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Panacea or empty promise?

Understanding the value and pitfalls of contingent assets supporting DB pension schemes

September 2023

Introduction

The use of various forms of contingent assets to support UK Defined Benefit ("DB") pension schemes continues to evolve – particularly as a growing number of schemes plan for their "endgames."

Whether to support a valuation funding plan; provide mitigation for covenant detriment; or – increasingly – help support a glidepath to a scheme "endgame", the use of structures such as guarantees, asset security, escrow accounts and other forms of collateral has featured in the toolkit of some trustees, sponsors and their advisers for years. Given sponsors' desire to avoid "trapped surpluses" their use may increase over time.

Sometimes these various instruments are used on a stand-alone basis; at other times, they may form part of a funding (and likely covenant) package. Sometimes they are put in place to provide a stopgap, pending some form of longer-term agreement; alternatively, they can be "evergreen" and form part of the structural framework supporting the scheme. Some – such as various forms of Asset Backed Contribution ("ABC") structures – can verge on the exotic given the nature of some of the assets historically used to collateralise schemes under these arrangements.

Importantly, whilst these various mechanisms can provide very considerable levels of support for schemes, they can also have pitfalls which may catch the unwary. Trustees and sponsors must be alive to such technical and commercial matters when considering these mechanisms against a simpler, but less flexible, cash arrangement that is typically the "default" alternative.

For example, an ostensibly all-encompassing guarantee may be of limited practical benefit if it is difficult (though only rarely legally impossible) to enforce; or subject to legal limitations by reference to the guarantor's corporate purpose (this can often be the case in, for example, Europe). Alternatively, the guarantee may be time-limited such that it falls away before it is actually called; be insufficiently flexible to deal with the implications of certain forms of corporate activity; or be of only limited value when it is actually called upon given the then financial position of the guarantor. The value of asset security can be heavily susceptible to fluctuations in underlying market value and therefore, the scheme may recover significantly less under its asset security compared to original expectations.

Against this backcloth, this paper critically evaluates different types of contingent assets from both core commercial and legal perspectives – highlighting both their benefits and how and when they can be used; and potential weaknesses or problems which can lead to unfortunate surprises.

The paper does not pretend to be exhaustive – and emphasises the crucial need for specialist legal, financial and actuarial advice when considering the nature and implications of contingent assets.

Order of this paper

Overview

As a precursor to exploring the nature and use of different contingent asset types, this paper summarises the legal and regulatory frameworks governing their use within the UK DB scheme funding regime.

It then evaluates and comments on:

1. Guarantees
2. Asset security
3. Bank guarantees and Letters of Credit
4. Surety bonds
5. Escrow accounts and similar "holding" structures
6. Contingent funding arrangements

Examples are used throughout to "bring alive" the key points.

A case study – using the fictitious Planetconserve Pension Scheme – is set out towards the end of the paper to illustrate a range of the points arising.

Finally, the paper sets out its conclusions.

Interaction with other creditor obligations

Where sponsor companies or groups have multi-creditor capital structures, it becomes particularly important for scheme trustees to be mindful of how any contingent assets in favour of a scheme rank alongside other sponsor obligations – and to be conscious of how to get a "seat at the table" should the sponsor or its group encounter financial difficulties.

Whilst this paper focusses on the value and operation of various individual contingent asset types, trustees should consider how best to ensure that a scheme's interests are appropriately reflected in, for example, inter-creditor agreements.

Clearly, the operation of other creditor obligations – such as cross-guarantees in favour of lending syndicates – may materially weaken the value recoverable under contingent assets in favour of schemes. In these circumstances, undertaking entity priority modelling ("EPM") may be helpful in forming a view around the value ascribed to a contingent asset by a scheme.

Legal and regulatory framework governing the use of contingent assets

The statutory provisions governing the funding of UK DB schemes are principally set out in the Pensions Act 2004 ("PA 2004"), as amended by subsequent legislation.

Background

Interestingly, PA 2004 does not define nor make reference to the "employer covenant" or contingent assets supporting schemes. Instead, these concepts were subsequently developed by the Pensions Regulator (itself formed under PA 2004) under its various codes of practice and supporting guidance related to funding and integrated risk management. Most notably, the concepts of contingent assets arise under Code of Practice 3: funding defined benefits and the detailed guidance 'Assessing and monitoring the employer covenant'[1].

