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Pensions briefing

Please RAAlease me, let's Halcrow ... (cutting the pension apron strings?)

Briefing

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Introduction

Companies in financial distress can often face unserviceable defined benefit pension liabilities. Often the pension scheme debt is the cause of, or a major contributor to, such distress. Ordinarily, in such situations, a statutory debt will be triggered on the defaulting employer, which it is unlikely to be able to pay as it enters insolvency proceedings, and the scheme will fall into the pensions 'lifeboat', the Pensions Protection Fund (PPF).

However, where insolvency looms there is a, to date, rarely used alternative, the regulated apportionment arrangement (RAA). This is a specific mechanism under the employer debt legislation which enables a struggling employer to be released from its defined benefit pension liabilities where insolvency is otherwise inevitable. RAAs have been newsworthy in recent years following high-profile instances such as those in relation to the Kodak scheme in 2014 and the Halcrow scheme in 2016.

Crucially, an RAA needs the support of both the Pensions Regulator (TPR) and the PPF and is subject to strict conditions. This briefing examines some of the legal and policy issues which may arise when an RAA is being considered.

Legislative background

Regulation 7A of the Occupational Pension Schemes (Employer Debt) Regulations 2005 allows for an amount which would have been the withdrawing (that is, nearly insolvent) employer's share of the debt to be apportioned to one or more of the remaining companies participating in the scheme. Sometimes, when an RAA is being constructed, the remaining company may be a shell company set up for the purpose of triggering an insolvency event, leading to an assessment period and entry of the scheme into the PPF.

The statutory conditions to effect an RAA are that

- The scheme is in a PPF assessment period or there is a 'reasonable likelihood' of employer insolvency and the scheme entering into an assessment period in the next 12 months. 'Reasonable likelihood' is not defined in the legislation but TPR and the PPF will need to be convinced that the employer's long-term financial health is ailing
- An 'arrangement under the scheme rules' is entered into between the trustee, the withdrawing employer and the receiving employer, meaning a rule change may be required
- A notice of approval from TPR is required
- The PPF must not object.

Isn't this scheme abandonment?

Deciding on whether to agree to an RAA may present a dilemma for TPR and the PPF. Entering into an RAA will, ostensibly, enable an insolvent employer to continue to trade unburdened by the pensions liability, with the PPF left to pick up the pieces. Questions are often rightly asked whether this is fair from a competition perspective: does the phoenix company have an unfair advantage over competitors who retain their schemes and is it fair on PPF levy payers to pay for another corporate's failure? Further, are the PPF and TPR complying with their statutory objectives?

The reality is more complex and further analysis reveals that TPR and the PPF have sought to work collaboratively with affected stakeholders to explore alternatives, where traditional insolvency will result in a poor recovery for the scheme.

TPR's role

In August 2010, TPR released a statement setting out its view of the situations in which an RAA may be appropriate. TPR expects RAAs to be very uncommon. Figures suggest there have been an average of only four each year since the legislation came into effect and TPR's note emphasises that it will only consider approving an RAA *"in circumstances where the scheme will enter into a PPF assessment period in any case, irrespective of whether or not TPR approved the arrangement."*

Further, TPR will expect an RAA to be accompanied by a clearance application and to have been discussed in detail with the affected trustees. It will also consider factors such as the ability to achieve a better deal for the members under its anti-avoidance powers and the potential impact on other creditors and the rest of the employer group. As TPR approval of an RAA is a requirement under section 93 of the Pensions Act 2004, sufficient time must be built into the process to allow for issuing the determination notice followed by the formal approval 28 days later. However, in practice, it is preferable for TPR to be closely involved in the project from its inception and as it develops, since this increases the likelihood that regulatory approval will be given.

TPR has also detailed its involvement in RAAs in a series of its statutory intervention reports (known as section 89 reports) issued following RAAs. These show that support for an RAA will be rare and only where it is clearly demonstrable that, having worked closely with the PPF, an RAA is the best available solution for scheme members.

The PPF's perspective

A statutory right of veto has been granted to the PPF because where an RAA goes ahead, it will usually mean the scheme will enter the PPF. Given the potential for criticism, the PPF has felt compelled to publish the principles which underpin its involvement. In August 2016, the PPF released two papers (The PPF Approach to Employer Restructuring and General Guidance for Restructuring and Insolvency Professionals) which state that an RAA will only be considered where

- Insolvency is inevitable
- The scheme will be significantly better off than if insolvency takes its course
- The offer to the scheme is fair compared to other creditors/shareholders
- The scheme/PPF takes at least a 10 per cent 'anti-embarrassment' stake in the surviving company. This is to ensure that the PPF is able to share in any windfall enjoyed by the restructured company
- An exercise of TPR's anti-avoidance powers would not yield a better result
- Any bank refinancing fees are reasonable
- The PPF's and the scheme trustees' costs will be borne by the party driving the restructuring.

The PPF is at pains to make clear that it has no obligation to consider restructuring proposals and will only engage where to do so is consistent with its regulatory functions and its role exercising the scheme's rights as a creditor. It is also clear that the PPF will work closely with TPR in considering restructuring proposals.

Examples of some scheme outcomes on RAAs

There have been a number of 'plain vanilla' RAAs where approval is given in return for payments in excess of the insolvency dividend to a scheme, and which ultimately results in the scheme transferring into the PPF (for example, Jessops in 2009 and BMI in 2012). However, both the PPF and TPR have shown a willingness to consider more imaginative structures which, atypically, have enabled significant scheme liabilities to survive outside the PPF. Examples of these are considered further below.

