The Actuarial Profession
making financial sense of the future

Pitfalls and Current Issues in Employer Covenants

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Agenda

Pitfalls and current issues in employer covenant assessments :

- Who can you count on?
- Who else may have a prior claim?
- Group issues? relationships, banking, facilities and trading
- Is your scheme 'in a box'? Isolation and practical abandonment

(A) Who can you count on?

Only those strictly liable in law – those adhered to the Scheme in relation to their own liabilities and the Scheme Sponsor. Do not rely upon:

- The Parent Company, the Sister Company or more generally the 'Group', unless they sign up to a water tight legal guarantee
- The Participating employer that is not a subsidiary of the Sponsor, unless they are irrevocably bound to the Scheme (as it can make a withdrawal payment and 'walk away')

(A) Who can you count on?

Kind words don't pay bills. Much to the surprise of many trustees and employees, warm words of group support are not 'bankable'. Such assurances :

- Generally *do not* support a less conservative set of technical provisions
- *Do not* constitute a 'facilities agreement' guaranteeing cash for on-going (or deficit reduction) contributions
- *Cannot* be relied upon if the Sponsor becomes insolvent

Group support is only meaningful if it translates into cash support and assistance *and* can be relied upon to continue …

(A) Who can you count on?

Weakly adhered companies may walk away if pension liabilities become onerous. For example, consider :

- Group with two sides to its corporate structure
- Scheme sponsor in one leg, *not* the “TopCo”
- Companies in both ‘halves’ of the group participating in the Scheme, but on ‘one side’ the liabilities and number of participating employees very much less than the businesses’ value

Result – one side of the group can shield itself from the majority of pension liabilities by withdrawing from the Scheme, those companies can walk away

Questions?

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(B) Who else may have a prior claim?

External financiers of the Sponsor, but also asset based lenders and other Pension Schemes.
Be particularly careful with:

- Group banking facilities (often multi jurisdictional, reaching through corporate veils, but can be pure UK)
- Other pension schemes and employees generally
- Assets on finance (operating or finance lease)
- Assets potentially subject to retention of title / walking possession / charging orders
- Assets subject to environmental legislation
- Assets outside the UK

(B) Who else may have a prior claim?

Group banking facilities can be a curse as well as a blessing. For example:

- UK Group with non UK Parent
- Multi-jurisdictional group banking facilities
- Facilities secured over the UK assets (as usual)
- UK Group exposed to the vagaries of financial performance of the world wide group
- UK credit rating and banking costs linked to wider Group's adverse fortunes
- Covenant weakened by Group influence

(B) Who else may have a prior claim?

Other pension schemes sometimes may have a prior claim (even if they don't, those schemes compete for the sponsor's resources). For example:

- Where another Scheme is sponsored by a subsidiary, the other Scheme will have a prior claim on the subsidiary's cash resources (and assets on insolvency)
- Schemes with the same sponsor will inevitably compete for the same cash resources (unless the aggregate pension schemes' contribution needs are much smaller than the sponsors' cashflow)
- Funding agreements between a pension scheme and the sponsor may give priority / advantage to one scheme over another

(B) Who else may have a prior claim?

Assets on finance offer no security and the rentals *must be paid.* This is a 'double hit' :

- Prior to insolvency, when a sponsor is in trouble, it must pay its rentals before contributions, or risk having key resources re-possessed
- On insolvency, there is no value to be shared amongst unsecured creditors (such as the scheme), the lessor takes all of the value in the leased asset
- Worse still, if there is a shortfall when the asset is repossessed, the shortfall is an unsecured creditor and ranks equally against the Scheme

(B) Who else may have a prior claim?

Assets subject to retention of title / walking possession also offer no security. Once again this is a 'double hit' :

- On insolvency, if legally binding at that time, there is no value in these assets available to unsecured creditors (such as the scheme)
- Where retention of title is proven the supplier simply takes back the assets. In walking possession, the business is treated as no longer owning the seized goods and the proceeds belong to the distrainor (even if sold by a liquidator)
- Once again, if there is a shortfall when the assets are repossessed, the shortfall is an unsecured creditor and ranks equally against the Scheme

(B) Who else may have a prior claim?

