The Pensions Regulator's new powers: what lenders need to know

Updated November 2021 Pension briefing

HIGHLIGHTS

Following the insolvencies of Carillion and BHS and the associated fallout for the pension schemes they sponsored, the Pensions Regulator (tPR) announced it was going to be "clearer, quicker and tougher".

The Pension Schemes Act 2021 (the Act) gives tPR significant new powers to intervene where the security of defined benefit (DB) pensions may be at risk. These new powers include an expansion of the moral hazard powers and an extension of the "notifiable events" framework. The Act also creates new criminal offences and liability for civil fines of up to £1m.

Lenders to corporate groups with DB schemes should understand the impact that the new provisions could have for structuring lending and on a borrower's ability to agree to changes to its capital structure or grant new credit support in the context of a restructuring. The wide scope of the new offences means that lenders should take careful advice to ensure transactions are structured in a way that takes into account tPR's expectations in relation to the security of DB funding.

This note considers the implications for lenders of:

- the new criminal offences and civil fines;
- tPR's extended moral hazard (contribution notice) powers; and
- the extension of the "notifiable events" which must be notified to tPR.

In a nutshell – what's new in this update?

Since the previous update of this note in August 2021:

- Many of tPR's new powers came into force on 1 October 2021, including in relation to the new criminal offences; power to impose civil fines of up to £1m ("section 88A fines"); and extended moral hazard powers to issue a contribution notice (CN).
- tPR has issued:
  - a final policy on prosecuting the new criminal offences;
  - draft policies on: exercising its information-gathering powers; its approach where it has "overlapping powers" (criminal, regulatory and civil fines); and the imposition of section 88A fines;
  - updated guidance on applying for clearance in relation to its moral hazard powers;
  - a revised version of Code of Practice 12 (on circumstances in which it may decide to issue a CN), plus draft code-related guidance.
- The DWP has consulted on draft regulations to extend the "notifiable events" regime.

These developments are explored in the rest of this note.

NEW CRIMINAL OFFENCES AND FINES

The Act has introduced two new offences – "**conduct risking accrued DB benefits**" and "**avoidance of employer debt**", as explained below. Each offence is punishable by up to seven years' imprisonment and / or an unlimited fine.

There are specific exemptions from both offences for insolvency practitioners, but not for other professionals. Potentially, an offence could be committed not just by a sponsoring employer but also by its parent company and advisers or other professionals who might have "aided and abetted" the commission of the offence, including, in theory, its lenders.

As an alternative to criminal prosecution, tPR has power to impose civil fines ("**section 88A fines**") of up to £1 million, in broadly similar circumstances.

Conduct risking accrued DB benefits (new section 58B of the Pensions Act 2004)

- Risking pension scheme benefits to which members have already built up rights may be an offence.
- A person may commit this offence by doing an act (or failure to act) which "detrimentally affects in a material way the likelihood of accrued scheme benefits being received".
- The person must also have known, or ought to have known, that the act, omission, or course of conduct would have that effect; *and not have a reasonable excuse*.

Avoidance of employer debt (new section 58A of the Pensions Act 2004)

- An employer with a DB scheme may become liable for a debt due under section 75 Pensions Act 1995 in particular circumstances (please see the box below).
- It may be an offence to prevent a section 75 debt becoming due; reduce the amount falling due; prevent the recovery of a section 75 debt; or compromise a section 75 debt.
- Similarly, the person must also have known, or ought to have known, that the act, omission, or course of conduct would have that effect; *and not have a reasonable excuse.*

What is a section 75 debt?

A DB scheme's section 75 debt is, broadly:

- the value of liabilities to pay benefits built up under the scheme; less
- the value of the scheme assets

calculated as if the benefits were being bought out with annuities from an insurance company.

