and guarantee issues and, if relevant, the impact of any other pension scheme acquired as part of the acquisition. This should include consideration of entity priority issues and their impact on cash flows and insolvency outcomes.

An assessment would normally incorporate a full analysis of the financing structure for the acquisition, including the impact on cash resources, debt (secured, senior vs junior) or equity. An example of this is provided on Page 19.

Key areas of judgement

Acquisitions present a number of subjective areas where professional judgement is required. These include:

- Understanding the consideration paid – in particular, whether it is fair value (balance sheet neutral); value-enhancing (perhaps due to synergies); or value-destructive (due to potential over-payment). Caution should be exercised where acquisitions are between related parties.
- Estimating the value and impact of deferred and/or contingent consideration.
- Considering the nature of liabilities being acquired such as any "off balance sheet" financing arrangements or other pension schemes.
- Considering the reasonableness of post-acquisition forecasts, taking account of transaction costs, restructuring costs, synergies, working capital requirements, and interest rate assumptions.
- Considering the impact of the acquisition on the risk profile of the sponsoring employer's earnings.
- Considering the impact of the acquisition on theoretical insolvency returns (taking account of any guarantees or other similar arrangements) together with the impact on the likelihood of insolvency.
- Considering the impact of the acquisition on creditor structural priority within the employer (for example, if the acquisition is made using additional secured debt).

3a. Transactions involving changes of share or asset ownership cont.

Acquisitions – "Pre" and "Post" financial analysis (Profit and Loss)

Pro-forma income statement

£m	Co A	+ Co B =	Post- Acquisition Pro-forma Enlarged entity			
	Pre-Acq		Yr 1	Yr 2	Yr 3	Yr 4
Income	100	20	120	120	120	120
Cost of sales	(50)	(10)	(60)	(60)	(60)	(60)
Gross profit	**50**	**10**	**60**	**60**	**60**	**60**
Operating expenses	(25)	(5)	(30)	(30)	(30)	(30)
Transaction costs	-	-	(5)	-	-	-
Restructuring costs	-	-	(15)	(10)	-	-
Cost synergies	-	-	5	10	15	15
Interest expense	(5)	-	(10)	(10)	(10)	(10)
Profit before tax	**20**	**5**	**5**	**20**	**35**	**35**
Profit impact relative to Pre-Acq position			(15)	-	15	15
Cumulative profit impact			(15)	(15)	-	15

Interest expense assumed to increase by £5m pa to reflect debt financing

In this example, the Sponsoring Employer, Company A, acquires Company B for fair value. Company B is effectively a "bolt-on" to Company A and remains as a subsidiary post-acquisition rather than its assets being integrated into Company A.

This page covers the outline P&L considerations with the balance sheet considerations set out on the following page.

The simple illustrative "Pre" & "Post" P&L analysis above highlights that the transaction is expected to reduce the sponsoring employer's earnings in the short term after transaction costs, restructuring costs and additional interest expense are taken into account.

Earnings increase over the longer-term (including synergies) but the cumulative profit impact (in comparison to company A's current level of earnings) is not expected to be positive until Year 4. For a more informative "Pre" & "Post" analysis of the impact on employer covenant, Company A's stand-alone plan for years 1-4 would be used as the comparator.

Consideration should also be given to the transaction's impact on risk and the stability of the future earnings profile: for example, does the acquisition deliver diversification benefit or create concentration risk?

Additionally, the impact on the combined entity's cash flow projections should be considered and compared against Company A's standalone forecasts. The cash flow impacts may be substantially different to the P&L impacts depending on timings such as the payment of transaction and restructuring costs.

3a. Transactions involving changes of share or asset ownership cont.

Acquisitions cont. Alternative financing structures example

Pro-forma balance sheet

£m	Co A Pre-Acq	+ Co B =	Post- Acquisition Pro-forma Enlarged entity (i) Cash	(ii) Snr sec debt	(iii) Unsec debt	(iv) Equity
Fixed assets	100	20	120	120	120	120
Goodw ill	-	-	65	65	65	65
Cash	100	-	20	100	100	100
Debtors	20	5	25	25	25	25
Total assets	**220**	**25**	**230**	**310**	**310**	**310**
Senior secured debt	-	-	-	(80)	-	-
Unscured debt	(40)	-	(40)	(40)	(120)	(40)
Other liabilities	(40)	(10)	(50)	(50)	(50)	(50)
Total liabilities	**(80)**	**(10)**	**(90)**	**(170)**	**(170)**	**(90)**
Net assets before scheme deficit	**140**	**15**	**140**	**140**	**140**	**220**
Scheme accounting deficit	(60)	-	(60)	(60)	(60)	(60)
Net assets after scheme deficit	**80**	**15**	**80**	**80**	**80**	**160**

In this example, the Sponsoring Employer, Company A, acquires Company B for fair value, being £80m (£65m goodwill and £15m NBV assets acquired). The pre-acquisition balance sheets of both companies are illustrated in the first two columns. Company B is integrated into Company A although legally they remain separate entities.

The post-acquisition position is shown under four different financing structure scenarios, being (i) financed through the employer's own cash resources; (ii) senior secured debt; (iii) unsecured debt, *pari passu* with Scheme; and (iv) equity.

Scenarios (i), (ii) and (iii) show that the impact of the acquisition is initially balance sheet neutral (before transaction costs); and balance sheet neutral / enhancing if financed using equity – scenario (iv).

However, if Company B underperforms, the value of purchased goodwill could become impaired / written off and in these circumstances the acquisition becomes balance sheet dilutive under scenarios (i), (ii) and (iii).

An illustration of what might happen under an insolvency of Company B is set out on the following page.

3a. Transactions involving changes of share or asset ownership cont.

