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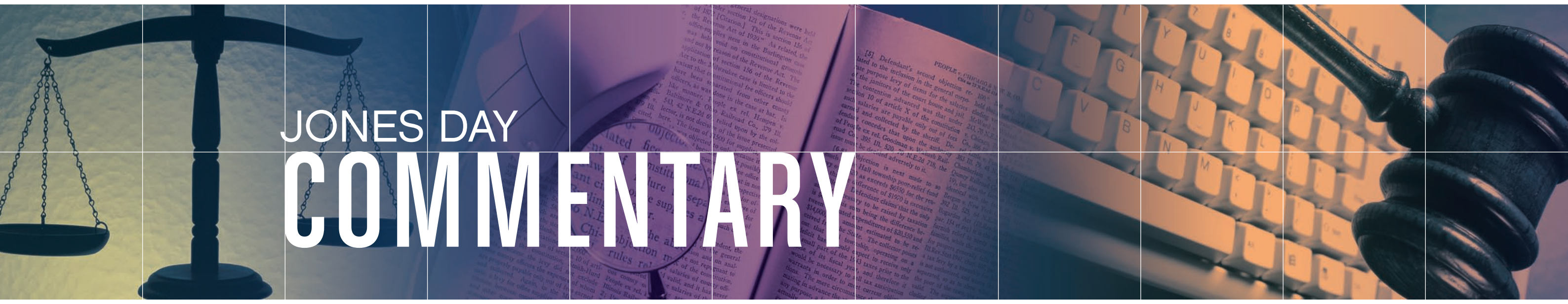

BRAVE NEW WORLD?
NEW FUNDING PITFALLS FOR UK PENSIONS

T.R. Malthus gloomily predicted that the human population would grow much faster than food supplies, dooming mankind to unending poverty and hardship. Luckily (for us), Malthus was wrong. Although the human population has exploded in a J-shaped growth curve over the past 200 years (from 1 billion to 6 billion people), food supplies have kept pace. A large part of the reason for the exponential growth in our population has been better medical care. This wonder of science is not, however, all good news. As retirees enjoy healthier and longer lives, defined benefit pension plans everywhere have become more expensive.

To make sure that pension promises are kept and to address the increasing cost of longevity, the United Kingdom recently enacted new laws fundamentally changing the way in which UK pensions must be funded. This *Commentary* provides a brief overview of the key issues confronting UK businesses sponsoring underfunded pension plans.

WHAT HAS CHANGED?

Provisions of the UK Pensions Act 2004 (also driven by EU pension legislation) have affected the way in which defined benefit pension plans are to be funded in the UK. Long-standing legislation in the UK requires pension plan valuations to be carried out every three years so as to determine the level of plan funding by sponsors. The current batch of UK pension valuations are generally producing much larger deficits than would have been expected from past history. Two key factors in pension deficit growth are: (1) changes in the assumptions as to how long retirees will live; and (2) new legislative mandates on pension valuation.

Life Expectancy. Mortality assumptions used by UK actuaries have recently been subject to successive updates and, consequently, the significantly increased life expectancy factored into valuations is having a marked effect on the cost of providing pensions in current valuations.

Valuation Methodology. Until September 2005, UK defined benefit pension plans were valued on a basis that, in most cases, was decided by the plan sponsor and not the trustees. The trustees could impose a minimum level of funding, known as the minimum funding requirement ("MFR"), on the sponsor. Although it was known that the MFR generally fell well short of the amount actually required to keep the plans adequately funded, even on an ongoing basis, the sponsor could generally decide whether or not to provide funding in excess of the MFR, and the trustees could not demand any additional funding.

Since September 2005, the method of valuation has changed. The new valuation methodology, which assesses the size of any deficit and the time period over which that deficit must be funded, must now be agreed between the sponsor and the trustees. If agreement cannot be reached, the UK Pensions Regulator (the "Regulator") must be informed. The Regulator can then impose the assessment of funding and time periods over which any deficit must be funded on the sponsor and plan. The sponsor can no longer simply decide the level of funding. Instead, plan sponsors must now negotiate and reach agreement with the trustees on these issues, or risk the imposition of an even stricter funding plan by the Regulator.

As these provisions are relatively new, the Regulator has not yet been called upon to adjudicate on many valuations, and its stance is not entirely clear. Nonetheless, the Regulator has statutory obligations to ensure that pension plans are secure. It is safe to assume that, given these new statutory mandates, a pension plan sponsor is unlikely to obtain a particularly sympathetic hearing if it is seeking to minimise the funding to a plan. The threat of referral of these issues to the Regulator has not only increased the level of negotiation between the sponsor and the trustees but also given trustees the confidence to negotiate more aggressively to seek the funding that the trustees believe is appropriate for the plan. Unsurprisingly, plan sponsors are, therefore, seeing increased funding demands from trustees, and trustees are also seeking deficits to be made good in no more than a five- to 10-year period (in line with Regulator guidance).[1]

HOW CAN THESE FUNDING ISSUES BE RESOLVED?