In more recent years, we have also seen a focus from the Pensions Regulator on contingency planning in schemes and managing funding in situations with an employer in distress. The most recent update in this space, the Pensions Regulator's blog 'Protecting schemes from sponsoring employer distress'[2], considers the various options for security, guarantees and other contingent assets that trustees may consider as mitigation, for example in a situation where an employer has requested a reduction to the deficit repair contributions as part of a restructuring and turnaround plan, and how such contingent assets may impact the trustees' standing compared to other creditors on insolvency.

Ongoing legislative developments

The concepts of the employer covenant and contingent assets seem likely to become enshrined in forthcoming legislation as and when this is enacted. Regulation 7(2) of the Draft Occupational Pension Schemes (Funding and Investment Strategy and Amendment) Regulations 2023 in particular defines the strength of employer covenant as the financial ability of the employer to support the scheme together with the level of support that can be provided by any contingent assets, to the extent that these contingent assets are legally enforceable by the trustees or managers and sufficient to provide that support at the time it might be needed. Contingent assets for these purposes include guarantees from a parent company or a third party.
The corresponding Draft DB Funding Code of Practice expands on this, building on the comments in the existing Codes of Practice, to make explicit the link between the strength of employer covenant and contingent assets.

"Moral hazard" issues

The Pensions Regulator also has powers under the Pensions Act 2004, known as its "moral hazard" or anti-avoidance powers, to impose liabilities on persons (individuals and companies) who are "connected" or "associated" with an occupational scheme employer. Commentary on these powers is beyond the scope of this paper. However, it should be kept in mind that the potential exposure of group companies under these powers may have been one driving factor behind groups implementing contingent assets in the first place. Putting such arrangements in place (eg a group guarantee) might be relevant to whether the Pensions Regulator considers a connected or associated person has assumed a measure of responsibility to a scheme in terms of its assessment of whether it is "reasonable" to extend liability further to the group if necessary. Any deterioration in the level of wider contingent support, if offered by an associated party rather than the scheme employer itself, could be relevant to the Pensions Regulator's view of deterioration of the ability for scheme benefits and section 75 debts to be met, again in the wider context of its powers - but this is a complex and fact-specific area.

Contingent assets and the PPF

It is also worth noting the specific nuances of the term "contingent assets" in the context of the Pension Protection Fund ("PPF"). References to contingent assets in the PPF guidance[3] relate to specific types of assets, which the PPF will recognise for the purposes of its insolvency risk calculation and thereby reduce the levy payable by the scheme. The guidance on these assets is prescriptive, and requires these assets to be documented on particular terms and submitted to the PPF alongside specific supporting documentation (typically legal opinions and/or guarantor strength reports). The PPF's focus is on the specific area of assessing the availability of funds on insolvency within the period for which any levy reductions are granted. Such concerns overlap with, but are narrower than, the concerns of trustees and the Pensions Regulator around longer term funding. Unless specifically stated to the contrary, this paper considers contingent assets in the wider sense, rather than in this narrower PPF context.

[1] In particular, see section 4 on Improving Scheme Security which considers the value trustees can place on contingent assets

[2] As updated on 10 May 2023

[3] https://www.ppf.co.uk/levy-payers/what-are-contingent-assets

Guarantees

In simple terms, a guarantee is a legally-binding undertaking by one party to meet the existing and future obligations of another party to a third person subject to the terms and operation of the specific agreement.

Guarantees are regularly used as covenant support mechanisms for scheme funding; and as part of mitigation arrangements where corporate activity would otherwise lead to "material detriment" and/or one or more of the Pensions Regulator's anti-avoidance tests being engaged. They typically provide that a financially (in relative terms) strong group entity will stand as guarantor behind certain defined obligations of a scheme's statutory employer(s) upon the happening of one or more trigger events.

Whilst ostensibly simple and straightforward instruments – and potentially of very substantial value – in practice their value and operation can be subject to a range of definitional and enforceability issues.