Acquisitions cont. Alternative financing structures example

In a theoretical insolvency of Company B post-acquisition, the employer would lose substantially all of its consideration paid with goodwill likely to be of no realisable value. The transaction would therefore be detrimental to covenant if funded by cash or debt. It should be noted that theoretical insolvency analysis becomes less relevant if an employer is robust and has a low likelihood of insolvency.

The Impact on theoretical insolvency recoveries assuming limited recoveries from the tangible assets of Company B

1 (i) & (ii) Acquisition financed by £80m cash or senior secured debt reduces theoretical asset recoveries to unsecured creditors (including the Scheme) by £80m **- (materially?) detrimental to covenant**

2 (iii) acquisition financed by £80m unsecured debt – no impact on asset recoveries to unsecured creditors but Scheme return is diluted by *pari passu* £80m claim **- detrimental to covenant.**

3 (iv) Acquisition financed by £80m equity – improves net asset position and potentially insolvency returns **- neutral / enhancing to covenant**

The creditors of Company B have priority over receiving any value realised from its assets ahead of Company A gaining any recoveries as shareholder. The payment of creditors in an insolvency situation follows prescribed rules regarding the priority of payment. The existence of any security over assets (such as fixed or floating charges) or amounts owed to preferential creditors can materially change the recoveries made by unsecured creditors and shareholders. The costs of the administrator are also paid ahead of any recoveries to shareholders and can be significant. Insolvency law can be complex and specialist advice should be sought to fully understand the impact on the scheme's theoretical recovery on an insolvency of an employer or subsidiary company.

Overall, the insolvency impact should be considered in the context of the **likelihood of insolvency** post- acquisition. Estimating the likelihood of insolvency will require forming a view on the trading outlook and cash flow generation of the entity, and any liquidity constraints; the scale and ranking of its creditors; and the proximity to an insolvency-related event (such as a lending covenant breach). Any insolvency analysis will also require a realistic appraisal of potential recoveries taking account of these and other factors.

3a. Transactions involving changes of share or asset ownership cont.

Disposals

Overview

The general principles set out on Page 7 in relation to acquisitions – including "pre" and "post" analysis across a number of dimensions - also apply when considering the impact of disposals.

If the sponsoring employer of a pension scheme is disposed of by a group then, absent issues such as pre-sale dividends, this may be a simple change of ownership and may not be detrimental to covenant. However, there could be "separation issues" to consider - for example, the employer's access to group treasury facilities could be withdrawn resulting in less ongoing access to liquidity.

In the situation of a subsidiary being disposed of by a sponsoring employer then the areas for consideration include:

- An understanding of the proposed use of proceeds: will the Scheme lose access to these (for example, if distributed to shareholders)? Or will the proceeds add liquidity or flexibility to the employer's future trading – or, for a regulated financial company, improve solvency capital ratios?
- The impact of the transaction on the reported profits and distributable reserves of the employer: will a loss on disposal be recognised? Even if a disposal does not complete, such a loss may crystallise in some circumstances if a fair market value is established through a marketing process that is below the current book value.
- What impact, if any, could there be on the covenant to the Scheme from the removal of pension or other liabilities (such as guarantees) attaching to the divested entity?
- Disposals to related entities require particularly close consideration given that there is no market testing of fair value and consideration may take forms other than cash.

Key areas of judgement

Disposals also present a number of areas where professional judgement is required.

Depending on the circumstances of the transaction, these may include:

- Understanding the consideration received and its impact on the sponsoring employer.
- An assessment of the strategic viability of the residual business.
- The impact on shareholder attitude to the residual business and their willingness to support both it and the Scheme.
- Consideration of the impact on theoretical insolvency returns – including understanding the implications of the disposal on any guarantee or security structure.
- Consideration of the impact on the likelihood of insolvency.
- In the case of multi-employer schemes, consideration of the specific consequences of the departure of an employer, including any Section 75 debts arising.
- In the case of a sale of business and assets by an employer (or another entity providing covenant support to a pension scheme), consideration of the impact on any pension scheme "left behind" including the use of disposal proceeds.

3a. Transactions involving changes of share or asset ownership cont.

Disposals – theoretical balance sheet impact

In this example the sponsoring employer divests its only investment which was carried on its balance sheet at £100m. The consideration agreed for the disposal is £60m. This requires the recognition of a £40m loss, as the investment is required to be revalued to the "net proceeds" value.

This revaluation may have been required in any event, therefore there is arguably a neutral covenant impact. In reality, the impact of such a disposal on the employer covenant will be driven by the value of the investment assumed within the strength of the pre-transaction employer covenant.

Balance sheet

£m	FY14 Pre-Disp	Impair investment	FY14 Pre-Disp Adj	Sales proceeds	Distribute proceeds via dividend	FY14 Post-Disp	Scheme "Section A"
Fixed assets	80		80			80	80
Investments	100	(40)	60	(60)		-	-
Cash	80		80	60	(60)	80	80
Debtors	20		20			20	20
Total assets	**280**	**(40)**	**240**	**-**	**(60)**	**180**	**180**
Unscured debt	(40)		(40)			(40)	(40)
Other liabilities	(40)		(40)			(40)	(40)
Total liabilities	**(80)**	**-**	**(80)**	**-**	**-**	**(80)**	**(80)**
Net assets before Scheme deficit	**200**	**(40)**	**160**	**-**	**(60)**	**100**	**100**
Scheme accounting deficit	(60)	-	(60)			(60)	(40)
Net assets after Scheme deficit	**140**	**(40)**	**100**	**-**	**(60)**	**40**	**60**
Technical provisions deficit	100		100			100	63
Net assets: TP deficit cover	2.0x		1.6x			1.0x	1.6x

The middle section of the above table illustrates the £60m of proceeds being distributed to shareholders. Net assets reduce from £160m to £100m excluding the pensions accounting deficit. Assuming a technical provisions funding deficit of £100m, this results in the "Net asset (excluding pensions): funding deficit" cover ratio falling from 1.6x to 1.0x – clearly detrimental to covenant.

