Memorandum

Empowering The UK Pensions Regulator—The Impact of The Pensions Schemes Act 2021 on Restructuring

1 October 2021

The efforts of the UK Pensions Regulator (***TPR***) to become a "*clearer, quicker and tougher*" watchdog in the aftermath of certain high-profile corporate failures, such as BHS and Carillion, are about to get a notable boost, at least on paper.

Today (1 October 2021), broader powers and notification requirements long-trailed by the Pensions Schemes Act 2021 (the ***Act***) come into force. Lawyers at Simpson Thacher and Sackers have collaborated to present this overview of the changes as well as notable potential impacts. As a reminder, the key provisions of the Act include:

- **Widened moral hazard powers:** Two new grounds have been added upon which TPR can issue a contribution notice (***CN***) in relation to a defined benefits pension scheme (a ***DB scheme***)—the "employer insolvency test" and the "employer resources test";
- **New criminal offences and civil penalties:** The Act also introduces two criminal offences of "avoidance of employer debt" and "conduct risking accrued scheme benefits", each with a maximum penalty of unlimited fines and up to seven years' imprisonment; and
- **Additional notifiable events:** Once draft regulations have been finalised, TPR will also need to be notified of decisions in principle that involve "material sales" and the "grant of security", and subsequently provided with notices and accompanying statements setting out key information, once the main terms of the event have been proposed.

Widened Moral Hazard Powers

Under existing legislation, TPR has certain "moral hazard" powers under which it can issue a CN to require third parties who are connected to, or associated with, companies operating a DB scheme—including other group companies, directors and major shareholders—to make a payment into the scheme. Before 1 October 2021, there were two grounds for issuing a CN:

- where an act (or failure to act) had a "material detriment" on the likelihood of accrued scheme benefits being received; and
- where the "main purpose" of an act (or failure to act) was to prevent the recovery of an employer's scheme debt or reduce the amount of debt that would otherwise be due.

The Act now allows TPR to also issue a CN where it is of the opinion that an act or omission, broadly speaking, has:

- materially reduced the scheme debt likely to be recovered in the event of an immediate insolvency (the "**employer insolvency test**"); or
- reduced the resources of the employer to a material extent when compared to the buy-out deficit of the scheme under s.75 of the Pensions Act 1995 (the "**employer resources test**").

However, before issuing a CN, TPR must be of the view that it is reasonable for that person to be liable to pay. In coming to that decision, under the existing legislation, TPR must consider the extent to which, in the circumstances, it was reasonable for the person to act (or fail to act) in the way that they did, together with other factors such as their degree of involvement in the triggering act and the value of any benefit received.

The Act will add two new factors to this "reasonableness" test:

- the **impact of the act (or failure to act) on the value of the scheme's assets and liabilities**; and
- whether the person has **complied with new requirements to provide information** to TPR regarding certain notifiable events (see further below).

There is also a statutory defence which in essence applies if the target of the CN can demonstrate that prior to engagement in that act (or omission) they:

- **gave due consideration** to the impact of the act or omission;
- **took all reasonable steps** to eliminate or minimise any negative impact on the scheme (if they concluded there was such negative impact); and
- **reasonably concluded** that the act would **not amount to a CN trigger**.

Each situation will, however, need to be considered in the relevant circumstances.

In addition to the new criminal offences discussed below, failure to comply with a CN is also now a criminal offence, carrying an unlimited fine and up to seven years' imprisonment. Civil fines of up to £1 million may also be imposed.

New Criminal and Civil Offences

The Act introduces two new criminal offences (and a related civil sanction) which apply in the context of DB schemes in the absence of "reasonable excuse":

- "**Avoidance of employer debt**" captures engagement in any act (or failure to act) or course of conduct intended to prevent recovery of a statutory debt due by an employer to a DB scheme, or which compromises, settles or reduces such a debt.

The application of this offence could be problematic for restructuring as the compromise of employer debts—for instance, by way of a company voluntary arrangement or pursuant to a regulated apportionment arrangement—is within scope.

- "**Conduct risking accrued scheme benefits**" similarly applies where an individual engages in an act (or failure to act) or course of conduct in a way that they know (or ought to have known) would have a materially detrimental impact on the likelihood of a member of a DB scheme receiving their accrued benefits.

Under these offences, any person can be held liable (with limited exceptions for insolvency practitioners in certain circumstances), not just scheme employers and persons "connected" or "associated" with them. The offences carry a penalty of up to seven years' imprisonment and an unlimited fine, and TPR may levy a fine of up to £1 million for civil offences which mirror the criminal provisions.

