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CLEARANCE – THE PRESENT DANGER?

1 INTRODUCTION

The Regulator's anti-avoidance powers¹ (and its guidance on the availability of clearance) have been at the heart of many corporate transactions which involve significant UK pension liabilities.

Trustees have quickly learned to flex their muscles to ensure that members are protected as clearance is often only available if trustees receive a quid pro quo (called "mitigation" in the guidance) where there is a materially detrimental event relating to the scheme. Therefore, the Regulator's guidance is an increasingly important negotiating tool for trustees.

The Regulator has now published revised guidance on clearance for consultation², available at:

<http://www.thepensionsregulator.gov.uk/pdf/clearanceRevisedGuidanceConsultation.pdf>

2 KEY POINTS

- Trustees and employers are expected to look to guiding principles rather than rules to establish if clearance should be sought (sections 4 and 5).
- The guidance on what events are materially detrimental to a scheme's ability to meet its liabilities ("type A events") is significantly expanded (section 6).
- There is new focus on scheme-related events, with compromises and scheme apportionments taking centre stage (section 7).
- More creative solutions to mitigate type A events are likely (section 8).

¹ Introduced in April 2005 by the Pensions Act 2004

² Consultation closes on 2 November 2007

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3 THE REGULATOR'S POWERS

The Regulator's anti-avoidance powers include contribution notices (CN) and financial support directions (FSD).

- A CN can be issued to an employer (or those connected or associated with it) requiring a contribution to the pension scheme where the Regulator believes an employer debt³ has been avoided.
- An FSD requires other group employers to provide financial support to a scheme where the Regulator considers that the sponsoring employer is a service company or is "insufficiently resourced". Back in June, the Regulator announced its intention to issue the first FSD in respect of the Sea Containers pension schemes (although this is subject to appeal)⁴.

Clearance was introduced in April 2005 as a voluntary process to meet concerns about how the Regulator was going to operate its new anti-avoidance powers⁵. Buyers and sellers can apply for clearance (or an assurance) that the Regulator will not use its anti-avoidance powers in relation to a specified transaction or event. The Regulator's guidance gives details on when clearance will normally be available. Any mitigation offered will be an important factor as this acknowledges that the Regulator, in giving clearance, has given up the opportunity to use its anti-avoidance powers.

4 PRINCIPLES NOT RULES

The Guidance has re-focused on the employer covenant "to encourage a move away from reliance upon prescriptive tests to a more principle-based approach". In future, trustees will

³ Arising under section 75 of the Pensions Act 1995

⁴ See its determination notice published on 18 June 2007 -

<http://www.thepensionsregulator.gov.uk/mediaCentre/pressReleases/pn07/pn07-10.aspx>

⁵ Sackers Extra News: "Anti-avoidance – guidance issued on Clearance Statements" dated April 2005, available from the client area of our website www.sackers.com

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be expected to look at the employer's legal obligations to the scheme and its financial position (both current and prospective), which comprise the employer's covenant.

The employer's legal obligation to the scheme

Trustees will normally require legal advice to establish, with precision, exactly what an employer's obligations are (particularly in relation to group schemes), as this will define the extent of the support for the scheme that the trustees can legally enforce.

The employer's financial position

Various factors play a part in the employer's financial position, such as the employer's competitive position and relative size within its particular industry, track record and profitability. Trustees are also expected to look at the nature of the wider employer group, such as whether the sponsor is an overseas company, the level of debt in the group, as well as the "investment timeframe of the ultimate owners" (hinting at the possible threat posed to pension schemes from private equity deals⁶).

5 EMPLOYER COVENANT

After trustees have considered the company's legal obligations and financial position, they will need to assess whether a particular event (for example, a sale) will result in a material weakening of the covenant. The aim is to determine "where the pension creditor sits in the allocation of proceeds in the event of the insolvency of the employer, and then consider the impact of that event on the potential allocation" (so, a "before and after" the event test).

Whilst the guidance lists a number of factors which trustees may find helpful in making the assessment, the Regulator acknowledges that trustees may need to take professional advice.

