JONES DAY

MAY 2009

LOSS OF GOOD FAITH: THE EXTENDED POWERS OF THE PENSIONS REGULATOR

Pension scheme deficits play a significant role in determining the solvency of a company. Any attempts to restructure or avoid these debts in order to ensure the survival of a business should be approached with caution. The Pensions Regulator (the 'Regulator') has the power to place substantial personal liability on directors or shareholders of employers (or entities associated or connected with employers) of defined benefit pension schemes in circumstances that result in the reduction or avoidance of the employer's liability to the scheme. The Pensions Act 2008 (the '2008 Act') has significantly extended these powers.

THE CURRENT LAW

At present the Regulator may issue a contribution notice to all parties associated or connected with an employer of a defined benefit pension scheme, demanding that they contribute to that scheme an amount decided by the Regulator. Parties associated and connected with the employer include any UK or overseas group company, any corporate shareholder with at least one third of the share of voting rights, and any directors of such entities.

The Regulator may currently issue contribution notices only where, in the reasonable opinion of the Regulator, a main purpose of an act (or failure to act) was to prevent the employer's liability from becoming due or to reduce the amount of that liability. The contributions demanded can be substantial and are intended to be punitive.

As the reach of the Regulator's powers extends to the corporate group of the employer, ring-fencing pension liabilities within a group company and then compromising that pension liability does not escape the risk of a contribution notice. Consequently, if such ring-fencing is to occur, it will be necessary to obtain a 'clearance statement' from the Regulator that it will not use its powers, including its power to issue a contribution notice, in respect of the proposed restructuring. This clearance procedure is voluntary, yet the clearance statement is binding on the Regulator.

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ABOLITION OF 'GOOD FAITH' DEFENCE

Current legislation provides that the Regulator can issue a contribution notice only if the act (or failure to act) was carried out 'otherwise than in good faith'. The 2008 Act abolishes this defence; it will no longer be of value to show that the act was carried out in good faith.

This abolition is likely to have a significant impact for restructurings. No longer will the preservation of an entity's solvency or the concerns and rights of other creditors be a defence to the reduction of an employer's liability or the reduction of the company's assets. Directors may well face a conflict between having to negotiate on behalf of creditors as a whole and having to ensure that the employer's liability is not reduced. The fact that the negotiated transaction benefits all creditors and/or protects the business will no longer be relevant in the eyes of the Regulator.

THE 'MATERIAL DETRIMENT' TEST: A NEW FOCUS

The 2008 Act significantly expands the power of the Regulator to issue a contribution notice when an act (or a failure to act) has, in its opinion, detrimentally affected in a material way the likelihood of benefits being paid in full. A lack of intention to avoid or reduce an employer's liability, resulting from the intention to create an attractive rescue package to creditors, will be irrelevant. The mere fact that the restructuring results in a reduction of the employer's liabilities to the scheme, by means of a sale or winding-up of the employer or the transfer of assets from the employer and/or its wider group to creditors or third-party purchasers, will satisfy this test.

The Statutory Defence. The 2008 Act provides a statutory defence against contribution notices issued under the material detriment test. The defence is applicable if the Regulator is satisfied that:

1. the party gave prior due consideration (after making diligent enquiries) to the extent to which material detriment may arise;
2. in any case where it was considered that the act might cause material detriment, all reasonable steps were taken to eliminate or minimise the potential detriment; and
3. having regard to all relevant circumstances, it was reasonable to conclude that material detriment would not then arise.

In practice, financial due diligence by a professional may well provide this defence. However, given that restructuring transactions often work to an extremely tight timescale, obtaining such due diligence is unlikely to be a viable option.

THE CLEARANCE PROCEDURE

The clearance procedure will continue to be applicable to contribution notices issued under the new material detriment test.

TIMETABLE FOR THE CHANGES

The main provisions of the 2008 Act, including the abolition of the good faith defence, came into force on 26 November 2008. However, the new material detriment test will not come into force until the Regulator publishes a code of practice in relation to the test. This will be a statutory code of practice detailing the circumstances when the Regulator expects to use its powers under this new test. It is expected that this new test will come into force in summer 2009.

Retrospective Effect. Once the new test is in force, the Regulator will be able to issue contribution notices under the material detriment test in respect of any act from 14 April 2008, the date on which the amendments were proposed. The removal of the good faith defence also has retrospective effect in respect of acts occurring on or after that date.

CONSEQUENCES

The introduction of a fact-based assessment, coupled with the removal of the good faith defence, will increase the risk of a contribution notice being issued to entities involved in a range of restructuring or insolvency events where there is a defined benefit pension scheme. A failure to consider the impact of a transaction or a misinterpretation of the effect of a transaction will be of no relevance. Nor will an argument

of good faith based upon ensuring the future sustainability of a business or the need to reach agreement with priority creditors. As such, the 2008 Act significantly increases the range of circumstances in which clearance should be sought before the restructuring or insolvency event takes place.

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