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NORTON ROSE FULBRIGHT

Pensions

Moral hazard and clearance

Briefing

September 2019

This briefing sets out the purpose of the "moral hazard" or "anti-avoidance" framework of powers of the UK Pensions Regulator (the Regulator) under the Pensions Act 2004 (the 2004 Act). It is an update to our previous briefing notes on this subject, and it examines the circumstances in which the anti-avoidance provisions apply and the persons who may be affected by them. It also looks at the conditions that need to be satisfied before the Regulator issues a contribution notice or a financial support direction and the clearance procedure under current legislation.

Purpose of the framework

The 2004 Act gives the Regulator wide-ranging powers aimed at preventing employers from avoiding their funding obligations in respect of under-funded defined benefit (including final salary) pension schemes (the so-called "moral hazard" provisions). The framework includes powers for the Regulator to issue contribution notices, financial support directions and restoration orders. The Regulator can impose liabilities not only on employers participating in schemes, but may also pierce the corporate veil and impose liabilities in relation to under-funded defined benefit pension schemes on other group companies, controlling shareholders and individual directors.

This is a key area for employers and trustees to consider in relation to

- Sales and acquisitions of companies
- Financial or corporate restructuring
- Banking transactions
- Any other transaction which may result in an employer (or group of companies) being less able to meet its funding obligations to a defined benefit pension scheme.

In this regard, of particular interest to employers and potential purchasers may be the clearance procedure (see below), which gives employers and potential purchasers comfort that they will not fall foul of the moral hazard provisions.

To whom does the anti-avoidance framework apply?

The Regulator's powers to issue contribution notices and financial support directions apply to defined benefit pension schemes and it is on these powers that this briefing concentrates. Whilst certain schemes fall outside the anti-avoidance framework, it applies in respect of the vast majority of private sector defined benefit pension schemes that have been registered with HM Revenue and Customs.

Contribution notices

What is a contribution notice?

The Regulator can issue a contribution notice requiring a person to pay either the whole or a specified proportion of the funding shortfall in a scheme. A contribution notice can relate to a series of acts as well as to a single act.

When may a contribution notice be issued?

The Regulator has the power to issue a contribution notice to a person only if it is of the opinion that the following conditions (under section 38 of the 2004 Act) are satisfied

- The person was party to an act or a deliberate failure to act on or after April 27, 2004
- The act or failure to act meets one of the following tests
  - The material detriment test (this applies to acts or failures to act occurring on or after April 14, 2008)
  - The main purpose or one of the main purposes of that act or failure to act was to prevent the recovery of the whole or any part of a debt under section 75 of the Pensions Act 1995 (the 1995 Act) which was due, or might become due from the employer
  - The main purpose or one of the main purposes of that act or failure to act was to prevent a section 75 debt becoming due, to compromise or otherwise settle such a debt or to reduce the amount of such a debt.

The Regulator also has the power to issue a contribution notice (under section 47 of the 2004 Act) where there has been non-compliance with a previously issued financial support direction.

The material detriment test

The Regulator has issued a code of practice setting out the circumstances in which it expects to issue a contribution notice under the material detriment test. These include the transfer of the scheme out of the jurisdiction and the complete removal or substantial reduction in the sponsor's support for the scheme.

The legislation and the code fall short of actually defining what "material detriment" means in practice, but the test will only engage where there is a material detriment to the likelihood of the accrued scheme benefits being received.

A statutory defence is available for parties to use against the issue of a contribution notice under the material detriment test, provided that a number of specified conditions are met. These conditions require due consideration to have been given to the effect of the act or failure to act on the likelihood of accrued scheme benefits being received. The defence also requires all reasonable steps to have been taken to eliminate or minimise any such detrimental effects that have been identified.

The imposition of a contribution notice must be reasonable

Before issuing a contribution notice, the Regulator must be of the opinion that it is reasonable to do so. The Regulator must have regard to the extent to which it was reasonable for the person to act or fail to act the way he did in all cases where the act or failure to act occurred on or after April 14, 2008. In addition, the Regulator must, where it considers relevant, consider a number of other factors. These include the person's degree of involvement in the act or failure to act and the relationship between the person and the sponsoring employer.

Who may be caught by a contribution notice?

The Regulator may issue a contribution notice against

- Any person who is both
  - A party to the act or omission
  - An employer in relation to the scheme.

- Any person who is both
  - A party to the act or omission
  - A person connected with or an associate of the employer, including group companies, controlling shareholders and directors.

For these purposes, “person” includes both individuals and corporate entities.