⁶ This was also highlighted in the Regulator's "clearance reminder" see our Sackers Extra Alert: "Clearance – TPR moves the goalposts" dated 3 May 2007

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The guidance also gives examples of the types of information which trustees should expect to receive from employers as a matter of course. These range from regular updates on the company's financial position and copies of reports and accounts, up to confirmation of compliance with banking and other creditor covenants (as well as any grant of new security).

6 MATERIALLY DETRIMENTAL EVENTS

Once analysed in the context of the employer covenant, each materially detrimental event (or, in the language of the guidance, a potential type A event) must be categorised as a scheme-related or employer-related event.

If the event is an employer-related event it will only be a type A event if the scheme has a "relevant deficit" (see section 8 below). But if it is a scheme-related event (see section 7 below), it will be type A regardless of the scheme's funding position. Examples of both are given in the guidance⁷, although trustees need to be aware that these lists are not exhaustive.

Clearance is only appropriate for type A events (as these are events which could have a detrimental effect on the pension scheme). But regardless of the proposed course of action, the Regulator expects a high level of involvement from trustees saying that they "should enter negotiations in relation to a type A event, whether or not the employer or other parties wish to apply for clearance".

7 SCHEME-RELATED EVENTS

The expanded description of scheme-related events now includes more information on compromises and the apportionment of employer debts⁸. This new focus may make both options less attractive in future.

⁷ Examples given of an employer-related event include change of control or a capital reduction such as a dividend payment

⁸ Employer debt legislation amendments are also in the pipeline, see our Sackers Extra Alert: "Draft Regulations - Forever in Your Debt?" dated 10 August 2007

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Compromises

Any attempt to compromise an employer debt will always be a type A event, regardless of the level of the deficit before or after the compromise. This is an additional factor which trustees would need to weigh up when considering whether to enter into a compromise. Schemes which compromise a debt may also be ineligible for entry to the Pension Protection Fund (PPF).

Apportionments

The Regulator has designated the “use, amendment or insertion” of an apportionment rule as a type A event, except where:

- it increases the debt that is then immediately payable by an employer who can afford it;
- it is a practical option because of the complexity of using one of the alternative methods of dealing with the deficit (such as where there are limited employment records which would make the statutory default method of apportionment difficult to operate); or
- the debt arises in circumstances where there is no net reduction in the employer covenant (for example, where there is a group consolidation with an associated transfer of assets and liabilities).

8 MITIGATION

The level and type of appropriate mitigation will vary depending on the scheme’s circumstances, the event’s impact and the relevant deficit. There is evidence from the revised guidance that the Regulator is expecting trustees and employers to get more creative with the types of mitigation offered. Alongside offers of a cash injection, escrow accounts, guarantees or letters of credit, the Regulator also lists negative pledges, performance thresholds and scheme rule changes as possible mitigation methods.

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Where a type A event has taken place and no mitigation is offered, or the mitigation is inadequate, the Regulator suggests that the trustees should consider contacting it. This is in addition to the general requirements for contacting the Regulator in relation to notifiable events.

9 ADDITIONAL POINTS

- The original guidance categorised events into type A, B or C. To simplify the guidance, the Regulator has removed the terms type B and type C (as these are rarely used). But it has retained the “widely recognised and used” term “type A events” and expanded the guidance on these.
- The relevant deficit for an employer-related event will usually be assessed by reference to “the highest of the scheme’s deficits according to the following bases”: a scheme’s technical provisions (scheme specific funding); its ongoing funding level (where technical provisions are not available); FRS 17 / IAS 19; or the PPF funding level (the section 179 basis). But where there are “reasonable doubts” that the employer will continue as a going concern, the scheme is in wind-up or where the event may cause abandonment⁹ of the scheme, the relevant basis will be the buy-out cost.
- The revised guidance also includes commentary on that other hot topic, conflicts of interest - the Regulator says that it “would generally expect trustees to seek legal advice...to ascertain the best way to manage [conflicts]”.

⁹See our Sackers Extra Alert: “Scheme Abandonment - discussion paper and guidance issued” dated 15 December 2006