A section 75 debt will potentially fall due from a sponsoring employer of a DB scheme if:

- the employer becomes insolvent (or goes into solvent winding-up);
- the scheme starts winding up; or
- where a scheme has multiple employers, one of the employer stops employing active members (employees currently earning pension benefits) when the scheme continues to have active members employed by other employers.

tPR's investigation and prosecution policy

tPR has issued a policy setting out its approach to investigating and prosecuting the new offences. It explains that it does not intend to prosecute behaviour it considers to be "ordinary commercial activity" but will investigate and prosecute the "most serious examples of intentional or reckless conduct" which would fall within its power to issue a contribution notice (CN) (please see the box on moral hazard powers below), or would do if the person was connected or associated with a scheme employer.

tPR's policy explains that prosecution will only be considered if the following five tests are met:

- **Act element**: there has been an act (or failure to act) satisfying the criteria under sections 58A or 58B;
- **Mental element**: for a section 58A offence, the person intended the act to have the relevant effect; for a section 58B offence, the person knew, or ought to have known, that the act would have a materially detrimental effect;
- the person had **no reasonable excuse** for the act (or failure to act);
- there is **sufficient evidence** likely to satisfy the criminal burden of proof (the "beyond all reasonable doubt" test); and
- prosecution must serve the **public interest**.

Reasonable excuse: who must show what?

It will be for the prosecution to prove (beyond reasonable doubt) that the person did not have a reasonable excuse. However, tPR expects persons it investigates to put forward sufficient evidence of any matters which might amount to a reasonable excuse. Evidence may include contemporaneous records such as minutes, correspondence and written advice.

When assessing whether a person has a reasonable excuse, tPR will consider in particular:

- whether the detrimental impact on the pension scheme was "central" or "incidental" to the act or failure to act. tPR's prosecution policy gives an example of a lender withdrawing funding as part of ordinary commercial activity – and considers that any harm caused to the employer's business (and therefore its ability to fund the pension scheme) as a result would be "incidental" to the decision to decline further lending;
- the adequacy of any mitigation to offset the detrimental impact on the pension scheme; and
- whether there was a "viable alternative" to the act which had a detrimental effect on the pension scheme. For example, there may be no viable alternative where new secured debt is critical to the employer's survival and the continuation of the employer is a better outcome for the pension scheme than the employer's insolvency.

tPR's moral hazard powers

Since 2005, tPR has had power in specified circumstances to issue:

- a contribution notice (CN) requiring a one-off contribution to be made to a DB scheme; or
- a financial support direction (FSD) requiring financial support for the sponsoring employer's pension liabilities to be put in place.

Before 1 October 2021, tPR could issue a CN if it is of the opinion that:

- the "material detriment" test is met in relation to the target's act or failure to act; or
- the main purpose, or one of the main purposes, of the act or failure to act was to:
  - prevent the recovery of the whole or part of a section 75 debt; or
  - prevent a section 75 debt becoming due, compromise or settle a section 75 debt, or reduce the amount of a section 75 debt which would otherwise become due.

Broadly, the material detriment test will be met if tPR considers that the target's act (or failure to act) has "detrimentally affected in a material way the likelihood of accrued scheme benefits being received".

A person who "knowingly assists" in an act or failure to act may also be subject to a CN.

From 1 October 2021, tPR may also issue a CN if it considers that the "employer resources test" or the "employer insolvency test" is met (explained below).

Clearance: parties concerned about intervention by tPR may apply for clearance which, if granted, provides comfort that it will not exercise its powers to issue a CN or FSD in relation to a particular transaction. Clearance is usually only granted if the pension scheme trustees support the application and if either there is no weakening in the employer covenant, or "mitigation" is provided to offset the reduction in the covenant.

CONTRIBUTION NOTICES: EXTENDED POWERS

The circumstances in which tPR may issue a contribution notice (CN) (please see the box on moral hazard powers above) have been extended, with the introduction of a new **"employer insolvency test"** and an **"employer resources test"**. tPR may issue a CN where either of the new tests is met in relation to a person's act or failure to act.

A recipient of a CN still needs to be associated or connected with a sponsoring employer of a DB scheme (for an explanation of these terms please see the box below) and tPR may only issue a CN where:

- it believes it is reasonable to do so, taking into account specified considerations; and
- it issues a warning notice in respect of the CN within six years of the act or failure to act.

Who is associated or connected with a sponsoring employer?

Who is associated or connected with an employer is set out in insolvency legislation.