First, just because a major group company appears financially strong does not mean that it can automatically provide an enforceable guarantee for a UK DB scheme.
Scheme guarantees may not be enforceable in a number of jurisdictions; and individual corporate constitutions may not permit the granting of guarantees in any event. It is vital that scheme legal advisers confirm both the enforceability of a guarantee and the capacity of the proposed guarantor to grant it. Linked to this is the question of whether the guarantee would be subject to the jurisdiction of English courts, which is generally the case; and whether such jurisdiction would be recognised and enforceable in the country where the guarantor is incorporated. We look at this further in the context of the provision of legal opinions below.

A second key issue is the determination of what is guaranteed (ie what liabilities of the statutory employer are covered by the guarantee) and when it can be called upon (ie what are the triggers for the payment of those liabilities by the guarantor).
A guarantee can be an "all monies" guarantee, covering all liabilities potentially payable by the statutory employer to the scheme which are not paid by the employer. Alternatively, it could just cover the payment of a Section 75 debt which may be payable on the insolvency of a statutory employer. It may be the case that a guarantee will only cover amounts due under an agreed Schedule of Contributions which remain unpaid by the statutory employer. This type of more limited coverage seems influential in the references to "look through" guarantees contained in the Pension Regulator's DB Funding Code consultation; and is explored further below.

Indeed, guarantees do not generally put cash into a scheme until the statutory employer defaults on an amount contractually due from it to the scheme. This can be as a result of the employer failing to make a payment by the time specified in the Schedule of Contributions or where the employer is unable to make a payment as a result, for example, of the employer becoming insolvent. Trustees also need to consider the period provided for in a guarantee to make a payment under it once they have given notice that a statutory employer has failed to make a payment (and whether it remains open to the statutory employer to make the payment).

Third, although guarantees – including under the PPF model form – may be "evergreen" (continuing until all guaranteed obligations have been met, unless all parties agree otherwise), many guarantees are time-limited which can have a material effect on the value which the trustees can place on the guarantee: put simply the guarantee may have expired when actually needed. By way of example, a guarantee which is assumed to be renewed periodically at each actuarial valuation (ie every three years) may be of little use to the scheme if (i) the time limit expires; and (ii) any default occurs subsequently. It can be the case that a short term guarantee can include provision for the parties to negotiate in good faith the terms of an appropriate replacement guarantee. However, as there is no binding obligation to enter into a replacement guarantee, this does call into question whether a guarantee with such a short term time limit should be taken into account by trustees for the purposes of, for example, setting assumptions for longer-term valuation purposes. Other time-limited guarantees also suffer from potential "cliff edge" effects – albeit that the longer their duration, the greater the chance that trustees may have to negotiate alternative support should the scheme face an unexpected under-funding risk prior to the expiry of the guarantee.

An additional consideration in terms of the time period for a guarantee can be whether there is a trigger for the guarantee to expire as a result of the trustees doing or not doing certain things. This can be something which a company could consider in order to provide it with a degree of leverage when entering into a guarantee. For example, appropriate triggers could be built into a wider funding agreement with the trustees such that if the trustees were to change investment strategy without the agreement of the company, the guarantee would fall away (acknowledging that the company could not stop the trustees taking any actions, as this would fetter the trustees' discretion, but that there could be consequences of it taking certain actions).

Fourth, many guarantees may have financial caps or only cover limited amounts – for example, the amounts which a statutory employer is liable to pay to the scheme under an agreed Schedule of Contributions: they may not be full "Section 75" guarantees which would fully fund the scheme to a buyout level upon employer insolvency. It is arguable that, if an employer was considered able to afford a Schedule of Contributions anyway, any additional strength from a guarantee simply covering this amount may be limited.

A variant on this which may be of greater value is a guarantee covering Schedules of Contributions periodically agreed from time to time – albeit that these still have certain of the limitations applying to "agreements to agree" generally in that a satisfactory Schedule of Contributions would need to be agreed at each valuation.

An additional point which may need to be considered is where there is more than one guarantee in relation to a scheme. For example, it may be the case that a PPF compliant guarantee is entered into providing coverage up to a certain level which is added to by a top-up guarantee (which does not need to comply with the requirements of the PPF model form). Where this is the case, it is necessary to ensure that it is understood how the two guarantees will interact when called upon.