It is possible that as part of the disposal the pension scheme is sectionalised with a proportion of assets and liabilities transferring along with the disposed investment. The right hand column shows the impact of the Scheme sectionalising, assuming in this example that 63% of the assets and liabilities remain with the sponsoring employer (Section A) and the remaining part of the scheme transfers to the disposed investment and/or new acquirer (Section B). In this scenario the proportion of assets transferring means the funding deficit cover on Section A is restored to 1.6x. A separate covenant assessment is likely to be required for Section B.

The above example could arguably be covenant-enhancing from a theoretical insolvency return standpoint if the proceeds of disposal remained within the business rather than being distributed and also assuming that the consideration achieved is greater than distressed value that would be realised from an insolvency process. This needs to be balanced with the impact on the likelihood of insolvency. If the likelihood of insolvency is low then the future cash generation of the disposed investment should be considered to confirm that the proceeds reflect fair value. Consideration should also be given to the likely use of proceeds over the short / medium term, rather than simply on day 1.

3a. Transactions involving changes of share or asset ownership cont.

Joint Ventures – summary of approach

Overview

A joint venture ("JV") is generally classed as an alliance or commercial enterprise between two or more entities to undertake a specific project or item of work. There can be a number of benefits to JV arrangements such as:

- Access to new markets or contracts that either JV shareholder could not achieve on their own.
- Access to wider skills and opportunities, possibly to develop new intellectual property.
- Complementary expertise allowing the JV to provide a more complete product/service offering than would otherwise be achievable.

Whilst there are numerous benefits to JVs, and indeed their use is common in the UK, there are a number of issues practitioners should consider where JV's sponsor defined benefit pension schemes.

Key areas of judgement

JVs, by their nature, may not be able to be relied upon to remain in existence indefinitely as their purpose may be to fulfil a specific contract or project. In contrast, when considering the obligations of a DB scheme, the time scales for paying benefits may extend considerably longer.

It is therefore crucial to understand the nature of the JV and form a view of the likelihood, timing and terms of its termination; or of its long term continuance.

A "project-related" JV may be anticipated to have a defined finite life; whereas an ongoing "trading" JV might be expected to continue into the long term as dissolution would not be in the shareholders' interests if the business continues to trade well. In these circumstances, the parties to the JV may change over time, albeit that the underlying business remains intact.

If possible, the JV agreement between the shareholders should be obtained and reviewed to allow practitioners to understand the commercial and legal position of the JV.

JVs may be formed from a hive-down of assets from an employer's business. It is important to understand the employer's continued access to cash generated from the JV.

Practitioners should ensure they have an understanding of the following key areas when assessing JVs:

- The planned life span of the JV, including any clauses which may indicate specific times in the future when shareholders may review the future strategy for the JV and if it is to continue to trade.
- Whether there are provisions in the JV agreement around the funding of pension obligations especially in the circumstances where the JV is wound up.
- The profile of dividend payments: JV shareholders may seek to obtain value via dividends over the life of the JV. In the context of the pension scheme, this may prevent the growth of net assets. In particular, in JVs where there is uncertainty over the entity's longevity, the distribution of value out of the sponsoring employer can cause trustees concern.

Continued overleaf…

3a. Transactions involving changes of share or asset ownership cont.

Joint Ventures – summary of approach (continued)

Key areas of judgement (continued)

- What provisions are there in any JV agreement to cover a change of control of the JV? There is a risk with two or more distinct shareholders that at a time in the future the shareholders may no longer wish to work together and may seek to buy out the other parties or even wind up the JV. It is important to understand the pension scheme's position in these situations and determine whether there is any level of protection available, to support the scheme.
- The JV's access to funding for its day-to-day trading activities and how this would allow potential pension scheme payments – including deficit recovery payments – to be made.
- The relative powers of each JV partner, including the ability of partners to access JV funds and the ability to exit from the JV.
- The relative financial strength of the JV partners including and understanding of both the likelihood of one of the partners defaulting and the impact this would have on the JV.
- The existence and reasonableness of any financial forecasts of the JV given that there may be very limited historical information available.

Franchise agreements and outsourcing arrangements

Where a transaction involves a franchise agreement, there are a wide range of factors to consider including, amongst others, the nature and terms of the franchise; the relationship of the employer / scheme to the franchise; the nature of the franchise issuer; termination provisions; and the basis under which the franchise may be extended or awarded in the future.

Where a transaction involves an outsourcing arrangement, similar relevant considerations regarding the nature of the agreement, its financial consequences, counterparty strength and termination arrangements – amongst others – apply.

3b. Transaction Group 2: Internal Reorganisations

Introduction

Practitioners may see a variety of types of internal reorganisations, with these tending to be more prevalent amongst those entities which are part of large corporate groups.

Trustees may not become aware of internal reorganisations involving sponsoring employers until after they have occurred. This may make discussions and negotiations more difficult than if they were taken in advance of a reorganisation with trustees informed as a key stakeholder. Adopting a “partnering approach” between employers and trustees – involving the trustees early in the process - can help ensure that the reorganisation is carried out in a way which is not seen as materially detrimental to covenant.

Internal reorganisations - overview

Objectives for reorganisations may include seeking to reduce corporate complexity and consolidate entities; or creating new business units. Issues around a pension scheme may not be a primary driver behind a group reorganisation but changes impacting on the statutory entities which are sponsoring employers can have a material impact on the scheme’s covenant support.

