

The Trustee toolkit downloadable

How a DB scheme works

Tutorial six: Corporate transactions

By the end of this tutorial you will better understand:

- ▶ the trustee's role when a sponsoring employer undergoes corporate or financial restructuring
- ▶ what moral hazard and clearance are
- ▶ how to apply for clearance

This tutorial is part of Scenario three.

Glossary

A detailed glossary of technical terms can be downloaded from the Resources tab when you log in at www.trusteetoolkit.com

Corporate and financial restructuring

Sales and purchases of companies or changes in financial arrangements very frequently cause uncertainty, particularly to trustees of DB schemes.

A scheme with a deficit

If there is a deficit in the scheme, it will be a creditor of the employer just as a bank or a supplier would be.

In 2005, the Pension Protection Fund (PPF) was set up to ensure that scheme members would receive a reasonable amount of benefit if the scheme's sponsoring employer became insolvent.

The government was concerned that employers might exploit this protection by arranging their business affairs to remove the scheme liabilities from the employer without honouring the employer's obligations in full.

Moral hazard powers

Moral hazard powers (ie powers to issue a Contribution Notice (CN) or a Financial Support Direction (FSD)) were given to The Pensions Regulator (TPR) to try to prevent this from happening.

CNs require a payment to be made into a scheme, and FSDs require financial support to be put in place for a scheme.

Trustee role

TPR expects trustees to assess the effect of a corporate or financial restructuring on the employer's covenant and to negotiate robustly with the employer if the restructuring appears to be materially detrimental to the employer covenant.

If a restructuring has had a materially detrimental effect on the position of the DB scheme, TPR may be able to use its moral hazard powers.

Useful links

Find out more about moral hazard powers in The Pensions Regulator's 'Clearance' regulatory guidance.

Clearance

Obtaining clearance

Employers (and related parties) have the option to approach TPR to seek assurance that TPR will not seek to use its moral hazard powers in relation any transaction that is thought to constitute a 'type A' event. This assurance is called a clearance statement.

Once a clearance statement has been issued, the applicants can take comfort that their actions (to the extent that they are fully set out in the clearance application and that application is accurate and complete) will not trigger the use of these powers.

Type A events

'Type A' events are events that are materially detrimental to the ability of the scheme to meet its pension liabilities. Examples of some 'type A' events are set out in TPR's 'clearance' regulatory guidance. TPR would only expect applications for a clearance statement in relation to 'type A' events.

Clearance and the trustees

An employer (or other related party) rather than the trustees would normally apply for clearance. However, trustees are expected to be involved in the application and are generally asked whether or not they support it.

Deciding whether a change may be materially detrimental to a scheme can be complex and trustees may decide they need some independent professional advice to do this. Much will depend upon the relative strengths of the employer covenant before and after the transaction.

TPR's view is that responsible employers should pay for the trustees to obtain relevant professional financial advice in relation to the event. Trustees need to record the decisions they take and the reasons for them. Clearance applications tend to proceed more smoothly and quickly where trustees already have the independent advice they need before the application is submitted to TPR.

If clearance is not sought

On the other hand, where trustees have serious concerns regarding a 'type A' event, but the employer has not sought clearance, then the trustees have the option of approaching TPR themselves. In such cases TPR will seek to understand the background to the negotiations and seek a fair outcome.

TPR expects trustees to negotiate assertively with the employer on behalf of the scheme and TPR will want to see evidence, for example, that trustees have taken professional advice if appropriate. If professional advice has not been taken, the trustees need to be able to explain the reasons why it was not thought appropriate.

TPR also expects the trustees to have considered ways in which the impact of the proposed transaction can be minimised and the position of the scheme can be at least maintained.

Case examples

The remainder of this tutorial will look at three examples of corporate transactions:

- ▶ asset sale
- ▶ share sale
- ▶ withdrawal of an employer

Asset sale: Willow Fences Limited

This example follows the actions taken by the trustees of the Willow Fences pension scheme.

Willow Fences Limited (WFL) is a company which manufactures garden fences and pagodas. It has a sister company, Willow Products Limited, which distributes and sells the products. Both are owned by a parent company, WF Holdings Limited (WFHL).