Fifth, it is clearly important that the financial strength of any guarantor is carefully evaluated to ensure that it is likely to be able to meet its guaranteed obligations over the duration of the guarantee. A "Day 1" evaluation suggesting a guarantee may provide appropriate cover may rapidly become superseded with the passage of time. As set out below, this is recognised in the context of the PPF guarantee where, to take account of the possibility that such guarantees, which can result in material reductions to PPF levies, could have guarantors which could not meet their obligations, an annual certification of guarantor strength was introduced. A further consideration is not placing excessive store on guarantees where the guarantor grants multiple guarantees to a range of creditors – such as banks – thereby diluting its financial capacity to meet its guaranteed obligations on, for example, a group-wide insolvency; or where the guarantor is a group company substantially reliant upon other group companies which in turn seem susceptible to insolvency over the period of the guarantee.

Where it is the case that trustees have placed reliance on the strength of the guarantor, which can be both for scheme funding purposes or for the purposes of mitigating or evaluating material detriment to the financial covenant supporting the scheme, the trustees will want to ensure that they are aware of any potential weakening of the strength of the guarantor. This can be achieved by ensuring that the guarantor is aware of any appropriate representations it has made in the guarantee (these tend to be continuing representations covering such matters as the financial strength of the guarantor and compliance with banking facilities etc). In addition, the trustees can seek the same level of information sharing and notification requirements as would be placed on a statutory employer. Another point worth considering by the trustees is agreeing that where the current guarantor were to weaken beyond a particular point, it should be replaced by another group company with a stronger covenant or, if such a company is not available, the provision of additional support to the scheme.

Finally, trustees will want to be sure that any guarantee is enforceable. The concerns for the trustees will be twofold. First, that the corporate entity has the capacity and corporate authorisation to enter into the guarantee; and second, where relevant, that the guarantee will be enforceable in a jurisdiction outside the UK. Consequently, whilst it is not a legal requirement, it is usually the case that trustees will only enter into a guarantee where there is an appropriate legal opinion as to capacity and enforceability. This is also something which the Pensions Regulator advises trustees to do as it notes that there are likely to be particular legal issues where a contingent asset is located outside the UK and/or the agreement needs to be enforced outside the UK (noting that where there is a non-UK guarantor, whilst it is usually the case that the guarantee will be subject to the jurisdiction of English courts, there is still the question of the enforceability of any judgment in the jurisdiction of the guarantor). Given this, it is usually the case that trustees will require the company's legal advisers to provide legal opinions as to capacity and enforceability in a form which they are comfortable with.

None of the above limitations is intended to diminish the considerable value that, for example, a fully enforceable, evergreen "Section 75" guarantee from a substantial guarantor can offer a scheme.

"Look through" guarantees

In its DB Funding Code consultation document, the Pensions Regulator refers to "look through" guarantees as being a source of potential covenant strength. The DB Funding Code refers to "look through" guarantees as being guarantees which "provide an unfettered ability for trustees to claim against the guarantor in respect of all monies owed by the employer to the scheme and cannot be revoked without trustee agreement". The outcome of the consultation is awaited – but practitioners have expressed concern that one inference of the Pensions Regulator's comments is that they (the Pensions Regulator) may see limited value in other guarantees.

It appears that a "look through" guarantee should have the commercial effect of making the guarantor a "proxy employer" for scheme funding purposes: essentially, the intent for scheme funding purposes is that scheme trustees should be able to take account of the financial strength of the guarantor in any assessingment of contribution affordability and the appropriate duration of a recovery plan to meet a scheme's deficit under a schedule of contributions. – on the basis that the trustees can effectively access the guarantor's cash on an ongoing basis.

However, strictly, a "guarantee" as such only triggers upon failure of the primary obligor (ie the scheme employer) to meet a required payment first (eg under a schedule of contributions). Guarantees are traditionally not a direct obligation that trustees can enforce absent employer default. It may be that the Pensions Regulator envisages forms of contractual commitments that trustees can directly enforce jointly and severally, whether contained in a "guarantee" or in separate legal documents.