On pages 16 and 17, examples of two of the more common types of internal reorganisations are described followed by illustrations of the potential impact on employer covenant that these situations may result in. The two types of reorganisations covered are:

- Corporate entity “streamlining” exercises and/or divisional activity realignments
- Shared service arrangements

Business unit vs statutory entity

The ongoing management of an organisation may effectively be operated and reported at a business unit level rather than a statutory entity level, particularly in complex groups operating across multiple territories.

This can lead to a divergence between the way the business is operated and managed and the legal sponsor support for the Scheme’s obligations. This is an area where practitioners may wish to exercise caution when receiving management information to ensure the information relates to the legal sponsoring employer rather than information used to manage the business internally.

Flexible Apportionment Arrangements

Flexible Apportionment Arrangements can allow an employer in a multi-employer scheme to exit the scheme and have a “clean break” without meeting its Section 75 debt arising under the Employer Debt Regulations, if the new and / or remaining employer(s) agrees to take on the liabilities.

There are certain tests which need to be met (including whether the new and / or remaining employers are reasonably likely to be able to fund the scheme and whether the FAA will adversely affect the security of members’ interests) and specific professional advice should be obtained in these areas. However, this mechanism can prove useful in a number of internal group reorganisation situations. Guidance in relation to these arrangements is given by TPR within their publication “Multi-employer schemes and employer departures” (2012).

3b. Transaction Group 2: Internal Reorganisations cont.

Corporate entity “streamlining” exercises and/or divisional activity realignments

Overview

Larger or more complex groups may wish to reduce their number of corporate entities and amalgamate the group into a smaller number of legal entities. The rationale behind this may vary from case to case but examples include reducing administrative costs; removing unnecessary tiers of management and reporting; providing increased focus for management; improving tax efficiency; or exiting from areas which have poor trading performance.

A corporate “streamlining” exercise may have the effect of enhancing the covenant if, as a consequence, additional work is carried out in a sponsoring employer company which was previously carried out in a separate entity (itself not a sponsoring employer).

As an alternative example, the streamlining could result in the sponsoring employer company becoming responsible for a greater number of defined benefit pension schemes as part of an amalgamation. This could have the effect of diluting the covenant support available to an existing pension scheme as sponsor support needs to be shared over a greater level of pension liabilities.

Areas for judgement

There are a number of areas where professional judgement needs to be exercised to assess the covenant impacts which might be encountered in this form of transaction. These include:

- Understanding whether the sponsoring employer of the scheme gains additional trade which had been previously undertaken elsewhere within the group. This could provide additional profits and positive cash flow, thus enhancing the support available the scheme.
- Determining to what extent the sponsoring employer could gain weak or loss-making trade from other group entities as a result of the streamlining, which in turn could dilute the strength of the covenant support.
- Should part of the trade of a scheme’s statutory employer be transferred to another group entity, then any change in the profit, cash generation and trading outlook needs to be considered in the context of the pension scheme obligations.
- A streamlining exercise could result in management having greater oversight and control of the trading business by removing the “background noise” of numerous statutory entities. The effect of the transaction on management’s ability to focus the direction of the business in the future may also form part of practitioners’ considerations.
- Dissolving non-trading subsidiary companies could reduce administrative burden and costs.
- A sponsoring employer may have to sponsor additional pension schemes which were previously sponsored by other group entities. Shared over greater pension liabilities, this could reduce the covenant support available. This is an area where practitioners will need to ascertain they have all necessary information on all relevant pension schemes to reach a conclusion.
- The impact on the theoretical insolvency recoveries arising from a streamlining exercise should also be considered including the impacts of priority and subordination.
- Business or assets could be moved away from a sponsoring employer with intra-group receivables used as consideration. This could have a potentially adverse impact on covenant.

3b. Transaction Group 2: Internal Reorganisations cont.

Shared service arrangements

Overview

Groups may seek to save central overhead costs, or enhance the freedom of movement of employees, by creating a central shared service company within a group.

Such a “shared service company” may carry out central functions such as finance, HR, and IT and recharge costs back to companies trading externally to the group. Shared service companies may also hold the employment contracts for employees within the wider group – who in turn may have had their employment contracts transferred from other (trading) group entities.

If the sponsoring employer of a pension scheme becomes a shared service company through a mechanism such as TUPE, then the impact on covenant in these circumstances is likely to hinge on the “new” (i.e. shared service company) employer’s access to profits and cash from the “customer facing” trading companies in the group to pay amounts into the pension scheme as and when needed.

Areas for judgement / consideration

In a change of sponsoring employer from a trading company to a shared service company, then absent appropriate protections, there is the strong potential for material detriment to the covenant supporting a scheme. For example, a shared service company is likely to have limited net assets and will be reliant upon profits generated internally from within a group rather than from trading directly with external customers.

In order to maintain a stable level of covenant support in the situation where the employer of the section could be changed to a shared service company, the scheme would need to have the same access to the profits, cash and balance sheet of the original sponsoring employer.

This could be achieved via legal documentation between the service company and the trading entities of the group including appropriate guarantee structures.

Professional judgement will be needed both from covenant practitioners and legal advisors to determine whether a proposed covenant package maintains the scheme’s position – and, for example, to confirm whether internal transfer pricing arrangements are appropriate.

If employees who are active members of a scheme are moved to another employer which is a service company then the trustees should take advice on the impact of this on the scheme’s allocation of liabilities between the employers. This may require legal, actuarial and covenant advice.

The cost paid by the employer for central services following the establishment of a shared service company should be compared to the previous cost of the employer carrying out this service themselves. The logic of the change should be that this improves the profitability of the employer but if this is not the case then care needs to be taken to understand if there is a value shift away from the employer.