The group management decided to stop making and selling pagodas and sold that business to another garden furniture company, Summer Furniture Limited. The pension scheme trustees were concerned because there was a deficit in the scheme, so they commissioned an independent business report from a professional services firm.

The report confirmed that the sale of some of WFL's assets would have two consequences affecting the scheme: cash flow and sale proceeds.

Cash flow

While the fencing business provided the majority of WFL's turnover, the pagoda business delivered a small but far more profitable portion of WFL's turnover. Therefore the availability of cash for making contributions to the scheme would be lower in the future, following the sale.

Sale proceeds

While the sale proceeds recognised the value of that future income stream, as well as the value of the fixed assets, WFHL wanted to use those proceeds in two ways:

- ▶ invest half in making the fencing production process more efficient (and therefore the products more profitable)
- ▶ pass the other half via dividends up to WFHL and, from there, to the group's shareholders

Conclusion

This meant there were likely to be lower contributions available to the scheme in the future, and – in the event of insolvency – WFL had fewer assets so the scheme’s share of those assets was likely to be lower. The trustees were concerned about both these consequences. Once the trustees received the advice, they needed to share their concerns with the management.

Negotiation

Having taken professional financial advice on the impact of the asset sale on the ongoing covenant, the trustees negotiated with the management team and agreed to accept a cash contribution to the scheme from WFL immediately after the sale, which was a quarter of the sale proceeds.

Half the proceeds would still be invested in the remaining business, and the remaining quarter would pass to the shareholders via dividends. In this instance, this payment was enough to clear the ongoing funding deficit identified at the last valuation. It also improved the position of the scheme on insolvency.

Clearance

The employer approached TPR with a clearance application explaining the proposed transaction, TPR provided a clearance statement based on the facts and the sale went ahead.

Outcome for the trustees

In this case the trustees were comfortable to support the transaction and they had no need to approach TPR on their own account, although they could have made a joint approach to TPR, once the arrangements with the employer had been agreed.

Share sale: Harris & Daughters Limited

This example follows the actions taken by the trustees of the Harris Fitters pension scheme.

Harris & Daughters Limited makes and fits window shutters, via two wholly owned subsidiaries (ie Harris & Daughters Limited is their only shareholder), Harris Shutters Limited which manufactures the shutters and Harris Fitters Limited which employs instalment teams.

Harris Fitters is the sole employer of the pension scheme. Harris Fitters has no bank debt, and the scheme is the largest creditor. There is a pension scheme deficit on a buy-out basis in respect of the current and former employees of Harris Shutters Limited of the order of £5 million, according to the trustees.

Harris & Daughters wants to sell Harris Fitters Limited to Sunnydale Interiors Limited, to concentrate on expanding the range of products it makes.

The trustees, having taken independent covenant advice, believe that the sale will have a detrimental effect on the scheme because the guarantee will be removed and there will be a new secured creditor.

Guarantee removal

Harris & Daughters currently provide a guarantee to the trustees of the scheme, the terms of which are that Harris & Daughters can be required to pay contributions to the scheme if Harris Fitters is unable to, up to the value of the buy-out deficit.

This has enabled the trustees to consider the Harris Fitters covenant as stronger than it would be by itself, and use less prudent assumptions when valuing the scheme. The guarantee will be removed at the time of the sale, so the employer covenant will be weaker than before.

A new secured creditor

Sunnydale Interiors has explained it will be funding the purchase of the shares of Harris Fitters Limited by taking out a bank loan, to be secured against the assets of Harris Fitters. This means that, in the event of Harris Fitters' insolvency, the bank will have the first call on the assets, diluting the scheme's return. In the past, with no bank debt in place, the scheme has been the biggest creditor to the employer. This weakens the employer covenant even further.

Conclusion

The trustees share this analysis with both Harris & Daughters and Sunnydale Interiors. Both companies decide to apply for clearance, and begin negotiating separately with the trustees on the appropriate level of mitigation.

Harris & Daughters

Harris & Daughters agrees with Sunnydale Interiors and the trustees that it will pay in an amount equivalent to the ongoing deficit at the last valuation (less any recovery plan payments already made) and reasonable expenses incurred by the trustees as a result of the sale (ie additional adviser fees). The reduction to the deficit will be reflected in the sale price, ie Sunnydale Interiors will pay more for Harris Fitters' as a result of this deficit reduction.