A person (A) (which may be a company, an individual or a body of unincorporated persons) is *connected* with a company if A is:

- a director (or shadow director) of the company;
- an associate of a director (or shadow director) of the company; or
- an associate of the company.

Broadly, a company (B) is *associated* with another company (C) if:

- B controls or is controlled by C;
- the same person controls both B and C;
- a person (D) has control of either B or C, while associates of D (or D together with his associates) have control of the other of B or C; or
- B and C are both controlled by the same group of persons (or by their associates).

For this purpose, a person (E) has *control* of a company (F) if, broadly:

- the directors of F are accustomed to act in accordance with E's instructions; or
- E is entitled to exercise, or control the exercise of, at least one-third of the voting power at a general meeting of F (or at a general meeting of a company which controls F).

New employer insolvency test

The employer insolvency test will be met if tPR considers that immediately after the target's act or failure to act (the "relevant time"):

- the value of the scheme assets was less than the amount of the liabilities (as estimated by tPR, on the section 75 debt basis); and
- if a section 75 debt had fallen due from the employer, the target's act (or failure to act) would have materially reduced the amount of the debt likely to be recovered by the scheme.

The new test may also be met by a series of acts, or failures to act.

Employer insolvency test: defence

tPR must not issue a CN in relation to the employer insolvency test where the target meets Conditions A to C below or, alternatively, can rely on Condition D.

- **Condition A:** before becoming a party to the act (or failure to act), the target gave "due consideration" as to how, if a section 75 debt became due from the employer immediately after the relevant time, the act or failure to act might materially reduce the amount of a section 75 debt likely to be recovered. Giving "due consideration" for this purpose means taking such steps as a reasonably diligent person would have done;
- **Condition B:** the target took all reasonable steps to eliminate or minimise the potential for the act (or failure to act) to have such an effect (where relevant); and
- **Condition C:** having regard to all relevant circumstances, it was reasonable for the target to conclude that the act (or failure to act) would not materially reduce the amount of section 75 debt likely to be recovered.

The target will also have a defence if tPR is satisfied that immediately after the relevant time the value of the pension scheme assets was at least equal to the value of the pension liabilities calculated on the section 75 basis (**Condition D**).

New employer resources test

The employer resources test will be met if tPR considers that:

- the act (or failure to act) reduced the value of the sponsoring employer's resources (determined in accordance with regulations); and
- that reduction was a "material reduction" relative to the amount of the estimated section 75 debt which would be due from the employer on a winding up, calculated as at the time immediately before the act (or failure to act).

The new test may also be met by a series of acts or failures to act.

An employer's resources for the purposes of this test will be its profits before tax, adjusted to exclude the effect of non-recurring or exceptional items. It will be for tPR to decide whether an item is non-recurring or exceptional, its value and the effect of the act (or failure) on the employer's resources.

The pension industry has raised concerns about the lack of clarity about how the employer resources test will be applied. Given the objective of protecting pension benefits, it would make sense for assets subject to a charge (to the extent that they would not be available to the pension scheme trustees on the employer's insolvency) to be excluded.

Employer resources test: defence

tPR cannot issue a CN in relation to the employer resources test where the target can demonstrate that it meets Conditions A to C above, except that "due consideration" must be given to the extent to which the act or failure to act might reduce the value of the employer's resources relative to the amount of the estimated section 75 debt.

There is no Condition D defence in relation to the employer resources test.

Will tPR choose to prosecute or issue a CN?

tPR has issued a draft "Overlapping Powers" policy, setting out its approach in situations where it has more than one power available. Pursuing both criminal prosecution and a section 88A fine in respect of the same circumstances is forbidden by the Act. However, tPR may combine either criminal prosecution or imposition of a section 88A fine with regulatory action, such as issuing a CN.

Code of practice

tPR has updated its Code of Practice 12 and associated guidance, to explain the circumstances in which it expects to issue a CN in relation to the employer resources test or the employer insolvency test (in addition to the existing "material detriment" test).

tPR has rejected calls from the pension industry for the Code or guidance to include more nuanced examples and an indication of materiality thresholds. Unfortunately, the examples given are fairly simple and are unlikely to be of much help to employers and lenders.