3c. Transaction Group 3: Refinancings

Introduction

In order to assess the covenant implications of a refinancing transaction, there are a number of baseline considerations that should be taken into account that will help the trustees in forming an objective overall view.

These include:

- The commercial driver or rationale for the refinancing, e.g.:
  - Debt reduction (where debt replaced with equity, for example a rights issue)
  - Maturity of existing facilities
  - Favourable market conditions
  - Dividend recapitalisation – (i.e. borrowing to pay dividends) typically for operating businesses owned by private equity funds / institutional investors
  - Capital investments / acquisitions
- The terms that have been amended, e.g.:
  - Tenor and repayment terms
  - Quantum
  - Margins
  - Security structure
  - Financial covenants and associated headroom
  - Non-financial covenants / undertakings (e.g. negative pledges or other restrictive covenants)
- Other financing considerations – e.g. interest-rate hedging (quantum and terms), use of proceeds of debt

3c. Transaction Group 3: Refinancings cont.

Refinancing example and commentary

In the example opposite, UK Limited is the sponsoring employer of a defined benefit pension scheme and is the main trading subsidiary of a private equity-owned leveraged group.

The Group has proposed a refinancing transaction which is primarily driven by the fact that its existing secured debt facilities are approaching maturity.

On refinancing, free cash balances are to be applied in reduction of the secured senior debt and mezzanine facilities, both of which rank ahead of the pension scheme.

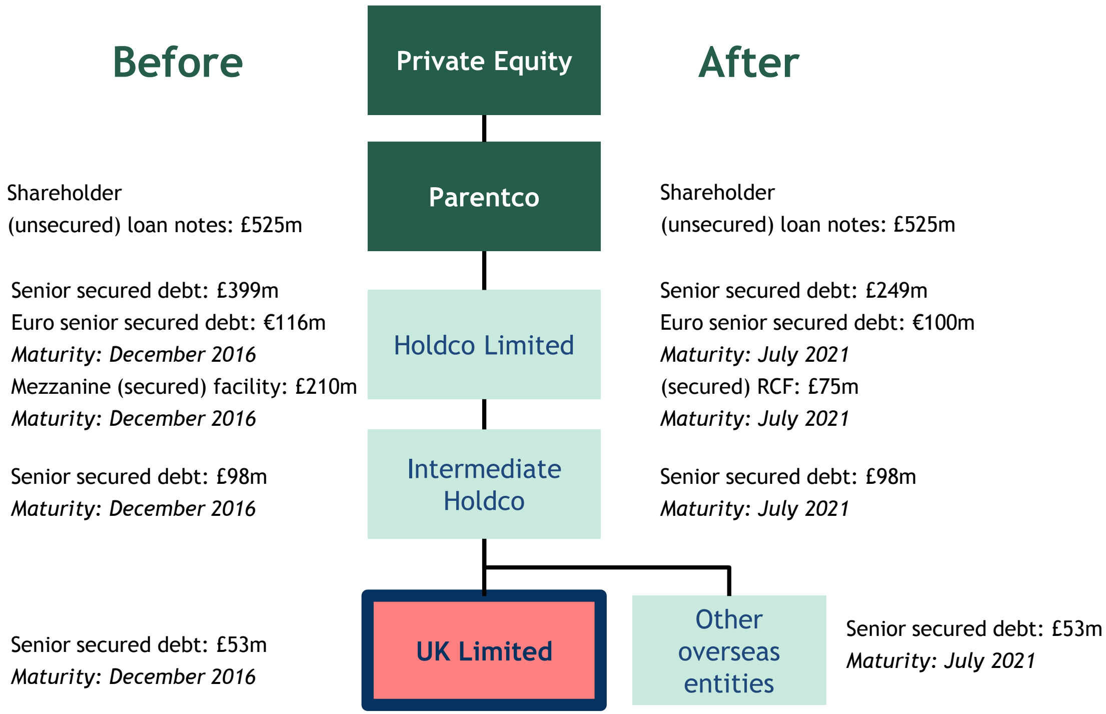
The debt margins increase due to changes in market conditions. However, the reduction in overall debt levels will result in lower total interest costs. The term of the debt is to be extended by c.4.5 years.

The senior debt retains the benefit of a fixed and floating charge over the Group's UK assets and subsidiaries. UK Limited continues to provide a share pledge and cross-guarantee in relation to the debt.

The Group has to comply with 3.0x interest cover and 5.0x net debt to EBITDA financial covenants. The financial covenants could change as part of the refinancing but in this example we assume they remain unchanged. Headroom improved for these covenants as a result of the debt reduction.

The quantum and timing of any deficit recovery plan will need to considered in the context of any refinancing risk.

The covenant implications of different elements of this refinancing are discussed overleaf. Additionally, it may be appropriate to consider the potential impact of any correlation between movements in the debt market and the pension scheme liabilities.



Loan	Margin Before	Margin After
Senior secured Debt	Libor + 450bps	Libor + 500bps
Euro Senior secured Debt	Euribor + 400bps	Euribor + 425bps
Mezzanine (secured)	Cash Libor + 350bps PIK Libor + 400bps	n/a
RCF (secured)	Libor + 400bps	Libor + 375bps

Denotes participating employer

3c. Transaction Group 3: Refinancings cont.

Refinancing example and commentary

The covenant implications of each of the amendments made to the Group's financing in the example are discussed below.