TPR has not been prescriptive in how it sees such arrangements being drafted. In summary, it would seem that the structure envisaged is one which:

a falls short (at least in a technical sense) of the guarantor actually becoming a "statutory employer" – given there are other legal mechanisms that can achieve that; and

b is more than a "very good parent guarantee" under which the guarantor assumes uncapped liability, on an evergreen basis (no time cap), on an unrestricted "all monies" basis (ie the guarantor must pay up – on demand and so with no lag – upon any failure by an employer to meet any contribution commitment whether under section 75 or ongoing contributions and whether under the scheme rules or the current or indeed any future schedule of contributions. This is generally the limit to how far a parent "guarantee" in its strict sense can go. As the Pensions Regulator does not mandate or suggest any particular forms of wording, it may be left to practice to develop over time as to how precisely these arrangements will be negotiated and documented – perhaps through further documentation ancillary to a core guarantee.

Clearly, such an instrument may expose a guarantor to very substantial potential cashflow obligations – and it remains to be seen what appetite there will be for such arrangements.

PPF guarantees

In order to reduce risk-based levies payable to the PPF by schemes, a guarantor may provide a guarantee to a scheme which – broadly – is limited to 105% of liabilities calculated on a "PPF" basis less the value of scheme assets at the time the guarantee is called (although a guarantor and scheme may agree a higher guaranteed amount). It should be noted that, unless otherwise agreed, the guaranteed amount may fall well short of a full "Section 75" deficit arising upon any insolvency of the employer – and, therefore, its value as a covenant enhancement tool may be limited.

The PPF provide a series of stipulated guarantee requirements , together with a "model form" for guarantees. The requirements include that guarantees are "evergreen"; and annual certification of guarantor strength: for guarantees resulting in a levy saving of £100,000 or more, an independent Guarantor Strength Report is required.

In summary, these instruments may have value to both sponsor and scheme – but that value should not be confused with full "Section 75" cover unless this is specifically agreed in the guarantee.

Worked example

The Reallyweak Limited Pension Scheme is sponsored by the struggling UK subsidiary of MegaStrong International Inc, a US listed global conglomerate with a market capitalisation of $12bn. The Scheme has a Section 75 deficit of £42m. Valuation discussions are underway: on a standalone basis, the weak covenant would only support a low-risk investment strategy with a discount rate leading to a substantial deficit which would absorb the sponsor's free cash flow for many years.

US management struggle to understand why the trustees do not go firmly "on risk" with the investment strategy and reduce the contributions to the scheme.

The trustees explain that the sponsor has negligible financial capacity to absorb a further funding downturn.

Megastrong offers a guarantee of the Schedule of Contributions if the scheme takes significantly more investment risk – but the trustees push back and explain that any guarantee will not cover an investment downturn. Megastrong returns with an offer of a 6 year Section 75 guarantee – but, again, the trustees resist this explaining that the six-year limit provides a "cliff edge" and the scheme could find itself substantially under-funded at the time the guarantee falls away.

In exasperation, Megastrong offers an evergreen Section 75 guarantee – but only if the trustees move the investment strategy firmly on risk and agree to an extended, but minimal, Schedule of Contributions.

This presents the trustees with a conundrum: it could be in the members' best interests to take such a strong guarantee which would likely ensure that, upon any insolvency of the sponsoring employer, the scheme was fully-funded on a buyout basis.

But how would additional cash be delivered if the investment strategy fell materially short of expectations - and how completely confident are the trustees that a long-term guarantee would meet the obligations when needed?

This is an example of where a "look through" guarantee could be ideal – but whether Megacorp would agree to it would need to be seen. A guarantee could potentially be backed by additional contingent funding security, such as asset security or an escrow arrangement.

Decisions, decisions...

Asset security

In its basic form, asset security gives the scheme[4] a proprietary interest in the relevant asset and, in the event there is an "enforcement event"[5], the scheme trustee will be entitled to enforce its security - including by selling the relevant charged assets and applying the sale proceeds to discharge the debts owed to the scheme trustees.

This simplified summary belies a number of complexities…

Types of security

Broadly, in UK law[6] a charge can be a "fixed" charge over a tangible asset such as land and buildings, or cash in a company or securities in a bank or securities account; or be a "floating" charge over assets – such as a trading asset like stock which will change regularly) or, again, cash or securities in a bank or securities account.