Assets subject to environmental legislation have a legal, or de facto, priority over unsecured creditors. For example :

- Contaminated land must either be remediated or sold at a value impaired by the contamination
- Whilst a sponsor may hold a provision in its accounts for such remediation, the provision acts as if it was a priority creditor (the remediation costs do not share in the insolvency losses)
- Similarly, assets subject to decommissioning legislation (oil rigs, pipelines etc) will be sold on insolvency *with* the burden of the de-commissioning
- Again, any decommissioning provision acts as if it was a priority creditor

(B) Who else may have a prior claim?

Assets outside the UK may be subject to local or international rules allowing set off of other liabilities, whether or not these are explicitly recognised in the UK accounts as having priority. For example :

- Tax obligations may adhere / attach to land or other property
- Workers in overseas jurisdictions are often in a privileged position on insolvency
- Crew claims for wages (etc) on ships and other vessels take priority
- The costs of realising non UK assets, which will inevitably be met out of the realisation proceeds

Questions?

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(C) Group issues : relationships, banking facilities and trading

The Sponsor may be strong but it can be fundamentally undermined by its Group. Problem areas include:

- Reliance on the group for raw materials, services, distribution, sales or management (or contracts with 3rd parties held in common)
- Group banking and facility arrangements : overdrafts, guarantees, undertakings (for duty, VAT etc), credit insurance
- Significant inter-company balances (amounts receivable or borrowed)

(C) Group issues : relationships, banking facilities and trading

A sponsor that is heavily dependent on its group may be condemned to fail if its group gets into difficulty:

- Suppliers may refuse to supply goods / services if the Group, or part of it, gets into difficulty (this includes credit downgrades)
- Operational failures (sales / distribution) may undermine perfectly good UK manufacturing operations
- Management attention diverted to other issues may take their eye off the ‘UK ball’ with disastrous consequences for a UK sponsor
- If a brand is tarnished and customer goodwill is lost, it may be impossible to recover the position

(C) Group issues : relationships, banking facilities and trading

A sponsor that is heavily dependent on its group may be condemned to fail if the group gets into difficulty:

- Working capital may become perilously tight in the UK (for example due to losses overseas), as the working capital is ‘joint’
- The struggle to meet banking covenants may lead to asset sales and to decisions that are not in the long term interests of the Sponsor
- The Group’s impaired credit may prevent the Sponsor from maintaining guarantees or undertakings critical to its business. Borrowings from the Group can become expensive (as often linked to Group rates of interest)

Questions?

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(D) Is your scheme 'in a box'? Isolation and practical abandonment

A scheme can be on the path to abandonment long before it is abandoned. Problem circumstances:

- Sale of one or more of the Sponsor's businesses (or a substantial part of them) and/or cessation of accrual
- Moves away from owning assets in favour of leasing assets and 3rd party ownership arrangements (eg consignment stock or stocking plans)
- Resistance to group guarantees / undertakings despite presence of group banking facilities (or significant inter-company balances)
- Significant loans to the group and/or large dividends and/or de-merger of the principal assets / businesses

(D) Is your scheme ‘in a box’? Isolation and practical abandonment

Sale of the Sponsor’s business (or some material part of it) exchanges future cashflow for a present cash sum and often, in practice, *undermines the covenant*, unless:

- the part of the contributions which would have funded on-going or deficit reduction contributions is retained *and* invested in a manner that generates cash to fund Scheme contributions

Sale of a business for market value does not, of itself, undermine a Sponsor’s covenant: provided that the cash generated is put to a ‘standard commercial purpose’, ie is <u>not</u>:

- used to pay off other unsecured creditors (for example group borrowings), or otherwise paid out by way of ‘management charges’ or bonus payments
- loaned to other companies / individuals at interest rates below those reflecting the risk attached, or loaned to companies / individuals which, in practice, may not be able to repay the capital loaned

