Pension Schemes Bill 2019-20: Potentially Hindering Legitimate Business Rescue

Briefing from insolvency and restructuring trade body R3 – February 2020

Overview

R3, the insolvency and restructuring trade association, recognises the need for Government action to ensure the integrity of the defined benefit pension scheme framework, and the pensions system more generally. We appreciate that the Pension Schemes Bill is a potentially important step in achieving these goals.

However, the Bill, as it stands, risks damaging the UK's business rescue culture – and ultimately the financial pension schemes the Government is seeking to protect – by making directors of financially struggling firms less likely to attempt a restructuring of their company and more inclined to simply seek a formal insolvency procedure as a way of resolving that company's financial situation. The Bill could also make it harder for directors to seek expert, regulated advice by exposing insolvency practitioners and other professional advisers to civil and criminal liability.

R3 calls on the Government to tighten the drafting of the Bill to ensure that those directors seeking to restructure their companies and pension schemes in good faith – and those advisers, including insolvency practitioners, supporting these efforts – do not face the threat of significant civil and criminal liabilities as set out in the legislation.

The role of the insolvency and restructuring profession in resolving financially distressed or insolvent companies' pension schemes

The insolvency and restructuring profession plays a key role in resolving the future of a financially distressed or insolvent company's pension scheme. When appointed as an office holder in an insolvency procedure, an insolvency practitioner, in some circumstances have a duty to inform the Pensions Regulator (TPR) whether the company has an occupational or defined benefit pension scheme, and to realise the company's assets before distributing any realisations to creditors in accordance with the statutory 'order of priority' for post-insolvency repayments. Pension scheme deficits are (usually) an unsecured debt, which rank alongside tax and trading debts. As advisors to struggling but still solvent companies, members of the profession also have a role in approaching TPR to discuss restructuring of pension schemes outside of an insolvency procedure.

Clauses to Address

Criminal offences – Clause 107: 'Sanctions for avoidance of employer debt etc'

The Bill contains a number of new offences, two of which in particular could have detrimental consequences for companies in financial distress and their pension schemes: 'risking accrued scheme benefits' and 'avoidance of employer debt'.

These offences could disincentivise responsible directors and other stakeholders from pursuing a turnaround plan or pension scheme compromise which could ultimately benefit the pension scheme and its beneficiaries. The clauses make it more likely that directors will consider putting companies into an insolvency procedure rather than risk personal criminal liability by continuing to trade. These offences carry a maximum seven year prison sentence.

1. **'Risking accrued scheme benefits'**: this offence applies where any person engages in an act of conduct that they knew or ought to have known would have a "materially detrimental effect" on a defined benefit pension scheme.

a. Directors of a financially distressed company face a difficult situation when considering their options. It may be that a restructuring of the company could ultimately benefit all stakeholders, including the pension scheme, but this restructuring may not be risk free. In order to implement the plan, the company will have to continue trading and expend resources or take steps which could reduce the amount available to creditors, including the pension scheme, if the restructuring is not successful. Under the legislation as drafted, such attempts to secure a restructuring of a company – which could benefit all stakeholders in the long-run – could fall within the scope of "risking accrued scheme benefits".

b. The liability placed on directors could therefore make them think twice about attempting to resolve the financial distress of a company through a consensual restructuring. In this context, if a restructuring is deemed too risky as a result of the potential criminal liability imposed by this measure, directors may then be more likely to cease trading rather than risk a fine and/or up to seven years in prison.

c. Although an individual will not be committing the offence if they had "reasonable excuse" for the act or conduct, the legislation is not clear as to the tests that will be applied in determining whether a director's actions or conduct were indeed reasonable. Without further clarification in the legislation, or extensive guidance as to the future approach to be taken by TPR, directors may be more inclined to cease trading rather than risk criminal liability for seeking to legitimately restructure a company.

