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More questions than answers?

How might the new Corporate Insolvency and Governance legislation affect Defined Benefit pension schemes?

Introduction

The Corporate Insolvency and Governance Act 2020 (the "Act") came into force on 26 June 2020. The bill was published on 20 May 2020 and passed through Parliament in record time. It initially passed through the House of Commons without amendment but received a far more critical hearing in the House of Lords as part of a wider debate in the insolvency practice. A number of Lords raised concerns as to the potential effect on DB schemes and the lack of a role for the Pension Protection Fund (the "PPF") or the Pensions Regulator ("TPR"). The Lords proposed a significant number of amendments, which were gradually reduced to a small number supported by the Government and approved by the Lords. These amendments are now reflected in the Act.

The Act brings the most significant change to UK restructuring and insolvency practice since the Enterprise Act of 2003. If trustees are involved with an employer that may need to undergo some form of restructuring, they will need to get up to speed quickly on the changes and their potential to impact the scheme.

The purpose of the Act is to provide relief to companies in these unprecedented times during and in the aftermath of the pandemic. It combines a temporary relaxation of some insolvency laws to provide companies with breathing space during lockdown, with the introduction of new restructuring tools to help companies to restructure and avoid insolvency. The temporary changes provide for the suspension of wrongful trading and the use by creditors of statutory demands and winding-up petitions against Covid-19 affected companies from the beginning of March to 30 September 2020. The permanent changes see the introduction of a "debtor-in-possession" moratorium (where directors remain in place with limited supervision by an insolvency practitioner as monitor) and a new restructuring plan, intended to make it easier to deliver restructuring plans and more difficult for hold-out classes of creditors to block such plans. These permanent changes have been mooted for a while as the Government has sought to improve the rescue culture in the UK with a move toward a more debtor-friendly Chapter 11 style regime.

At this stage, the Act raises as many questions as it answers for stakeholders such as pension schemes. The Act has come out in record time in response to the pandemic and so inevitably there will be wrinkles to iron-out (and the Act includes plenty of scope for secondary legislation to clarify and extend its provisions). The initial bill apparently allowed all bank and other financial services debt to be accelerated in a moratorium and then to enjoy super priority status in a subsequent insolvency process, which would have had a significant impact on other creditors including DB schemes. However, amendments reflected in the Act have removed the super priority status. More issues may still be clarified by the use of regulations and "Henry VIII" powers (allowing the Government to make changes without recourse to Parliament) provided in the Act, but others will need to be resolved by the courts once the new procedures first come into use.

Pension schemes are often a significant (if not the largest single) creditor in a restructuring and as such trustees should be prepared for the changes brought by the Act. Should trustees be worried that they will be locked-out by the temporary suspension of insolvency laws or can they take a longer term view given the long term nature of pension liabilities? Will trustees find the new restructuring plan being used to bind schemes into new arrangements or will companies be looking to trustees to help vote through new arrangements affecting other creditors? Will trustees find they have more or less say and influence? Perhaps trustees can take comfort from the stated aim behind the Act, which is to allow the rescue of companies (their sponsoring employers) and not to act as a precursor to an insolvency, or should they be concerned that the Act provides more opportunity for companies to avoid or replace/reduce their obligations to the scheme?

This note asks some of the questions arising from the Act that will be of importance to trustees and provides comment and answers where possible.

DB schemes and insolvency currently: an overview

Prior to the sponsor entering an insolvency process, a scheme's principal creditor claims are in respect of any unpaid contributions or expenses (to the extent that the sponsor has agreed to meet these). The level and timing of contributions is set periodically at actuarial valuations – and it is usually not possible for trustees unilaterally to "create" increased contribution obligations between actuarial valuations. In addition to the general body of creditor protection legislation, creditor protection mechanisms for schemes prior to any insolvency will principally take the form of contractual arrangements (such as negative pledges or asset security), or protection via the various "moral hazard" provisions of the Pensions Act 2004.

At the point of sponsor insolvency, the position changes: first, the creditor claim of the scheme becomes the "Section 75" debt – typically, a very much larger amount than any deficit calculated on a "Technical Provisions" or "ongoing" basis. Second, upon a "qualifying insolvency event" a scheme enters an assessment period with the PPF whereby the PPF evaluates, broadly, whether the scheme should enter the PPF as a "lifeboat" arrangement, with the PPF providing members with benefits based on its specific and capped terms. At this point, the role of creditor in respect of the scheme in the insolvency process passes to the PPF and, in that capacity, the PPF votes as a creditor.