	Covenant enhancing	Covenant neutral	Detrimental to covenant
Extension of expiry	✓		
In the normal course of business, the longer the term of the debt the lower the refinancing risk			
Increase in margins			✓
All else being equal, this would result in an increase to interest costs which compete with a pension schemes' requirement for contributions and therefore have a negative impact on the ability of the sponsor to meet its pensions obligations. Increased margins may also indicate that the lender's view of the borrower's credit risk has deteriorated.			
Secured debt reduction	✓		
Reduces those creditors ranking ahead of (or pari passu with) the Scheme and may also reduce interest costs, both of which would normally improve the strength of employer covenant. Care should be taken in assessing the impact on future liquidity available to the sponsor of using free cash balances to irrevocably reduce debt.			
Increased headroom in financial covenants	✓		
This implies reduced risk of an event of default under the financing facilities. A review of future business plans and cash flow forecasts would be required to demonstrate the planned headroom available post-refinancing			
No change to security structure		✓	
No change to covenant. However, it is good practice to review the employer's legal obligations to both the pension scheme and the banking security suite during a refinancing transaction review.			
Using cash to pay down debt	✓		✓
Reduces cash headroom which may affect deficit recovery options and potential for investment in the business. However, also leads to reduced interest payments so may have both positive and negative impacts.			

3d. Transaction Group 4: Value Distributions

Introduction

This section considers some of the potential employer covenant issues arising from a range of transactions which involve the distribution of value out of the sponsoring employer of a pension scheme. The ECWG document entitled 'Principles of covenant assessment for scheme valuations' explained that, in our view, the definition of employer covenant as set out in CoP3 could be further distilled into "an employer's ability to put cash (or other assets that can be converted into cash) into a pension scheme when needed."

In the context of this definition of covenant, a value distribution can have the effect of transferring cash, or assets that can be converted into cash, out of a company sponsoring a pension scheme, thus reducing the ability of the sponsor to support the scheme at a future time when support may be needed.

There are several forms value distributions may take, with dividends and share buy-backs considered more closely on the following pages along with comments on areas practitioners may wish to be aware of in relation to other transfers of value such as intra-group charges and the repayment of subordinated debt.

The Pensions Regulator notes that a return of capital which reduces the assets of the employer or wider group may, depending on circumstances, be classed as an employer-led Type-A event.

3d. Transaction Group 4: Value Distributions cont.

Dividends: overview

A dividend, whereby a portion of a company's distributable reserves is paid to a class of its shareholders, is probably the most common form of value distribution and can, depending on circumstances, be detrimental to a scheme's covenant. The reasons for making the decision to issue a dividend can vary depending on conditions such as the annual retained profit, the level of distributable reserves, available cash, market and shareholder expectations of dividend payments along with considerations of alternative uses for the cash/assets being retained and reinvested in the business.

Shareholders may have an existing expectation to receive dividends which may be especially relevant for listed companies with institutional investors having significant shareholdings. Should a company's dividend level reduce, then markets may lose confidence - in turn limiting access to equity share capital. Institutional investors, such as pension schemes in particular, may wish to retain investments with stable dividend policies to match against their liability profile. Paying dividends at an unaffordable level to satisfy shareholder demands will weaken the employer and brings no guarantee of future equity injections.

The beneficiary of the dividend can also affect the way it may be viewed in the context of the pension scheme's covenant. For example, dividends paid to a parent group which are retained and reinvested in the group as a whole may provide some benefit to the sponsoring employer albeit more contextually. The employer will not have direct access to the funds paid out as dividends and any comfort taken should be in the context of the parent's history of directly funding payments to the scheme.

A dividend paid directly to individuals or institutional shareholders is less likely to have benefits for the sponsoring employer's covenant.

Whilst paying a dividend may be classed as being in the normal course of business, where there is a material pension scheme sponsored by a company the directors should also consider the impact the dividend may have on the employer covenant of the scheme.

Large dividends made prior to a transaction (*pre-sale dividends*) may indicate a significant transfer of value or repatriation of cash. Practitioners should seek to understand the circumstances of such a payment in evaluating the covenant impact of it.

If a group obtains some benefit, e.g. by way of dividends received, from a subsidiary which sponsors a pension scheme, then wider group companies could become classed as "connected parties" by TPR. This could potentially lead to Contribution Notices or Financial Support Directions being issued against group companies should the pension scheme liabilities be left insufficiently resourced. Reliance should not be placed on TPR's powers being engaged. Trustees should, where appropriate, act to protect the scheme themselves. Where they have no co-operation from the employer and believe there has been material detriment without appropriate mitigation, they should make TPR aware. Specialist advice should be sought in this area which can be legally complex.

Set out on the next page are simple examples on dividends along with the issues practitioners may wish to consider in these situations.

3d. Transaction Group 4: Value Distributions cont.

Dividends: overview

Practitioners may see dividend payments across a wide range of circumstances, from relatively small dividends paid from profitable companies with robust balance sheets and significant cash reserves to comparatively large dividends paid by companies with less robust balance sheets, less financial resources and uncertain trading outlooks.

Two basic examples are set out here highlighting a selection of the key areas for judgement which need to be considered. On the whole, practitioners should consider the effect a dividend may have on a sponsor's immediate trading outlook, its strategic ability to invest in its business for the longer term and the ability to fund the pension scheme with cash when required.

Company A. The £10m dividend declared would have the effect of limiting the growth of the net assets of the business in the year of the dividend due to 50% of profits being paid out. Although the pension scheme is fully funded on a technical provisions basis, the dividend reduces the coverage of the solvency deficit by company net assets to around 30%. Whilst this is a crude measure which does not take into account the quality or liquidity of the assets, it can act as an indication that there could be a negative impact on employer covenant.

It would be important to understand whether the payment could lead to cash flow/working capital pressures or to the company having to use some form of bank finance. Further, taking account of the trading outlook of the company, consideration should be given as to whether the cash could have better been retained and reinvested in the business to support growth in the future rather than being distributed. Paying dividends to the detriment of a company's future prospects may well be detrimental to the covenant supporting a pension scheme.