(D) Is your scheme ‘in a box’? Isolation and practical abandonment

Cessation of accrual and sale of a sponsor’s business are a troublesome combination. Particularly so if:

- The vast majority of the members cease accrual on sale
- The residual business of the sponsor is much smaller than the business sold, or has weak prospects

The ‘problem’ is that the Sponsor’s residual business no longer has any scheme members and there is no commercial imperative for it to support the pension Scheme. It may be tempting to:

- Take out the proceeds of the business sale (by dividend or loan or management charges); and
- Leave the Scheme attached to a weak residual business
- Over time the Scheme’s deficit may ‘overpower’ a weak residual business, leading to Scheme failure (but by then the funds which ought to have supported the Scheme are long gone).

(D) Is your scheme 'in a box'? Isolation and practical abandonment

Moves in favour of leasing and 3rd party ownership arrangements create 'asset light' Sponsors (offering little to a Scheme on insolvency). Typical signs of potential trouble:

- Sale and leaseback of land and buildings, or plant; and/or
- Replacement of assets using finance or operating leases; and/or
- Sale of part of a Sponsor's business (described at the time as a 'focus strategy', divesting 'non core assets'); and
- the decision *not* to reinvest the proceeds within the same corporate entity, using the cash generated to deal with losses or to invest elsewhere

Such transactions have the effect of draining liquidity and undermining scheme security (as assets potentially providing security on insolvency will have been sold and the proceeds transferred elsewhere)

(D) Is your scheme ‘in a box’? Isolation and practical abandonment

Where there are significant group arrangements, the separate legal identity of a Sponsor may become ‘diluted’, putting the Scheme at a disadvantage, because:

- cash can pass unfettered, back and forth between a Sponsor and related parties. Standalone operation of the Sponsor’s business may be impossible operationally, managerially or strategically.
- resources, expertise, know how, intellectual property and cash readily flow between the Sponsor and its Group, but the Scheme liabilities are ‘stuck’ - attached only to the Sponsor

In such circumstances, resistance to a Group guarantee amounts to the Group wanting to “have its cake and eat it”, namely:

- working around and being unimpeded by the separate limited liability status of the sponsor most of the time;
- *except* when the separate legal personality limits recourse of a Scheme to wider Group resources

(D) Is your scheme ‘in a box’? Isolation and practical abandonment

For a pension Scheme at risk of abandonment, any payment of cash by a Sponsor to a related party is potentially risky - in practice, such transactions either *intrinsically* give nothing in return, or often are not on arms length terms. For example:

- Significant dividends, a return of capital, or de-merger of a sponsor’s principal (or more promising) business puts assets beyond the reach of the Scheme (these transactions ‘give nothing in return’)
- Repayment of unsecured parent company/shareholder/related party borrowings, which reduces the capital employed in the Sponsor - gives priority to those repaid
- Unsecured lending to the parent company/ shareholder/related parties at sub-market interest rates, or with questionable security of repayment – this transfers value out of the Sponsor

(D) Is your scheme 'in a box'? Isolation and practical abandonment

Whilst the Pensions Act 2004 contains provides the Pensions Regulator with powers to address 'liability avoidance', Trustees and advisers must be alert, because:

- the Trustees have the primary duty of care, not the Regulator
- advisers have a whistle-blowing obligation to the Regulator
- it is far more difficult to rectify abandonment after it has happened than to deal with it at the time
- there is a commercial imperative for some companies to seek to avoid or limit their Scheme obligations
- where there is a commercial imperative, ways will be found to seek to circumvent Scheme obligations
- the Regulator's powers have not yet been tested in the Courts

Questions?

Notes

Legal reliance

PKF(UK)LLP is a limited liability partnership registered in England and Wales with registered number OC310487. A list of members' names is open to inspection at Farringdon Place, 20 Farringdon Road, London EC1M 3AP

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