In some circumstances, a sponsor may leave an insolvency process with the full pension scheme obligations still attached to it and the scheme can be "rescued" – with the PPF approving a Withdrawal Notice. Alternatively, there may be restructuring options through the use of an insolvency process such as under Regulated Apportionment Arrangements ("RAAs") - whereby a scheme can be separated from its employer, and enter the PPF, resulting in the employer being able to continue to trade without needing to meet its ongoing obligations to the scheme. RAAs are relatively rare, very tightly governed and require TPR clearance and PPF approval, as well as appropriate mitigation. Regulatory tests prior to RAAs being approved include – very broadly - tests about (1) the inevitability of insolvency absent the arrangement being put in place (2) the arrangement offering a materially better outcome than insolvency for the PPF as creditor and (3) equitable treatment for the scheme relative to other creditors of the sponsor.

Absent any specific security arrangements that they might have agreed, a scheme's trustees are unsecured creditors. However, whether secured or unsecured creditors, trustees will typically have a seat at the table when any restructuring is being considered in relation to the employer(s) that support the scheme. Sometimes this will be because their agreement is specifically required - (eg) in the case of an RAA or proposals which involve the trustees exercising specific powers. On other occasions, the spectre of employers and their associates being caught by the TPR's moral hazard powers will ensure that trustees are fully involved.

Whatever the reason for their involvement, the trustees' overriding duty in these circumstances, as always, is to act in the best interests of their beneficiaries, having regard to all relevant circumstances – which will include, as appropriate, the stance taken by TPR and/or the PPF. Assuming that there is no deliberate attempt to avoid scheme liabilities, members can expect to receive at least PPF level benefits - either because the scheme will enter the PPF or because the PPF and TPR, will help ensure that any restructuring will provide members with benefits above PPF levels.

Questions raised by the proposed new legislation

Building on the commentary above, the Act raises a number of questions around the position of DB schemes under the proposed moratorium, restructuring plan or related restructuring process.

These include – amongst others:

Question	Comment
During a moratorium, what happens to ongoing scheme funding and associated obligations – including deficit repair contributions, scheme expenses and payroll deductions? Do these continue to get paid?	Contributions for continuing accrual of active members to an occupational pension scheme under the terms of an employment contract are deemed to be wages and salary and should continue to be paid during a moratorium. These sums would also enjoy super priority in an administration or liquidation that takes place within 12 weeks of the moratorium. However, deficit repair contributions and scheme expenses do not appear to fall within this category and do not apparently fall into any of the other exceptions to the moratorium – in which case, the trustees will be unable to collect these payments during the period of the moratorium, enforce security or take any other enforcement action. A moratorium lasts for 20 business days initially, can be extended for a further 20 business days provided the directors/monitor consider a rescue is still likely and moratorium debts hae been paid and can be extended for further periods with creditor (including the trustees/PPF in respect of any outstanding amounts due to the scheme) or court consent or where a CVA is proposed.