Company B. A £10m dividend is also declared in this example. A potential area of concern is the company's loss-making trading position. Does this indicate ongoing trading issues or is this a one-off loss? If the business is seen to have ongoing trading issues then the dividend could be viewed as a way of stripping assets out of the company. There may also be alarm as to how the dividend is funded given the low cash balance.

The dividend also has the effect of significantly reducing the net assets which reduces the coverage of both the pension scheme's technical provisions and solvency deficit by the company's net assets. Given the existence of the technical provisions deficit, questions may be raised over such a large payment made to equity shareholders when there are higher ranking obligations of the company which it appears are not being met.

	Company A	Company B
Annual retained profit	£20m	£(5)m
Cash balance pre dividend	£10m	£5m
Net Assets Pre dividend	£25m	£12m
Dividend declared	£10m	£10m
Pension scheme technical provisions funding shortfall	nil	£(2)m
Pension Scheme solvency funding shortfall	£(50)m	£(10)m

3d. Transaction Group 4: Value Distributions cont.

Share buy-backs / repurchase

Overview

In addition to dividends, an alternative form of value distribution from a company to its equity shareholders is via a share buy back/repurchase program. In this situation a company would use its own funds to repurchase a number of shares from the shareholders. This has the effect of returning value to shareholders and reducing the number of shares in circulation. By reducing the number of shares available to the market a share buy back can increase the value of each remaining share, and also the earnings per share ratio.

Key areas for judgement

Some of the key areas where professional judgement needs to be exercised in this area are set out in the following paragraphs.

- It is important to understand the financial and commercial rationale behind the buy-back. For instance, does it indicate a lack of opportunities to reinvest in the growth of the business or is management under pressure from the company's shareholders to buy-back its shares?
- Practitioners may wish to ascertain whether senior executive share options have the effect of incentivising buy-backs.
- Share buy-backs have the impact of reducing net assets and potentially available cash. Depending on the circumstances of the pension scheme's funding, this may indicate a significant payment to equity holders in preference to meeting a deficit to the pension scheme (which ranks as a higher obligation).
- A key factor to consider is the scale of the share buy-back in the context of the pension scheme and its funding position. Practitioners should ask if the available cash to fund ongoing pension scheme obligations, as well as the theoretical dividend paid to the scheme on an employer insolvency, has been materially reduced due to the transaction.
- The method of funding the buy-back and impact on capital structure and gearing should also be reviewed. If the buy-back is made from cash reserves, consideration should be given as to whether the cash could have been better spent invested into the business or to pay off existing debt. If debt is used to fund the buy-back then this is likely to lower the company's cost of capital but increase its financial risk profile as debt interest and principal always need to be paid back, whereas dividends can be cut and equity does not need to be.

3d. Transaction Group 4: Value Distributions cont.

Other distributions and transfers of value

Overview

In addition to dividends and share buy backs there are other value distributions which may be encountered by practitioners. These include intra-group payments (in return for goods and/or services), the repayment of subordinated debt and *in specie* distributions.

Intra-group payments – key areas of judgement

In the case of intra-group payments (e.g. management fees or royalties), practitioners should take care to ensure that the calculation is made on a fair and reasonable basis and the company receives genuine benefit in exchange for the charges. The charges may be paid in cash or they could lead to a build up of an intragroup creditor balance which could attract interest. There will likely be tax rules influencing the allowable amounts which can be paid in group charges.

As with dividend payments, transfers of value to the wider group from intra-group charges could lead to the group becoming classed as "*connected parties*" by TPR as part of their Type A regime. This could potentially lead to Contribution Notices or Financial Support Directions being issued against group companies should the pension scheme liabilities be left insufficiently resourced. Relying on TPR is not an approach we would necessarily advise but the possibility of such an action can act as a deterrent to the payment of excessive group charges.

Overall, the impact of the payments to the group needs to be considered "in the round". What benefit does the sponsor obtain from making these payments? Do the payments reduce the ability of the sponsor to put cash into the scheme as and when necessary?

Payment of subordinated debt – key areas of judgement

Another potential distribution of value to consider is the repayment of subordinated debt. By meeting this obligation ahead of a pension scheme liability, the assets available to meet any scheme liability will have been diminished by virtue of meeting a lower ranking obligation. However, removing debt from the balance sheet, even if it is lower ranked than the scheme, may be beneficial to the employer covenant as it could reduce the level of interest payments the employer needs to make. The impact will need to be considered on a case by case basis.

The terms of any subordination agreement should be reviewed if such a payment is made to check if a scheme trustees' approval was required for the transaction and, if so, whether it was received.

***In specie* distributions**

A distribution of value may take place *in specie* – a distribution of an asset other than cash. An example might be the distribution of shares in a subsidiary to a holding company.

In these cases, it is necessary to consider the "pre and post" position, taking account of the distribution, and to evaluate its impact on covenant.

4. Forms of mitigation

Overview

The overall objective of mitigation should be to ensure that the strength of covenant supporting a scheme is no worse following a transaction than before it – taking account of all key elements of scheme funding "in the round".

The Pension Regulator's Clearance Guidance suggests that, for a materially detrimental ("Type A") event, appropriate mitigation should "take account of" the "relevant deficit" – the "relevant deficit" being the larger of a range of deficit measures (including solvency where sponsor continuity is in doubt).

Whilst cash into a scheme is clearly an attractive form of mitigation, other forms of mitigation may be as – or more – attractive. A substantial cash payment may actually constrain an employer's growth prospects, whereas an uncapped, "evergreen" Section 75 guarantee from a strong guarantor or asset security may provide very long term, substantial covenant support which sees cash retained in the employer to support its growth.