Time-frame for imposing a contribution notice

The Regulator may review any act or failure to act up to six years after that act or failure to act. For this reason, it is particularly important that decisions relating to the scheme, its funding and any considerations relating to the employer debt are fully documented, along with reasons why the parties decided on a particular course of action.

Although the act or failure to act which gives rise to a contribution notice must have occurred within this time-frame, the Regulator does not consider this restriction to apply to issues that are taken into account when it assesses the reasonableness of issuing a contribution notice.

Examples of contribution notice decisions

The Regulator has decided to issue contribution notices on the following occasions

Bonas

The Regulator considered that by arranging for the sponsoring employer to go into administration, the acts of its Belgian parent company had as their main purpose the avoidance or reduction of the sponsoring employer’s pension liability. The Regulator was of the view that it was reasonable to impose a contribution notice on the parent company given its close involvement in the acts and its close association with the pension scheme (through its funding of the sponsoring employer). The case was settled in 2011 with the Regulator agreeing to issue a contribution notice in the amount of £60,000.

Desmond

The Regulator decided to issue contribution notices against two individuals who were controlling shareholders of the sponsoring employer. The series of acts which led to this decision included the members’ voluntary liquidation of the sponsoring employer at short notice, which required at least 95 per cent shareholder approval. The Regulator considered that the two individuals had exploited a “loophole” to reduce the sponsoring employer’s liabilities to the scheme, whilst receiving significant payments from the sponsoring employer themselves. In May 2015 a settlement was reached under which the individuals agreed to make a payment to the scheme.

Storm Funding

The Regulator decided to issue contribution notices to sponsoring employers in the Lehman Group following non-compliance with financial support directions. In December 2013, the High Court ruled that the aggregate maximum amount either specified in the contribution notices, or the amount recovered under them, could exceed the scheme’s section 75 debt. As a result of this judgment, the level of a scheme’s recovery will depend on the number of target companies in receipt of contribution notices, which seems bizarre. The decision relates to contribution notices issued as a result of a failure to comply with a financial support direction; it is unclear whether it

also relates to contribution notices issued under circumstances where the material detriment test is met, or where an act or failure to act prevents the recovery of an employer debt. In the absence of any appeal, our view is that the better interpretation is the narrower one. However, as things stand, the judgment is of concern to group companies with schemes in which a funding deficit may arise.

Carrington Wire
In April 2015, the Regulator issued a contribution notice against the sole director of a UK-based wire supply company who bought the sponsoring company of the Carrington Wire scheme for nominal consideration from its Russian owner in 2010. The sale was not revealed to the scheme's trustees (or reported to the Regulator) until it had taken place. By then, a valuable parent company guarantee had lapsed, and the new owner refused to offer a similar guarantee. The amount of the contribution notice was approximately £390,000 and reflected the amount transferred to the director of the purchaser company following the completion of the share sale. Claims for a contribution notice against the previous Russian owners of the business had been settled beforehand in return for payment of £8.5 million to the scheme. It was found that both the "main purpose" and "material detriment" tests had been satisfied and, on the facts, it was apparent that the need to terminate the guarantee was the "fundamental driver" of the series of events culminating in the share sale. It followed that one of the main purposes of these acts was clearly to prevent recovery of the section 75 debt.

Financial support directions

What is a financial support direction?

The Regulator may issue a financial support direction to require other companies who have sufficient resources within a group company structure to support a defined benefit pension scheme in circumstances where one company in the group participates in that scheme but is unable to meet its funding liabilities.

This support may include arrangements under which

- All the companies within the employer's group are jointly and severally liable for the whole or part of the employer's pension liabilities in relation to the scheme.

- The holding company of the employer's group is liable for the whole or part of the employer's pension liabilities.

In addition, other forms of support, such as bank guarantees, may constitute financial support.

When may a financial support direction be issued?

The Regulator may issue a financial support direction if it is satisfied that an employer sponsoring or participating in a pension scheme is either a service company or is "insufficiently resourced" at any time during a two year look-back period.

An employer is "insufficiently resourced" if two conditions are met

- The value of its resources is less than 50 per cent of the scheme's section 75 debt, as estimated by the Regulator.

- The value of the resources of a person or the aggregate resources of persons who are connected with or associates of the employer and each other is at least equal to the "relevant deficit". The relevant deficit is the difference between the value of the employer's resources and 50 per cent of the estimated employer debt.

No act or omission is required, but the Regulator may only issue a financial support direction if it considers it reasonable to do so.