2. **'Avoidance of employer debt'**: this offence applies where any person commits an act that "prevents the recovery of a section 75 debt…or otherwise compromises or settles such a debt". A section 75 debt is incurred when employers withdraw from a pension scheme (usually when the employer has become insolvent), and amounts to the employer's share of the scheme's liabilities.

   a. Unfortunately, the legislation as drafted could apply to arrangements permitted under existing legislation, such as 'regulated apportionment arrangements' (RAAs). RAAs are used by companies in financial distress to renegotiate a section 75 debt. This offence could also apply to other statutory mechanisms such as Company Voluntary Arrangements (a statutory restructuring tool which sees a company in financial difficulty agree a debt restructuring with its creditors), as well as to consensual compromises outside the Pension Protection Fund.

   b. This means that directors who use arrangements already permitted by law to more effectively manage the significant liability of a section 75 debt, could be committing a criminal offence – this provides directors with another incentive to avoid a restructure of a company and could instead make directors more likely to simply cease trading. Again, an offence will not be committed if a director can show they had "reasonable excuse" for the action they took but without greater detail as to what this might mean in practice, the effect of this measure as it stands may be counterproductive.

While it is welcome that there is a carve out for these criminal offences in respect of an individual's function as an insolvency practitioner, what this will mean in practice is unclear. As outlined above, insolvency practitioners can play a role in resolving a distressed company's pension scheme, but this can be either as a formally appointed office holder (either as an administrator or liquidator, depending on the insolvency process in question), or as advisors to struggling but still solvent companies. The legislation does not set out whether the exemption will apply to insolvency practitioners in one or both of these functions.

As a result, the impact of these new offences could make it harder for distressed companies to obtain proper advice as insolvency practitioners and others (noting that the exemption does not apply to other professional advisers) understandably do not wish to risk exposure to criminal liability simply as a result of providing advice on, or facilitating, legitimate restructuring or other corporate activity. This could be highly detrimental to business rescue in the UK, ultimately damaging the financial position of employees and pension schemes.

Expansion of moral hazard powers – Clause 103: 'Grounds for issuing a section 38 contribution notice'

The Bill grants TPR two new grounds on which it will be able to issue contribution notices (which require a payment into a scheme by parent or associated companies, directors or shareholders, in order to protect the benefits of scheme members and to ensure that pension liabilities are not avoided or unsupported):

1. **Employer insolvency test**: this test will be met if, in the opinion of TPR, a pension scheme had a deficit immediately before a company transaction and where this transaction materially reduced the amount that might have been recovered for the scheme, if there had instead been an immediate insolvency, rather than a transaction.

2. **Employer resources test**: broadly, this will be met if TPR considers an act or failure to act "reduced the value of the resources of the employer" and that reduction was material relative to the amount of the estimated section 75 debt in relation to the scheme.

Essentially, if a director now faces the risk of being issued with a contribution notice because the restructuring they have attempted in good faith fails, they may be less inclined to attempt the restructuring in the first place. This could deprive the company and pension scheme of the chance of turning the situation around, and ultimately the chance to protect value for all stakeholders including the pension scheme.

Although directors will be able to claim a defence against these measures if they can show that they reasonably concluded that their actions would not have a negative effect, without greater clarification in the legislation, or extensive guidance around TPR's approach to issuing contribution notices on these grounds in future, there is a risk that this aspect of the Bill could be counterproductive in encouraging a move straight to insolvency rather than attempting a restructuring.

Pensions Regulator notices – Clause 109: 'Duty to give notices and statements to the Regulator in respect of certain events'

The Bill introduces a new requirement to notify TPR of certain corporate activity or events and to set out what the impact of that activity will be on the defined benefit pension scheme.

Although the Government has consulted on what activity and events should require notification, these are not detailed in the Bill and will instead be set out in regulations and TPR guidance. However, it is expected that the events will include: change of control of an employer; sale of material assets; and, granting security which ranks ahead of the pension scheme.

The timing of notifications, particularly if notification is required before a transaction takes place, could delay actions that needed to be taken in order to preserve value and employment. The risks of such a delay will need to be addressed in any regulations that set out the detail of the notification requirements.

Further, when a distressed company is seeking new funding to support a restructuring, or simply to continue trading, the sources of such funding will often require additional security, which may rank ahead of the pension scheme in an insolvency situation, as a condition of providing new money (given that lending to a distressed company is riskier than lending to a financially stable one). In these situations, publicising a company's difficult financial situation can lead to a loss of support from stakeholders who take action against the company (for example, issuing a winding-up petition) to shore up their position as creditors via a formal insolvency procedure now, rather than risk a poorer position following a restructuring later.

It will be very important for TPR to take a sensitive and nuanced approach to the application of the new notification requirements.