The quantum and form of mitigation therefore requires care and judgement. Crucially, the scheme actuary's view should be sought by trustees and their advisers to ensure that any mitigation referable to a scheme deficit is based upon up-to-date information.

Mitigation which is "short dated" – such as a three year guarantee – is unlikely to provide meaningful long term covenant support for a scheme. Short term guarantees can be enhanced if they are callable in the event that they are not renewed or extended.

Mitigation for a transaction should usually be separately agreed to any valuation deficit recovery / contribution plan (Schedule of Contributions). There may be circumstances where a valuation is ongoing and the impact of mitigation can be reflected in the valuation – but on the basis that this is additive to cash or security which would otherwise be available to a scheme in the normal course.

Employers and trustees should consider how they might use Integrated Risk Management / contingency planning as a tool to support the identification and management of the risks facing the scheme, taking account of the interactions between employer covenant strength, investment risk/strategy and the scheme's funding position. This could help determine the most appropriate form of mitigation based on the impact of a transaction.

Examples of types of mitigation which could be sought, together with a brief explanation of when they might be appropriate, are set out on the next page.

4. Forms of mitigation cont.

Example forms of mitigation

In addition to cash, example forms of mitigation and the situations where they may be appropriate are set out in the table below. The precise form and quantum of mitigation will depend on the circumstances of the transaction, including the scale and nature of any detriment, and the position of both the employer and its parent group (if any).

Form of mitigation	When it might be appropriate
Long dated or “evergreen” guarantees	This form of mitigation is often used where the employer is part of a wider group which has greater financial strength than the employer. This may have no cash impact on the employer’s group but can significantly improve the scheme’s backstop security position.
Security over assets	Suitable when an employer owns valuable assets over which security may be granted. The scheme’s recovery under an insolvency scenario is improved.
Negative pledges / Non-distribution agreements	If there are concerns over value being transferred out of an employer via dividends or intra-group payments then these type of arrangements may be appropriate and can help to retain value in the employer. Can also be used to prevent the employer granting security against any of its assets to the detriment of the scheme’s position.
The enhancement of Trustee powers	Where the existing balance of power over contribution rate-setting, investment decisions and benefit structure is viewed as inequitable, or where there is a desire for scheme members to share in post-transaction up-side benefits.
Letters of credit issued by a bank	These instruments provide a form of security to the scheme which is not reliant upon the covenant strength of the employer or its group. Payment under such an instrument may be contingent upon future scheme funding or employer related events.
Surety bonds and trust arrangements	These insurance-type or cash-backed arrangements may be appropriate where the principals are restricted in providing standard guarantees or letters of credit.
Loan subordination arrangements whereby debt is subordinated to a scheme.	Could be appropriate where there are significant liabilities within the employer or its group. Subordinating this debt to the scheme may significantly improve the scheme’s theoretical recovery under an insolvency scenario.
Profit related payments	If there is potential for future profitable trading the scheme could share in the employer’s prospective upside which could improve the scheme’s funding position in the future.

5. Dealing with trustees and employer considerations

Overview on dealing with trustees

Where trustees' agreement is required to a transaction (for example, under a Clearance application), it is strongly recommended that early engagement with them takes place – unless there are compelling reasons for not doing so and the covenant is likely to be maintained or improved as a consequence of the arrangements.

Where employers are not seeking clearance, trustees still need to understand the impact on covenant of material transactions to determine if they should be seeking mitigation and/or amending their investment approach.

Early engagement with trustees will enable them to appoint advisers and make arrangements for any special meetings which may be needed outside their usual meetings cycle.

Approaching trustees late in a process where there is a risk of covenant detriment may exacerbate their caution and, in turn, delay a transaction for which trustee approval is a condition.

Employer Considerations

Employers will need to determine whether they wish to make a Clearance application in relation to a transaction.

Furthermore, employers may find it helpful to consider how the trustees may view the impact of a transaction and anticipate the concerns that trustees may raise. The employer may then be able to address trustee concerns earlier in the process.

Whilst this Guidance advocates, where possible, employers and trustees engaging early to consider and agree upon the impact of a transaction and any mitigation required, there are further considerations which may be appropriate for employers to consider such as the Statutory Defence to Contribution Notices. Even then, the employer would be expected to have undertaken comprehensive analysis of the impacts of its actions or proposed actions; and to have discussed these with the Trustee.

Confidentiality

Many transactions may involve commercially sensitive or price sensitive information.

Legal advice should be sought regarding confidentiality arrangements surrounding the provision of information to trustees and their advisers – including, in particular, transactions covered by the UK "City Code" on takeovers and mergers.

Glossary of terms and abbreviations

A

Glossary of terms and abbreviations

Term	Definition
DB	Defined Benefit
Clearance Guidance	TPR's Clearance guidance published in March 2010
CoP3	Code of Practice no.3 "Funding Defined benefits", published by TPR
EBITDA	Earnings before interest, tax, depreciation and amortisation
ECWG	Employer Covenant Working Group Limited
Guidance	This document, "Transactions in a non-distressed environment – Guidance for practitioners" as published by the ECWG
JV	Joint venture
P&L	Profit and Loss account
Section 75 debt	References Section 75 and 75a of the Pensions 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 scheme

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B

Important Notice – Disclaimer and copyright information

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Practitioners and their clients should consider commissioning legal, actuarial or investment advice on a basis appropriate to the circumstances of any transaction. Whilst some comments are made in relation to situations involving listed companies (in particular, dealing with price sensitive information), specialist advice should be sought in relation to the specific requirements, implications and obligations of dealing with them (for example, under the UK City Code or applicable listing / stock exchange rules).

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