Question	Comment
During a moratorium, are there restrictions to Trustee governance powers of the type which could be used to increase company liabilities – for example, to set scheme investment strategy?	None apparent: the moratorium relates to the conduct of the company not the trustees of the scheme. Whilst trustees could in theory make changes that increase liabilities, there will be no means to claim additional liabilities during a moratorium.
Does a moratorium or restructuring plan trigger a PPF assessment period – and is the scheme's debt calculated on a Section 75 basis?	No: a restructuring plan is a Companies Act procedure (like a scheme of arrangement) which suggests it is not intended as a qualifying insolvency event to trigger a PPF assessment period. The court does, however, have wide powers to determine the voting rights of creditors in a restructuring plan, so it remains to be seen how a pension debt will be determined for these purposes. Although a moratorium is an Insolvency Act procedure, its stated aim is to rescue a company as a going concern and not to lead to an insolvency event. The fact that a restructuring plan and moratorium are not "qualifying insolvency events" was debated in the House of Lords and apparently accepted. If a moratorium is a precursor to a CVA, then the CVA itself will trigger a PPF assessment period. However, trustees should check scheme rules to establish whether either a moratorium or restructuring plan will trigger a winding up of the scheme. Also, trustees should consider whether the inability to collect deficit repair contributions during a moratorium may have consequences under any security arrangements that they may hold.
What class of creditor would a scheme form part of for voting and other purposes? Who would represent the scheme's interests?	Criteria for class assessments have not yet been stipulated but are anticipated to be in line with class composition for schemes of arrangement. Unless a scheme has security it would as a minimum continue to be an unsecured creditor. The Act provided powers for the Secretary of State to transfer the creditor rights of trustees' or managers' (in respect of an eligible scheme for the purposes of s126 Pensions Act 2004) to the PPF and The Pension Protection Fund (Moratorium and Arrangements and Reconstructions for Companies in Financial Difficulty) Regulations 2020 duly came into force on 7 July 2020 (the 'Regulations'). The Regulations provide that the PPF may exercise the rights of trustees/managers as creditors in a moratorium in voting for an extension or challenging actions of the directors at court and also that the PPF may exercise the rights of trustees/managers in relation to a restructuring plan (in addition to the trustees but to the exclusion of the trustees in relation to voting on a restructuring plan). Where the PPF use these rights they must first consult with the trustees/managers.
How would any compromise or "cram-down" arrangements affect a scheme? Could they go so far as to affect the basis of the scheme – including benefit arrangements?	The nature of liabilities which could be the subject of compromise or cram-down is unclear at present, though it seems to be deliberately unprescriptive as to the nature of an arrangement or timeframe for an arrangement to allow companies to be flexible in their approach whilst relying on the discretion of the court to approve. It is difficult to see how the overall obligations of a scheme to its members could be fundamentally altered (not least on account of TPRs powers and the court involvement). However, it is conceivable that short term funding accommodations could be an ingredient of any compromise arrangement (such as by reducing DRCs and pushing them out of a longer period) and where trustees could be out-voted by members of the same class or crammed-down by other classes of creditors.
What will the role of trustees, the PPF and TPR be at various points in any process?	The key amendments to the original draft of the bill reflected in the Act, provide for the PPF and TPR to receive the same notification and information as the trustees and other creditors where there is an eligible scheme (under s126 Pensions Act 2004) i.e. at the start of a moratorium, an extension or termination of a moratorium or proposing a Restructuring Plan. The amendments also allow the PPF and TPR to make representations at relevant court hearings and to have the same rights of challenge to the actions of monitors and directors enjoyed by other creditors. One proposed amendment to require PPF/TPR consent to the court-approved disposal of any asset pledged to a scheme, was rejected. The trustees will vote on behalf of the scheme unless the PPF exercises its rights under the Regulations to take over any of those rights (or to exercise those rights alongside the trustees). Trustees should therefore insist on being as informed and involved as possible and keep in communication with the PPF so everyone is clear who is taking the lead. Given the current approach of TPR it is difficult to envisage a situation where they and the PPF are not keen to be involved alongside the trustees at an early stage even if the PPF assessment period has not yet been triggered.

Question	Comment
Will this proposed legislation override the various moral hazard protections in the Pensions Act 2004 (and those in the current Pension Schemes Bill) – leaving trustees and TPR powerless to seek mitigation or other redress?	The interaction between these legislative frameworks is unclear at this stage: as drafted, the Act does not override the Pensions Act 2004. However, the Pension Schemes Bill is also still progressing through Parliament and it remains to be seen whether anything will be done to clarify the relationship between the new insolvency and moral hazard provisions. This point was flagged in the House of Lords debate, so at least it is on the radar of the legislature.

Actions for Trustees

Particular issues for trustees include the potential impact of the Act on any security arrangements and the possibility that a restructuring may not properly take account of the pension scheme.

The trustees can mitigate their risks by:

- Being sure to keep up to speed with the development and use of the changes brought in by the Act and the evolving answers to the questions that we pose above.
- Reviewing scheme rules and any existing security arrangements to understand the potential impact of the suspension, during moratorium, of deficit repair contributions and/or the impact of a restructuring - for example, whether a scheme wind up might be triggered, whether rights under security arrangements will be prejudiced if triggered under moratorium and not exercised. Are there any special protections for members under scheme rules that might come into play?
- Ensuring that they are kept up to date with information about the company's financial performance. This may require a greater degree of persistence or insistence from the trustees to get agreement from the company to provide different and/or more frequent information and the trustees may need to agree new confidentiality obligations as a quid pro quo.
- Getting the company to agree, where possible, to consult the trustees at an early stage in relation to any moratorium or restructuring plans/proposals. This could be part of the "ask" from trustees if agreeing any security or contingent asset arrangements in future. Where the trustees are an unsecured creditor, this might be best achieved through an amended relationship agreement.
- Seeking timely advice from legal and covenant advisers.
- Engaging with the PPF and TPR at an early stage.

The anticipated wave of restructurings and insolvencies following lockdown in combination with the proposed new legislation to tackle them mean that trustees should be alert and making appropriate preparations. Whilst many unanswered questions on the impact of the new legislation remain, this is likely to evolve rapidly.

Any questions? Get in touch

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