EXTENSION OF THE NOTIFIABLE EVENTS REGIME

Sponsoring employers already must notify tPR of certain "employer-related" events. However, in our experience, notification can sometimes be an afterthought or even forgotten entirely.

The list of employer-related notifiable events will be extended and two-stage notification will be required in relation to three types of event:

- the sale of a "material proportion" of a sponsoring employer's business or assets (defined as a proportion of the business that accounts for more than 25% of the employer's annual revenue, or more than 25% of gross asset value);
- the grant (or extension) of a "relevant security" by the employer (or one or more of the employer's subsidiaries if the security is of more than 25% of the employer's consolidated revenues or gross assets), where the security ranks higher than the pension scheme trustees on the employer' insolvency; or
- a decision to relinquish control of the sponsoring employer, or receipt of an offer to acquire control of the sponsoring employer.

Each of these events must be notified to tPR both:

- by the employer, when a "**decision in principle**" has been taken to undertake one of the events. (A decision in principle means a decision before any negotiations or agreements have been entered with another party); and
- by the employer and any persons connected or associated with it, when "**main terms**" are proposed in relation to one of the events. This stage 2 notification must include a description of the impact on the pension scheme and steps taken to mitigate any adverse effects.

Failure to comply could give rise to a fine of up to £1 million.

The DWP issued draft regulations for consultation in September 2021. Given the impetus to strengthen tPR's powers in the other areas described in this note, it will not be surprising if the notifiable events changes are brought into force in the near future – 6 April 2022 would seem likely, or possibly earlier.

For more details, please see our notifiable events briefing note.

IMPLICATIONS FOR LENDERS

New offences: implications for lenders

- Theoretically, lenders themselves may come within the remit of the new offences (which may be committed by "any person"). It is not necessary to be associated or connected with a sponsoring employer (which is the case for the tPR's pre-existing moral hazard powers – please see the box above).
- The circumstances in which the new offences might be committed are wide-ranging. Any action which lessens an employer's ability to fund its DB scheme could affect the likelihood of benefits being paid and so, potentially, could be an offence. This may cause directors concern when borrowing new money, or giving security and guarantees, if it could weaken the financial position of the employer.
- Concern about the new offences could also lead to an increase in applications for clearance. Ultimately, lenders may be left in a worse position if concessions need to be made to pension scheme trustees.
- When considering whether there was a "viable alternative", lenders may take some comfort from tPR's statements that:
    - a prospective lender would not be expected to have explored whether a competitor might have lent to the employer on less detrimental terms;
    - a lender's directors (in an example in tPR's policy) owed duties to act in the best interests of its shareholders; and
    - tPR would not seek to argue that a viable alternative was for the lender to lend on uncommercial terms.
- However, more concerning is another example in tPR's policy:
    - In this example, an employer has breached its banking covenants – entitling the lender to withdraw facilities immediately;
    - The employer is entitled to significant payments from debtors over the next month;
    - tPR comments that an extension of facilities by one month is "highly unlikely to risk the lender's interests", meaning that a one-month extension of the facilities is likely to be a viable alternative.

  This example seems hard to reconcile with tPR's statements elsewhere in the policy about lenders being able to act in their own commercial interests and in the interests of shareholders. Of course, any real-life scenario will be more complex than this four-line example in tPR's policy. In real life, this scenario could raise further questions such as:

- what about the real value of the debts owed to the employer? Would the lender be expected to investigate the financial strength of the employer's debtors, their previous payment records, or enforceability against any debtors not based in the UK?
- If the "significant payments" only amounted to, say, 80% of the amount owed to the lender would a one-month extension of the facilities still be considered to be a viable alternative?
- What if the employer's debtors dispute some of the "significant payments" owed, for example if there are complaints about the specification or quality of the goods or services supplied by the employer? This could impact the timing and amounts of the "significant payments" to the employer – but would the lender be expected to investigate to this level of detail? If yes, then at what point would the effect of the complaints mean that a one-month extension was no longer a viable alternative? Or would the lender be expected to consider a six-week, or two-month extension?

- Obviously, the above is only an example from tPR guidance. In practice, lenders should take advice and ensure they have a sufficient audit trail explaining the background and rationale behind their decisions.

New offences: would clearance help?