Whether or not a charge is characterised as "fixed" or "floating" will depend, in large part, on the level of control (including negative control) the creditor can exercise over the asset. In the case of cash for instance, for there to be a valid fixed charge over cash, the relevant sums need typically to be deposited in a segregated, blocked account from which withdrawals cannot be made without the creditor's consent.

Enforcement of security

For the security interest granted under the charge to be enforceable, an "enforcement event" (as defined in the documentation) will need to have occurred. This typically includes a number of events including where debts are unpaid or the sponsor is insolvent or subject to an insolvency proceeding. There could be a wide array of negotiated trigger points, some of which may well be quite fact-specific depending on the business in which the sponsor operates or the historic funding position of the scheme.

If the scheme benefits from fixed charge security, as a fixed charge holder, it will have the ability to enforce such security and receive first payment from the sale of that particular charged asset and so, to a large extent, sit outside the general insolvency estate.

Where the security granted is only "floating charge" security, charge holders will rank above unsecured creditors (but behind certain "preferred", prior ranking creditors) in the "waterfall" of payouts from the proceeds of the insolvent company's asset.

Sharing of security

Security over assets may be shared such that one creditor has a "first" charge and another has a "second" charge – the latter ranking behind "first" charges in the distribution of proceeds arising from the sale of the charged asset(s). In complex, multi-creditor capital structures, a number of matters – including security arrangements – may be governed by inter-creditor and other agreements.

Depending on the complexity of the sponsor's capital structure and the number of financial creditors at play, these discussions can become incredibly involved and drawn-out, with the focus primarily on the parties' relative priority, ability to call an event of default and/ or instruct the security trustee to enforce the relevant security (on the assumption that there is a common security package in favour of both the financial creditors and the scheme).

[4] Please note that in this paper the word "scheme" is used in circumstances where strictly, this means the trustees (or trustee) as the holder of legal rights in respect of the scheme: with this caveat, the terms are used interchangeably.

[5] Enforcement events are defined in relevant security documentation.

[6] Strictly, the law of England and Wales.

As with guarantees, asset security is subject to a number of considerations when used as a tool to support an employer's covenant. These include:

1. **Valuation**: valuing some assets will be self-evidently more straightforward than others. Even land and buildings can be susceptible both to general market fluctuations and specific demand issues if they have been tailored to a company's needs (for example, a factory or industrial plant). Valuing a "floating charge" can be particularly difficult given fluctuations in underlying assets, particularly in any run-up to an insolvency.

2. **Realisation problems with mobile assets:** enforcing security over assets such as ships or aircraft operating in different territories can be challenging. Specific legal advice will be required on the appropriate method of enforcement of security which may, or may not, involve the threatened or actual arrest of the asset. The processes for arresting such an asset may vary depending on where the asset is located at the time and consideration will need to be given to the practicalities, extensive costs, and potential for reputational damage (for both company and trustee) that would result from forcibly taking possession of the asset.

3. **"Hardening periods":** there are specific provisions governing "hardening periods" for asset security granted in certain circumstances. The rules vary across jurisdictions but the impact of "hardening periods" may be that any security granted in the lead up to the grantor's insolvency is potentially susceptible to challenge upon the appointment of an insolvency officeholder. The period for which an insolvency administrator can potentially challenge any security (the "lookback period") varies across jurisdictions, and can be up to a period of two years in the UK.

4. **Costs:** the costs of asset realisation (being the costs of any security trustee, valuation to be procured, taxes etc.) will be deducted first from the proceeds realised from the sale of the asset. On occasions, funds may also be needed to preserve the value of a secured asset pending disposal.

5. **Negative pledges and other restrictions:** legal advice will be needed to ensure that assets which are proposed to be charged in favour of a scheme are not subject to prior charges; negative pledges in favour of other parties; or any other restrictions limiting the security (such as third-party consents being required). Conversely, negative pledges in favour of a scheme can be valuable protection tools to stop other creditors taking security ahead of the scheme.

