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BORROWERS WITH PENSION SCHEMES: RISKS AND ISSUES FOR LENDERS IN THE UNITED KINGDOM

Defined benefit pension schemes have become a crippling cost for many companies. This is especially true in the UK, where liability within those schemes and the powers of their trustees and of the UK Pensions Regulator to demand funding can cause issues for secured creditors of the company.

REPRIORITISING THE PENSIONS DEBT

The obligations of the borrower to its pension scheme are unsecured and, therefore, generally rank behind a secured creditor. However, whilst having stopped short of giving statutory priority on an insolvency to the pension scheme, Parliament over recent years has enacted legislation to give pension schemes a stronger position and, to some extent, reprioritise their rights with respect to other creditors. In particular, two changes have occurred:

Encouraging the Granting of Security to Pension Schemes. The triennial valuation of the pension scheme determines the amount of ongoing payments into the scheme required to make good any deficit and, since the UK Pensions Act 2004 (the "Act"), the trustees of the scheme must agree to the terms of any valuation. If they do not agree, then the Pensions Regulator (the "Regulator") can impose its own valuation and payment schedule. This gives the company substantially less power in deciding the repayments of the pension liability and, in particular, the Regulator encourages the trustees to look for additional security in order to keep the payments low.

As a result, many companies are seeking to provide either parent company guarantees or charges over assets to the pension scheme. This would not override any existing obligations to a secured creditor, but the borrower is often under pressure to renegotiate with the secured creditor in order to provide charges to the pension scheme. Historically, trustees have received second-ranking security, but they are putting increased pressure on companies to give first-ranking security on specific assets. Granting security also reduces the size of the

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Pension Protection Fund levy which, being an annual tax on pension schemes, can often run into six or seven figure sums, which may lead lenders to agree to give trustees first ranking security on some assets in certain circumstances.

The Reach of the Regulator. The Regulator was also established by the Act and was given powers to demand, again as an unsecured debt, payments into the pension scheme in certain circumstances from associated and connected parties of a pension scheme employer. "Associated" and "connected" are defined in the Insolvency Act 1986 and include directors of the company and significant shareholders. The obligation to make payment to the pension scheme, particularly on the part of directors, has had a very significant effect on the attitude of companies towards the pension scheme. In particular, they are discouraged in financially difficult times from paying liabilities to any other creditors, including secured creditors, when no payment is being made to the pension scheme. This can extend to interest and scheduled repayments, as well as prepayments, of loans when companies are unable to make due payments to the pension scheme because of cash-flow issues. As a result, directors of companies with defined benefit pension schemes are increasingly unwilling to make any due payments when approaching insolvency and find protective filings for administration more attractive.

ACTION OF THE PENSIONS REGULATOR AGAINST LENDERS

In general, the Regulator's powers to extend the liability beyond the company that has the pension scheme do not extend to creditors. However, the definition of "associate" which is used in the Act relates to any party that has "control" over the company with the pension scheme or over its group of companies. A creditor that exercises power over and management of a company may find itself to be an associate for these purposes. In particular, upon the occurrence of a default, a lender may be able to make or veto managerial decisions. Furthermore, a creditor which takes equity either by appropriation of the company's shares or by some form of debt for equity swap may find itself to be a shareholder which has "control" (generally held to be a shareholding of one-third or more of voting shares).

In these circumstances, the creditor itself may be at risk of claims by the Regulator. The Regulator may issue a contribution notice demanding immediate payment in circumstances where an action has been taken which has reduced the security of the pension scheme as a creditor or where it is intended that the action should reduce the amount payable to the pension scheme or its chances of being paid. The Regulator may issue a financial support direction demanding that some financial security be given to the pension scheme where the company with the scheme is "insufficiently resourced" for its pension liabilities and it is reasonable to issue a direction. The legislation is still young, and the Regulator has yet to take this final sanction against any lender, but the actions of lenders to protect their own position may inevitably lead to a reduced security for unsecured creditors such as the pension scheme, and the Regulator has proved itself keen to engage with any party who has some control and the financial strength to assist the pension scheme funding.

The legislation does not make the process of issuing a financial support direction or a contribution notice a quick one, and the Regulator generally uses the process to engage with the relevant parties in an attempt to gain assistance and, where necessary, payment in order to avoid the use of its powers. Early engagement with the Regulator to discuss any concerns either it or the trustees of the pension scheme may have generally keeps any costs or demands to a minimum.

DEALING EFFECTIVELY WITH THE PENSION RISK

The increased cost and demands of a defined benefit pension scheme on a borrower should not prevent secured creditors from providing financing to such companies. A degree of caution, however, is needed. In particular:

- Due diligence should establish the funding level of the pension scheme. An analysis of the present demands and likely future demands of the pension scheme should indicate the effect of the pension scheme on cash flow. In particular, the accounting assessment of the pension deficit is much less representative than an analysis of the funding valuation and present asset and liability levels.

- If any requests are received to release security so that charges can be given to the pension scheme, it should be borne in mind that these charges are expected to be long term, often for the period of life of the pension scheme.
- If the creditor itself is likely to become an associated party and vulnerable to attack by the Regulator, it is well to approach the trustees and the Regulator early to ensure that they have no intention to take action against the creditor. The Regulator will grant clearance in certain circumstances which then precludes it from taking action until circumstances change.
- Given that enforcing share security may result in a creditor being at risk of claims from the Regulator, lenders may wish to push for asset security in addition to share security.

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