Factors in determining reasonableness

In assessing whether it is reasonable to impose a financial support direction, the Regulator must have regard to a number of factors. These include the relationship between the person and the sponsoring employer and the value of any benefits received by the person from the employer (directly or indirectly).

Who may be caught by a financial support direction?

The Regulator may issue a financial support direction to an employer in relation to the pension scheme or to a person who is connected with or an associate of the employer. The Regulator may not impose a financial support direction on individuals (such as directors), except in limited specified circumstances.

Time-frame for issuing a financial support direction

The Regulator may issue a financial support direction only if it is satisfied that the target was either a service company or insufficiently resourced at the "relevant time", and that target was the employer, or associated or connected with the employer, at that time.

The "relevant time" is a time determined by the Regulator that falls within the two-year look-back period ending when the Regulator issues a warning notice to parties directly affected by the financial support direction under consideration.

Failure to comply

The Regulator may issue a contribution notice, and thus may require an actual contribution to be made, if a financial support direction is not complied with – see Storm Funding decision above.

Priority of financial support directions in an insolvency

Following the Regulator's decisions to issue financial support directions against companies in the Nortel and Lehman Brothers groups (please see below), the groups' respective administrators applied to the High Court for directions as to the effect of financial support directions.

The Court's decision allows the Regulator to impose significant liability on a financial support direction target, which will rank as an expense of a relevant insolvency process. This gives liabilities under a financial support direction priority over the target's other liabilities and may render a restructuring strategy commercially unworkable.

In October 2011, an appeal in The Court of Appeal against this decision was unsuccessful. However, this was overruled by the Supreme Court in July 2013, where it was held that financial support direction liabilities were a provable debt, meaning they rank alongside other unsecured creditors. This has been welcomed as a sensible decision as liabilities under a financial support direction have the same priority as the employer debt to which they relate.

Examples of financial support direction decisions

The Regulator has decided to issue financial support directions on the following occasions:

Sea Containers

The Regulator decided to issue financial support directions against the Bermudan parent company of the sponsoring employer of two UK defined benefit pension schemes. This was decided on the basis that the sponsoring employer was a service company and was insufficiently resourced, whereas its parent company had substantial assets. It was deemed to be reasonable to issue financial support directions given the parent company's close connections with the pension schemes and the benefits it received from the sponsoring employer.

Nortel
The Regulator decided to issue financial support directions against 25 Nortel group companies. These companies were based in Canada, US, Europe and Africa and were in the same group as the sponsoring employer. Following the administration of the sponsoring employer, the Regulator determined that it had been insufficiently resourced. The Regulator was of the view that it was reasonable to issue the financial support directions, as the Nortel group was run as an integrated global entity and the parent companies effectively controlled the "woefully inadequate" contributions paid to the pension scheme. In addition, the Nortel group benefitted significantly from the sponsoring employer's activities. In May 2015, five years after the issue of the original financial support directions, and following extensive litigation, US and Canadian judges in a joint trial on the allocation of assets ruled in favour of the trustees and the PPF. The residual assets held in an escrow account are to be allocated on a pro rata basis, meaning the scheme could receive up to 71 per cent on claims, which is considered a victory for UK pensioners. In May 2017 this in-principle judgment was formalised by two judges from the US and Canada, meaning the scheme is due to receive about £1 billion, and it should therefore avoid falling into the Pension Protection Fund.

Lehman Brothers
The Regulator decided to issue financial support directions against the three main Lehman Brothers UK operating companies and the three UK holding companies of the sponsoring employer. The Regulator based this decision on the sponsoring employer being a service company that employed the majority of the group's UK employees. In addition, a general cash sweep-out from the sponsoring employer to the holding companies was considered to benefit the holding companies at the expense of the sponsoring employer. In August 2014, the parties agreed a settlement of an amount which is expected to be sufficient to buy out the members' benefits in full.

Box Clever
The Regulator decided to issue financial support directions against ITV and a number of its subsidiaries. The financial support direction related to the financial position of the Box Clever group (which sponsored a defined benefit pension scheme) following ITV's highly leveraged acquisition of the group. Although the ITV group companies had ceased to own shares in the sponsoring employers, the Regulator was satisfied that the ITV group companies were deemed still to be associates of the sponsoring employers. The ITV group companies appealed the Regulator's decision to issue these financial support directions. In May 2015, ITV appealed successfully against a strike-out application made by the targets of the financial support direction.

The Court of Appeal ruled that, while there is no statutory requirement relating to the precise contents of a warning notice issued by the Regulator, the notice must make clear to the target the case against it.

