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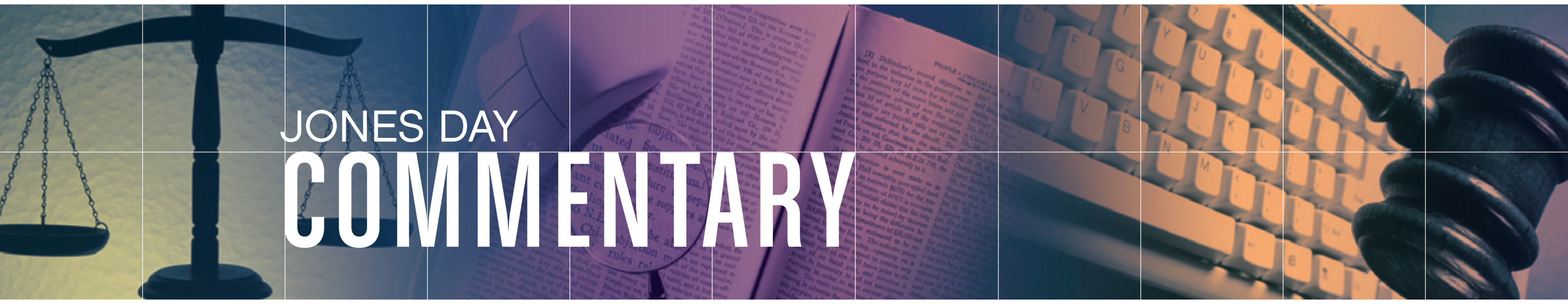

THE EXTENSION OF THE PENSIONS TRAP: NEW CONCERNS FOR PRIVATE EQUITY INVESTORS

The Pensions Act 2008 (the "2008 Act") received Royal Assent on 26 November 2008. The 2008 Act will significantly extend the powers of the Pensions Regulator (the "Regulator") to issue contribution notices to entities and individuals connected with a defined benefit pension scheme. This will increase the Regulator's ability to require people and businesses that are not directly responsible for pension schemes to pay for them.

This *Commentary* briefly summarises the current position and highlights the features of the new legislation that are of importance to the private equity industry.

THE PRESENT LAW

Under the Pensions Act 2004 (the "2004 Act"), the Regulator has the ability to issue a contribution notice to all parties associated or connected with an employer of a defined benefit pension scheme, demanding that they contribute an amount decided by the Regulator to that scheme. Associated or connected parties in this context include other group companies, any shareholder with at least a one-third shareholding or with significant control exercised through special investor rights (such as a significant private equity investor) and any employer of a director of the employing company (such as a manager of private equity funds which appoints a special director to an investee company's board).

At present the Regulator may issue contribution notices only to a person who was a party to (or associated or connected with such party) an act (or failure to act) that occurred on or after 27 April 2004 where, in the reasonable opinion of the Regulator, a main purpose of that act (or failure to act) was to prevent or reduce the recovery of, or the amount of, any debt payable by the employer to the scheme. The payments that may be demanded under a contribution notice can be substantial and are intended to be punitive. The Regulator has the ability to issue a contribution notice up to six years after the act (or failure to act).

When the 2004 Act came into force in 2005, there was particular concern amongst private equity investors that, having "deeper pockets" than some other investors, their funds might be particularly vulnerable to attack.

In late 2008 private equity investor Duke Street Capital ("Duke Street") was forced by the Regulator to call in approximately £8 million from investors to reduce the pensions deficit of the Focus DIY fund, a fund of a business that it had sold over a year previously. Duke Street was approached in its capacity as the only vendor of the business whose interest exceeded one-third before the sale. The action taken by the Regulator was in the context of potentially issuing a contribution or financial support direction and indicates the Regulator's willingness to exercise its substantial powers over private equity firms.

The risk of a contribution notice may be extinguished by obtaining a clearance statement from the Regulator. Clearance is a voluntary process that allows employers and others to obtain a statement from the Regulator that it will not use its powers in relation to a particular event. Once given, the clearance statement is binding on the Regulator, providing that the information provided to the Regulator is not materially different from the actual circumstances of the case.

THE "MATERIAL DETRIMENT" TEST: NEW FOCUS ON EFFECT, NOT PURPOSE

Under the 2004 Act, to conclude reasonably that a "main purpose" of the act (or failure to act) was to reduce or remove the liability of an employer to the scheme, the Regulator necessarily had to establish the likely intent and objectives of those involved. Private equity investors could take comfort in the analysis that their intentions rarely took into account the position of the pension scheme.

However, the 2008 Act expands the power of the Regulator to issue a contribution notice, enabling it to assess a transaction without having to look at the intentions of the parties. The Regulator will be able 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 accrued scheme benefits being paid in full. Thus, private equity investors may be at risk of a contribution notice despite a lack of intention to avoid or reduce an employer's liabilities towards the scheme.

THE STATUTORY DEFENCE

The 2008 Act provides a statutory defence against contribution notices issued on the basis of the material detriment test. The defence is applicable if the Regulator is satisfied that:

1. the party concerned 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, to avoid the need for clearance. However, because all three tests must be met, if there is any suggestion in the due diligence that there is a risk of a material detriment, then the test will not have been met, and clearance will be the only remaining option.

TIMETABLE FOR THE CHANGES

The provisions of the 2008 Act establishing 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 for the circumstances when the Regulator expects to use its powers under this new test.

However, once in force, the Regulator will be able to issue contribution notices on the new basis in respect of any act from 14 April 2008, the date on which the amendments were first proposed, so it is important to consider these issues on transactions before the amended rules are brought into force.

CONSEQUENCES

This extension of the Regulator's powers will leave private equity investors more vulnerable to a contribution notice, leaving their investments at increased risk of attack. The new statutory defence is likely to be a time-consuming process, requiring professional assessment of the transaction. Consequently, the 2008 Act significantly increases the range of circumstances in which private equity investors should consider seeking clearance.

LAWYER CONTACTS

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