- The clearance regime applies only in relation to issuing by tPR of CNs and FSDs (please see the box on tPR's moral hazard powers above) and tPR expects clearance applications to be made only by persons who could be subject to a CN or FSD. A lender would therefore only be eligible to apply for clearance if it had become associated or connected with the employer.
- tPR's updated clearance guidance makes clear that clearance should not be sought as a means of settling any ongoing enforcement action (action by tPR which could result in a criminal prosecution or the imposition of a financial penalty).
- However, while the scope of the clearance regime does not extend to the new criminal and civil penalties, it should be difficult for tPR to convince a court that a person had no reasonable excuse for an act (or failure to act) in respect of which it had previously given clearance.

New CN tests: implications for lenders

These new grounds for issuing a CN may cause difficulties in employer restructurings as they focus on the strength of the employer's covenant. While defences are available to the target, these rely on the target evidencing that the act or failure to act would not materially reduce the amount of the debt likely to be recovered by the scheme or reduce the value of the resources of the employer relative to the estimated section 75 debt in relation to the scheme. Accordingly, they may not provide much help if priority new money or additional credit support are needed. Given the risk of stakeholders incurring criminal or civil liabilities if the new grounds do arise, where a structural workaround cannot be found we may see an increase in parties seeking assurances, via the existing clearance regime, that tPR will not exercise its powers.

As far as lenders themeslves are concerned, in 2005 the Financial Markets Law Committee raised concerns with tPR that a lender could be deemed to have control of a company to which it had lent money (bringing it in scope for moral hazard powers as a connected or associated party), where the terms of the debenture provide for control of the company to vest in the lender if the company defaults on its obligations.

tPR responded that in circumstances where either:

- control has not vested in the lender; or
- control has vested in the lender but has not been exercised,

the lender would not be party to an act (or deliberate failure to act) with a main purpose of avoiding the company's pension liabilities – meaning that the lender would not be in scope of a CN. tPR added that in these circumstances it would also not be reasonable for tPR to issue an FSD to the lender.

The material detriment test was subsequently added, to apply in relation to any act or omission from 14 April 2008. The material detriment test – and the new employer insolvency and employer resources tests – are concerned with the *effect* of an act or omission, not the *purpose* behind it. To be within scope for a CN, the target must be connected with or an associate of the sponsoring employer "at any time in the relevant period". The relevant period begins with the date of the act or omission and ends when tPR gives a warning notice that it is considering issuing a CN. As the legislation is drafted, if a lender gains control of an employer following an event of default, it will potentially be in scope for a CN, even if it was not associated or connected with the employer at the time of taking security. However, the comfort from tPR around what it means for a lender to have control still holds good.

Lenders to groups with DB sponsoring employers should think carefully and take advice before enforcing rights which could cause them or a newly incorporated purchasing vehicle to become associated or connected to the employer and therefore within scope of tPR's moral hazard powers. This has always been the advice but, given the enhanced tPR powers, it is now more important than ever.

Notifiable events: implications for lenders

Lenders will fall outside the notifiable events obligations unless, in relation to stage 2 notifications, the lender is connected with or an associate of the employer. However, the following concerns may arise:

- Smaller borrowers in particular may not be aware of the strengthened notification requirements and so may fail to notify tPR of new "relevant security". Lenders may wish to update their documentation to obtain confirmation that notification requirements (where applicable) have been complied with.
- tPR issues public reports of some of its regulatory interventions, and lenders may be concerned about reputational risk if they make a loan which is then not properly notified to tPR – even if the obligation to notify applied to another party.
- tPR may first become aware of a transaction or other corporate activity via the notifiable events regime – which might result in further regulatory action under its other powers.

HOW WE CAN HELP

Through our active participation in the pension industry and involvement in some of the highest profile cases involving DB schemes, we can give you an informed view on tPR's approach and how that develops in light of these new powers.

Our pension and business restructuring and insolvency teams can support you in structuring and restructuring lending to groups with DB schemes to achieve the best possible outcome for lenders whilst avoiding any members of the group (or indeed the lenders themselves) falling foul of the new regime.

This note is written as a general guide only. It should not be relied upon as a substitute for specific legal advice.

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