Uniq plc (2012)

As at March 2010, the scheme's buy-out deficit was estimated at around £430 million. The employer's market capitalisation at the time was below £10 million and it had been unable to raise external capital due to the size of the pension creditor. Conventional funding plans were not realistic as the only affordable payment schedule would have led to a recovery plan in excess of 40 years. Without a corporate restructuring, insolvency was inevitable and, as TPR acknowledged in its section 89 report, the economic reality was that the pension scheme effectively owned the group.

The result was a deficit-for-equity swap effected through an RAA, under which the scheme took ownership of over 90 per cent of the equity in Uniq plc in return for the scheme surrendering its claim as a creditor. The company's shares were subsequently sold, with the trustee receiving in excess of £100 million, which enabled purchase of a buy-in policy to pay benefits at least equal to the compensation that would have been payable if the scheme entered the PPF.

Kodak (2014)

The US parent (EKC) of the scheme employer entered chapter 11 insolvency proceedings in the US. Whilst the UK employer remained solvent, it was clear that if EKC (which also provided a guarantee in favour of the scheme) failed to emerge from the chapter 11 process, the UK employer's insolvency was inevitable. The trustee was by far the biggest creditor in the chapter 11 proceedings with an unsecured claim of US$2.8 billion under EKC's guarantee.

During the chapter 11 process, EKC had sought to sell its viable document and personal imaging business (known as Alaris), but given its weak bargaining position, had attracted low bids. The trustees considered the Alaris business to be profitable with long-term cash flows which matched the profile of a significant part of the scheme's liabilities. A deal was struck to sell the Alaris business to the trustee for US$325 million, approximately half the value at which it had originally been marketed, in return for the trustee releasing its claim under the guarantee.

Following significant due diligence, the trustees were satisfied that the value of the Alaris business far exceeded the dividend the scheme would otherwise have received in insolvency. However, as the effect of an RAA would be to remove all material employer covenant, the PPF remained concerned that it would effectively be underwriting the scheme. Therefore, a proposal was made to members under which they could elect to join a new scheme, which would provide lower benefits than the original scheme but higher than those in the PPF.

Following an extensive communication exercise, members representing more than 94 per cent of liabilities agreed to transfer to a new scheme with the unconsenting remainder of the membership transferring to the PPF. In return for supporting the RAA, TPR also negotiated additional governance requirements for the replacement scheme, ensuring that the PPF's related ongoing risks were kept under review.

Halcrow (2016)

Following failure to agree a recovery plan which was affordable to the struggling UK business, the trustees and the employer explored ways in which the scheme could avoid entering the PPF.

The employer's US parent had historically provided significant assistance to the UK employer to help fund the scheme but was unwilling to provide this indefinitely, or on a formal basis. The employer had originally agreed with the trustee to a transfer without consent of all members to a new scheme which provided benefits higher than the PPF but lower than the original scheme. In order to effect such a transfer, an actuary's certificate would be required confirming that the members' benefits would be 'broadly no less favourable' in the new scheme. The trustees sought a declaration from the High Court on certain issues before proceeding with the transfer. One of the trustees' claims was that the actuary should take into account the comparative security of benefits in each of the schemes. In her judgment, Asplin J held, somewhat reluctantly, that the scheme actuary could not take account of the fact that members' benefits would be more secure in a new scheme in assessing whether a certificate for a no-consent bulk transfer could be given.

Instead, in conjunction with TPR, an alternative approach was agreed under which members were offered the chance to transfer to a new scheme and those who elected not to would transfer to the PPF. An RAA was entered into releasing the UK employer from its liabilities to the old scheme and the US parent agreed to pay a further cash sum to the new scheme. The PPF also took a stake of between 25 per cent and 45 per cent in the surviving UK employer. Non-consenting members entered the PPF and additional restrictions on the length of the recovery plan and the investment strategy for the new scheme were put in place.

Throughout its engagement with the parties, and in particular in connection with the RAA proposal, TPR continued to consider whether it would be reasonable to use its anti-avoidance powers against the US parent and decided that it would not. In reaching this conclusion, TPR's section 89 report states that it took into account the significant financial support which the US parent had provided voluntarily, and which had allowed the UK employer to continue to support the scheme. As in the Kodak case, it was highly unusual for a successor scheme to be allowed to survive outside the PPF with prospects for future entry. However, as TPR was satisfied that

- Members would receive better benefits than in an insolvency situation
- They had actually consented to join the new scheme with lower benefits
- The extra governance protections would further protect members.

it could therefore approve the RAA.

Where next?

It is clear that RAAs are not entered into lightly. The regulatory bodies will only consider agreeing to a restructuring where there is little or no reasonable chance of paying the benefits promised with acceptable levels of risk and where the alternative is much worse for the PPF and scheme members. However, the PPF and TPR have shown that they are willing to work with employers to achieve innovative solutions. Typically, TPR will insist on mitigation and ongoing additional governance requirements as part of the package.

It should be remembered though, that such deals remain very rare and are arranged on a bespoke basis. With TPR recently preferring to take enforcement action in relation to the BHS pension scheme rather than strike a deal and with the spectre of Tata Steel looming large on the regulatory radar, it remains to be seen how far TPR and the PPF may be willing to extend the RAA safety net.

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