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Tough on liability dodgers

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To toughen up on employers trying to avoid final salary scheme liabilities, the Pensions Regulator can serve contribution notices and issue clearance statements.

A key objective for the new Pensions Regulator is to minimise the risk of situations arising that may lead to compensation being payable from the Pension Protection Fund (PPF). The regulator will therefore be concerned to ensure that employers do not structure their commercial transactions to avoid liabilities towards final salary schemes, leaving members to rely on the PPF. The Pensions Act 2004 gives the regulator various important anti-avoidance powers.

This article considers one of the regulator's key powers, the ability to serve 'contribution notices', and asks whether clearance statements will be an effective mechanism for providing comfort and certainty to those involved in commercial transactions?

In broad terms, section 75 of the Pensions Act 1995 provides for a debt to be due from employers in relation to a final salary scheme, if there is a deficiency in the assets on winding up the scheme. The debt on wind-up is calculated on the buy-out basis. Similar provisions apply in the context of a multi-employer scheme, so that a debt is triggered when an employer stops participating in the scheme and is calculated by reference to the employer's share of the overall liabilities.

Trustees are responsible for collection of s75 debts. However, from 6 April 2005, they will be backed up by a proactive and empowered regulator.

In broad terms, the regulator will be able to pursue any person who acts – or fails to act – with the main purpose, or one of the main purposes of preventing recovery of the whole or part of any s75 debt. And it will be able to impose a contribution notice on them. It can also pursue a person who, otherwise than in good faith, prevents recovery of such a debt, compromises or settles the debt, or reduces the amount of the debt. The contribution notice can be served on any person who was party to the act, or failure to act, and require them to pay the sum specified in the notice to the scheme's trustees (or the board of the PPF if relevant).

Many corporate actions could be construed as preventing recovery of an s75 debt. A few examples follow:

- Company A, which is the principal employer of a final salary scheme, regularly pays large dividends to its US parent. If it were to become insolvent, it would have insufficient assets to meet its s75 liabilities on the winding-up of the scheme.
- Company A sells the assets in its subsidiary B. B is principal employer of a final salary scheme and on the asset sale retains all liabilities in relation to the scheme. Following the sale, B has insufficient assets to meet those liabilities. It goes into liquidation leaving the scheme in deficit on a buy-out basis.
- Company A has a number of unsecured creditors, including the trustees of its final salary pension scheme. It gives security to all creditors except the final salary scheme. It subsequently goes into liquidation leaving the scheme in deficit on a buy-out basis and with insufficient assets to meet the claims of unsecured creditors.

It is important to bear in mind that the anti-avoidance provisions will only apply where the main purpose or one of the main purposes of the act is to avoid the debt. The regulator is only likely to be concerned if the act has a material effect on the scheme's liabilities. This would be assessed by reference to both the funding position of the scheme and the strength of the employer's covenant. If the effect is material, however, the burden will be on employers to demonstrate that the purpose of the act is not the avoidance of the debt.

For example, in the case of an unusually large dividend payment, the regulator will look at both the funding position of the scheme affected and the strength of the employer's covenant. If either or both of these are unsatisfactory, it will expect to see money going towards the scheme deficit, rather than to shareholders.

As such, the regulator expects scheme trustees to get involved and assert their rights as an unsecured creditor. This means employers will have to change their approach and consider informing trustees of commercial dealings at an early stage.

Trustees will also need to monitor corporate actions and have independent advice about extent to which they can or should be seeking additional funding for the pension scheme in light of the employer's proposed actions.

When deciding whether to serve a contribution notice, the regulator must have regard to a number of factors, such as the degree of involvement of the person in the act that avoids the debt, their connection with the pension scheme and with the employer, and their financial circumstances.

A source of comfort for any person involved in a transaction is to obtain a clearance statement from the regulator. An application may be made before the transaction takes place for a binding opinion from the regulator that the applicant will not be caught by the anti-avoidance provisions if they take part in the transaction, or that it would not be reasonable to impose any liability on the applicant.

Clearance only applies to the applicant. If more than one party could potentially be served with a contribution notice, it appears that each will have to make a separate application.

Clearance statements will be available on and after 6 April 2005. Until that date, the Occupational Pensions Regulatory Authority (Opra) is operating an informal clearance procedure, although it can only give an opinion. While it might be expected to take a similar approach, the comfort derived from the regulator will be limited necessarily.

Opra has indicated, informally, that it expects the regulator to be able to issue clearance statements within 48 hours of receipt of the application. The legislation requires a response "as soon as reasonably practicable". Even with the benefit of external professional help, that it is understood the regulator will be able to call upon, 48 hours is an ambitious target.

In addition, time will have to be factored in for advisers and applicants to put together the information the regulator requires. This may include an independent account's report to assess the strength of the employer's covenant. Advisers need to bear this in mind and ensure preparations are made at an early stage.

If the clearance statement is to be binding, it will be crucial that information provided is accurate and complete because the benefits fall away if the circumstances are materially

different from those described. Although it is not yet clear what information will be required, the regulator will be interested in the structure of and rationale for the transaction, and its impact on the pension scheme. It may want details of any negotiations and access to the company's advisers and financiers (where relevant). It is also required to give notice to people who it considers would be directly affected by the issue of a clearance statement and give them the opportunity to make representations. This could include scheme trustees if they would be directly affected by the clearance.

This leads on to one of the most significant issues: confidentiality. Companies may be concerned about providing price-sensitive information that could potentially be disclosed to trustees or even competitors. Limits on the information that the regulator can disclose are set out in the Pensions Act 2004 and this appears to provide the body with a way out of any obligations it might have under the Freedom of Information Act 2000. However, employers will be concerned to ensure they have robust confidentiality agreements in place with scheme trustees if they are to be informed of the proposed corporate activity.

There is also power for regulations to authorise the regulator to charge fees to meet the costs it incurs in connection with clearance applications. Although no details of these potential fees have yet been released, there is a no reason to believe that they will be nominal, flat-rate application fees. If the regulator does call on external professional assistance, the costs could be significant.

Regulations are awaited on anti-avoidance and once the regulator is in full swing, no doubt, guidance will be published clarifying some of the issues. Trustees should be aware of the need to monitor corporate actions and to take their role as an unsecured creditor seriously.

There is no requirement to apply for a clearance statement to cost and confidentiality are likely to be major considerations. Initially, however, there is likely to be a period of caution and uncertainty along with numerous applications for clearance.