Sunnydale Interiors

Sunnydale Interiors offers the trustees a guarantee of contributions up to the PPF deficit. The trustees, following discussions with their covenant advisers, are concerned that this still leaves the scheme with a weaker covenant than before as a result of the bank being given security. They request that the guarantee cover contributions up to the buy-out deficit.

In negotiation with Sunnydale Interiors, it becomes clear that Sunnydale Interiors does not want to provide an unconditional guarantee on contributions up to the buy-out deficit. Instead, the trustees agree to accept an unconditional guarantee of the PPF deficit, together with a guarantee of the buy-out deficit which will fall away when the bank releases its security over the employer's assets.

Clearance

With the clearance application updated to reflect the improved mitigation, TPR grants clearance.

Withdrawal of the employer: Wolfram Distribution

This example follows the actions taken by the trustees of the Wolfram Group pension scheme.

The Wolfram & Hind group of companies was formed out of a merger of two similar businesses around 20 years ago. The group is made up of a holding company, Wolfram & Hind Limited, and its two wholly owned subsidiaries, Wolfram Distribution Limited and Hind Logistics Limited.

Both Wolfram Distribution and Hind Logistics are in the haulage industry and are participating employers in the Wolfram Group Pension Scheme. The scheme has a buy-out deficit of £12 million, of which £5 million relates to Wolfram Distribution and £7 million relates to Hind Logistics.

One of the employers withdraws from the scheme. Wolfram & Hind is selling Wolfram Distribution Limited to CX Transport Limited. The Wolfram & Hind group intends expanding into rail haulage and, whilst Hind Logistics is already partly established in that business, Wolfram Distribution is not and all its sites are located for access to the motorway network.

The pension arrangements

Neither the purchaser nor the seller wants the Wolfram Distribution employees to continue to participate in the Wolfram Group pension scheme following the sale. The purchaser has its own group pension arrangements and the seller does not want employees who are now outside its group to continue to participate in the Wolfram Group pension scheme.

The liabilities

The purchaser also wants to ensure that Wolfram Distribution is not liable to make any payment to the scheme following completion of the sale. The purchaser wants certainty regarding Wolfram Distribution's historic liabilities and will want to reflect any future payments due from Wolfram Distribution in the purchase price it is paying.

Wolfram Distribution's liability to the pension scheme becomes a key issue of negotiation between the seller and the buyer in seeking to agree the terms of the sale. The trustees decide to seek legal advice, in addition to the covenant advice sought, in order to understand the options and which might be relevant to their situation.

Legal advice

The trustees receive legal advice on the options available for dealing with the section 75 debt, other than allowing the debt to be triggered when Wolfram Distribution is sold. They note that all the options relevant to their circumstances require the trustees to satisfy themselves that a 'funding test' is met.

Covenant advice

The covenant advice received demonstrates that the sale reduces the cashflow available to the scheme. The trustees decide to engage with group management to find solutions to both issues, ie, how to deal with the section 75 debt that arises, and how to mitigate the detrimental effect on the scheme.

It is important for trustees to understand the detrimental effect of the sale on the scheme and obtain mitigation for it, separate from how the departing employer's debt is dealt with.

Once the trustees receive the advice, they need to share their concerns with the management.

Negotiation

In this case, the Wolfram & Hind group offers the trustees a proportion of the sale proceeds equal to the scheme's PPF deficit and security over the property portfolio of Hind Logistics in mitigation for the detriment caused by the sale. Clearance is granted for the transaction.

Flexible apportionment arrangement

The trustees also agree to enter into a flexible apportionment arrangement, which apportions Wolfram Distribution's liabilities to Hind Logistics, as they are satisfied that in this case the funding test is met. The trustees inform TPR of this arrangement, in accordance with the notifiable events regime.

Flexible apportionment arrangement

A flexible apportionment arrangement (FAA) allows the liabilities of one employer to be apportioned to another.

Useful links

Find out more at www.tpr.gov.uk/multi-employer.