The offences could therefore apply to trustees and sponsors of DB schemes, as well as any lenders, insurers, professional advisers or asset purchasers engaged on a transaction which could impact the position of the group supporting that scheme (although an insolvency officeholder acting properly within their functions is exempt from liability). Although TPR's consultation on its draft policy on criminal prosecutions and penalties (now finalised and issued on 29 September 2021) emphasised that it does not intend to utilise its extended powers to penalise routine business activities (rather, it sees them as targeting the more extreme end of behaviour already within scope of CN powers), the measures are likely to bolster its bargaining position with respect to any transaction falling within the Act's ambit.

The broad scope of the offences has generated concern that they could capture ordinary business activity, particularly in a restructuring or turnaround context. Pending clarity on the meaning of "reasonable excuse", caution should be exercised when making decisions such as whether to continue trading or make a dividend payment to shareholders if the company is in financial distress. Given this, professional advice should be sought at an early stage and decisions should be carefully documented. Early engagement with DB scheme trustees is also to be encouraged, and indeed is going to become inevitable once the new notifiable events become effective (see further below).

Retrospective Effect?

Following widespread concern as to whether these new powers might be imposed with retrospective effect (possibly to the date they were announced), the commencement and transitional regulations have made it clear that these powers will not apply where the relevant act (or failure to act) occurred before 1 October 2021, or, in relation to a series of acts, where the first in the series occurred before 1 October 2021.

However, it should be noted TPR's recently published criminal offences policy notes it can take into account facts prior to 1 October 2021 as part of their investigations—for example, where those facts indicate a person's intention

for an act taking place on or after that date. TPR has also indicated that a person can rely on facts prior to 1 October 2021 as part of their statutory defence.

Additional Notifiable Events

Although still under consultation (with the resulting regulations likely to take effect next year), the Act contains a framework for new trigger events requiring TPR to be notified and for accompanying statements detailing, and explaining the impact of, the event on the DB scheme to be prepared and provided to TPR.

Draft regulations were recently published by the UK government Department for Work and Pensions, indicating that notification will be required where an employer:

- intends to sell a material proportion of its business or assets (a "**material sale**"); or
- intends to grant or extend security over its assets, resulting in the secured creditor ranking above the DB scheme (a "**grant of security**").

These build on the existing requirement to notify TPR of the following events:

- any decision which will result in a **debt due to a DB scheme not being paid in full**;
- any decision to **cease to carry on business** in the UK;
- the receipt of advice of **wrongful trading** or there being **no reasonable prospect of avoiding insolvent liquidation** (although this is expected to be removed from the legislation);
- **breach of financial covenants** (other than where it has been agreed not to enforce);
- a decision to **relinquish control of an employing company** (this is being tweaked to extend to decisions in principle); and
- **convictions of directors** for dishonesty offences.

Once in force, the expanded notifiable events regime will likely give TPR (and DB scheme trustees) more negotiating power in any relevant corporate transaction, refinancing or restructuring and at an earlier stage. Employers will also need to make difficult decisions in respect of when to make any such notifications. The draft regulations are drafted on the basis that the first notification will be made as soon as decisions have been reached in principle. "Initial" and "secondary" notifications must be made as the likelihood of the event increases (but before any binding agreement is reached) and when main terms are proposed. Certainty, confidentiality and the risk of failing to comply with the notification obligations will therefore need to be carefully balanced.

Civil penalties of up to £1 million may be imposed for failure to comply with the new notification requirements.

Conclusions

While TPR may be slow to use the Act and its broader scope to crack down on ordinary business behaviour, the new provisions certainly introduce grey areas in the conduct of restructuring activity. It seems clear that a key aim of the new legislation is to give TPR an early warning of corporate activity and an ability for them and DB scheme trustees to get around the negotiating table before the impact on the pension scheme becomes a forgone conclusion.

We can also expect TPR to be taking a more proactive approach to address perceived reckless and unscrupulous behaviour of employers in respect of DB schemes which puts members' returns at risk. As a result, we may well see a more interventionist stance from TPR as it looks to firm up its position as a key stakeholder in UK restructurings by imposing its new criminal and civil powers. However, in practice, given the high burden of proof that must be met for a successful criminal prosecution (*i.e.* beyond all reasonable doubt), it is more likely that TPR, with its finite resources, will pursue civil penalties and reserve criminal prosecution for the most egregious behaviour.

While clearance is not available for criminal offences, the changes to the moral hazard regime are quite likely to precipitate an increase in clearance applications to insure against the risk of a CN being issued. If such clearance is granted, by extension, this could evidence "reasonable excuse" and provide a defence against criminal liability.

In practice, it has become increasingly important for any parties exposed to a DB scheme to seek appropriate professional advice and begin to carefully document decision-making in light of the complex legislative regime (which now has a few more teeth) at an early stage. A clear record that consideration has been given to the impact on the DB scheme, and what mitigation is available, will become an essential part of corporate activity generally (and restructuring in particular).

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