Business owners and pension plan sponsors facing underfunding issues in the UK should consider several different strategies to alleviate these problems. Because each situation is unique, funding issues can only be tackled in the context of the particular plan, the plan's own rules and requirements, and the plan sponsor's own financial situation. Some strategies used by pension plan sponsors in dealing with these new mandates are summarised below.

Improving Funding. Increasing funding to a pension plan in the near term will, of course, reduce the future liabilities and improve the balance sheet of the plan sponsor. Another important factor is that such funding will also reduce the levy that is annually payable by each plan to the Pension Protection Fund, a fund (similar in scope to the US Pension Benefit Guaranty Corporation) established to provide benefits for members of plans whose sponsors have become bankrupt. These levies can reach hundreds of thousands, or even millions, of dollars per year and will constitute a significant drain on the cash resources of any plan sponsor, particularly in the context of a poorly funded plan.

The good news is that trustees have become more sophisticated (in no small part due to the encouragement of the Regulator) in accepting different forms of funding. Trustees are willing to consider not only cash but also liens over property and third-party guarantees (either from within the group or a third-party lender) to improve the funding of the plan, and to be called upon in the event of bankruptcy of the plan sponsor. If appropriately drafted, such security can significantly reduce the need for remedial contributions to deal with any plan deficit and, as stated above, can reduce the drain on the company's cash resources to meet the Pension Protection Fund levy.[2]

Sharing Costs With Members. As costs rise, the sponsor may consider passing some of the increased cost to pension members to ensure that those who continue to accrue a pension are those who consider it to be a valuable benefit. Demanding additional contributions from pension members will, however, require the consent of the plan trustees as well as the contributing members.

1 The Regulator publishes guidance notes on how trustees and companies should act. While the Regulator's guidance is nonbinding, it may be considered by courts if a dispute arises as to whether the company or the trustees have breached their duties to the pension plan. The Regulator has not provided formal guidance on funding levels to be achieved, but the guidance does state that it would want there to be a good reason for a repayment period exceeding five to 10 years.

2 Employer stock remains an uncommon form of funding in UK pension plans. The amount of pension funds that may be invested in employer-related investments (including employer and group stock) is limited by statute to no more than 5 percent.

As independent parties, the trustees will need to be convinced that it is in the best interests of pension members to consent to any change. Trustees will consider whether refusal will result in the imposition by the sponsor of a more drastic change that does not require their consent. To obtain the trustees' agreement, the plan sponsor must often agree to improve the funding of the plan.

Since member contributions are taken out of wages, under UK law, any additional deductions from wages to meet these increased contributions cannot be effected without the written consent of every one of the affected members. If any individual member's written consent is not obtained, that member retains the right to bring an action for a return of the unlawfully deducted extra contributions.

Reducing or Ceasing Benefits. While reducing future benefits works to reduce a plan sponsor's costs, a pension member's already accrued benefits cannot generally be reduced. Any such action should, however, be assessed in the light not only of the financial savings but also the legal risks and restrictions on any such change. Particular stumbling blocks can include the following:

- Amendments to reduce benefits or cease future benefits may be in breach of the employees' terms and conditions of employment. In some cases, this risk can only be adequately dealt with by obtaining the members' written consent to the benefit changes.
- UK law also requires the plan sponsor to consult with employees over certain benefit changes. This consultation must be with all members or elected member representatives and must commence at least 60 days before a final decision is made.
- Detrimental changes cannot be made to accrued benefits without the written consent of all affected members (including those who are no longer employees). This is usually impractical and rarely occurs.
- Most benefit changes require the consent of the trustees of the plan. The trustees are not permitted by law to give their consent unless the plan sponsor promises some benefit to members (for instance, better funding or the introduction of other employee benefits). The trustees may also be constrained by the terms of a trust from agreeing to such changes.
- Some changes—for instance, freezing the plan to stop future benefit accruals—may give the trustees the right to terminate the plan and, therefore, demand that the plan be fully funded immediately. It is absolutely essential for a plan sponsor to review the terms of the trust to ensure that any such right is not inadvertently triggered by any action it takes.
- Many changes will indicate to the trustees that the plan has a less secure long-term future. The trustees will, accordingly, look to the next actuarial valuation to seek additional funding for the plan over a shorter period of time and on a lower risk, and therefore higher contribution level, in order to secure members' benefits.

NEXT STEPS

Dealing with UK pension issues, whether in the context of an ongoing business or a prospective sale or purchase of a UK business, has now come to the forefront as a fundamental business issue. Because most UK pension issues are highly visible and important, they must be dealt with by using the utmost care.

LAWYER CONTACTS

Jones Day's team of experienced international benefits lawyers can provide thoughtful and practical advice to successfully resolve UK pension funding issues. To fully consider these issues before they become a burden to your business, please feel free to contact the employee benefits attorneys listed below. General e-mail messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

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