In May 2018 in the hearing on the two substantive issues (of whether ITV was sufficiently "associated" or "connected" with Box Clever, and whether the Regulator acted "reasonably" in issuing a financial support direction), the Upper Tribunal ruled in favour of the Regulator.

In June 2019, The Court of Appeal dismissed ITV's challenge to the Upper Tribunal decision and confirmed that the Regulator could look back to periods before the introduction of its moral hazard powers when considering issuing a financial support direction. While a financial support direction does not itself impose financial obligations, ITV will now be expected to make plans for its future funding of the Box Clever scheme.

The Court refused ITV's requested permission to appeal but this does not rule out a direct application for leave to appeal to the Supreme Court.

Clearance procedure

What is the clearance procedure?

It is possible to apply for a clearance statement binding the Regulator not to issue a contribution notice or a financial support direction in relation to specified circumstances. The statement will bind the Regulator so long as there is no material non-disclosure of fact.

Who may apply for clearance?

The Regulator expects applications to be made by parties that may be issued with a contribution notice or financial support direction. The Regulator also expects applicants for clearance, where possible, to have discussed this with the trustees of the pension scheme concerned. Trustees may see clearance applications as opportunities to negotiate improved funding terms. The Regulator has said that it sees itself in the role of a referee rather than a player in negotiations regarding clearance.

What is the "price" for clearance?

The clearance procedure is entirely voluntary. Although the clearance guidance is not explicit, in our experience, the Regulator is likely to require some form of accelerated payment of the deficit in a scheme (not being limited to accelerated or alternative mitigation payment of a recovery plan) in return for granting clearance in respect of a given transaction.

When will the clearance procedure be applied?

The Regulator has issued guidance as to when it may be appropriate to apply for clearance, but does not prescribe any circumstances where a clearance application is mandatory. However, the Regulator does expect a clearance statement to be sought in relation to a so-called type A event.

Events which are or could be type A events

A clearance application should only be considered in relation to a type A event. Type A events are all events that are materially detrimental to the ability of the scheme to meet its pension liabilities.

The guidance sets out a list of examples of situations which could be type A events, but the Regulator stresses that these are merely examples and the list is non-exhaustive. Examples of employer-related type A events include a change in creditor priority, a return of capital and a change in the sponsoring employer of the scheme. Examples of scheme-related type A events include apportionment arrangements (unless certain conditions are satisfied) and compromising scheme liabilities.

Time-frame to apply for clearance

The Regulator aims to be sensitive to the commercial timescales of a deal and will try to meet any reasonable deadlines the applicant may have.

However, the Regulator recommends informing it of a possible application as soon as possible. Adequate time should also be allowed to collate the detailed information required by the Regulator as part of the clearance application. Unless this information is readily available, this could take a significant amount of time. In addition, time allowances should be made for discussions between the employers and trustees of the scheme, which the Regulator will often expect to have taken place before any clearance application.

Appeals

Appeals against determinations must be made within 28 days of the determination.

Comment

The Regulator has, to date, issued contribution notices and financial support directions in only a very limited number of circumstances. However, this should not be viewed as indicative of a reluctance to act, as, in our dealings with the Regulator, it is clear that it keeps a very close eye on the financial press, with a view to following up any transactions it suspects may fall foul of the moral hazard framework. Indeed, it is not known how often the Regulator has directly threatened to exercise its powers and where this has resulted in the parties concerned altering the structure of their transactions. However, one such example was in relation to a clearance application for a share sale of shares in Database Group, submitted in 2015. The Regulator concluded that the offer did not reflect the potential loss of covenant. It negotiated with the applicants to buy-out members' benefits in full, thus avoiding either a possible contribution notice or a financial support direction.

The March 2018 pensions White Paper on protecting defined benefit schemes sets out a range of measures to strengthen the voluntary clearance regime. However, it now seems unlikely that any related legislation will progress during this Parliament, due to the pressure on the legislative timetable as a result of the Brexit referendum. Nevertheless, the receipt of a warning notice, together with press scrutiny, is sometimes enough to prompt an employer to offer additional scheme funding at a level acceptable to the Regulator, as was the case with the Coats Pension Plan and the BHS Scheme.

The threat of receiving a contribution notice or a financial support direction remains real, and employers and potential purchasers should consider carefully whether an application for clearance is necessary or desirable when undertaking commercial transactions. Employers should take care when engaging in certain corporate activity to ensure that they undertake appropriate due diligence in respect of the impact of the transaction on their pension arrangements and should seek expert advice where necessary. In addition, the Regulator has made it clear that employers and trustees should take appropriate action and protect the scheme as far as possible against any detriment.

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