The use of asset security by schemes as a means of covenant support is less frequent than guarantees – not least due to the complexities above and the availability of appropriate uncharged assets. For example, the European lending market is largely a "secured market" – such that any sponsor seeking to raise external debt financing will likely need to provide comprehensive security to its creditors. Nonetheless, in the right circumstances asset security can be very valuable – often as a component of a broader "package" of support.

Worked example

The Gearedco Pension Scheme is sponsored by Gearedco Limited, a private equity-owned mid-market industrials group.

Gearedco has high degrees of financial leverage – albeit that the debt is presently unsecured and ranks pari passu with the scheme.

Gearedco's asset base includes a major industrial plant in Eastern Europe; a Head Office in the Midlands; and various stocks and debtors arising as part of its trade.

There is an ongoing scheme valuation and the trustees have been advised to seek asset security to bolster the covenant supporting the scheme.

The Section 75 deficit is some £18 million.

The industrial plant might be worth £46 million on a going concern basis – but far less on any insolvency. The Head Office has recently been valued in the range £6-10 million. Stock and debtors presently total £12 million.

The lenders' indebtedness totals £54 million. There are very few other creditors.

Upon further analysis, the trustees receive legal advice that enforcing security over the Eastern European plant could be problematic. The concept of security over the Head Office is tabled to the company who point out that there is a negative pledge in favour of the lenders prohibiting the granting of security unless the lenders share in it pari passu.

On balance, the trustees decide not to pursue the matter further as their analysis suggests that the benefits could be quite marginal if the lenders share in the security; but the cost and complexity of the arrangements would be significant.

Bank guarantees and Letters of Credit

It may be possible for sponsoring employers or other group companies to procure a guarantee or Letter of Credit ("LC") from a bank in favour of a scheme. Such arrangements are more commonly used to facilitate international trade – particularly, in the case of LCs – as suppliers can be confident that they will be paid by the bank if the customer defaults and there is an appropriate LC in place.

Commercially, the arrangements have similar effects – the bank pays an agreed amount to the scheme upon the occurrence of a specified event such as payment default or insolvency. However, in the case of a guarantee, the bank will usually only pay out if the primary obligor fails to do so; whereas LCs typically have fixed payment dates and default criteria.

These arrangements will not be without cost; and will be factored into the relevant bank's assessment of its overall exposure to the sponsor group. Typically, such arrangements attract some form of recurring margin referable to the sums and risks involved. In practice, they are likely only obtainable from the sponsor's usual bank: given the bank's counterparty due diligence (to assess and price the risk of sponsor default) in any event, this should be much more straightforward than seeking to put in place arrangements with a new bank. Further, new bank client onboarding processes would make it impractical for a sponsor to go to a new bank at speed, hence again this favours the sponsor's usual bank(s) as providers for such arrangements.

In practice, whilst potentially very reliable forms of support, these instruments are used comparatively rarely in scheme funding. There are a number of reasons for this in addition to cost – including the duration of the agreements (banks will typically not agree to longer term or evergreen arrangements without periodic refreshers): given limited durations, trustees may wish to insist on pre-agreed mechanisms for substituting alternative scheme support should an LC expire and not be refreshed.

From the sponsor's perspective, they may also need to provide some level of cash collateral to the bank to support the grant of the LC and therefore, given that such an arrangement would have an impact on cash in any event, the sponsor may prefer to use alternative funding and support arrangements.

One practical example of their use has been to help bridge a sponsor's pension contribution deferral arrangements before an agreed deferred or special contribution (perhaps with interest) would be paid.

The following aspects of the documentation and negotiation process and commercial realities should be borne in mind:

Trustees and sponsors should understand the fundamental difference between the bank's role and interests and the trustees'/sponsor's roles and commercial positions when entering into discussions. The bank will focus on simplicity and price. It will usually have its own – very short – guarantee document. This will tend to permit little if any negotiation of its terms - trustees and employers should expend their energy on other aspects of their negotiations.

The bank will accept no discretionary role.
The arrangement will be reflected in a simple document stating, in essence: "we the bank will pay a sum up to £Xm on simple demand from the trustees in agreed (very short) form confirming a trigger event for payment (from the sponsor) has occurred". The bank will not put themselves into any position of potential future debate with the trustees or sponsor about if, how or when the bank will make payments – or indeed to consider whether the trustees even had any legal right at all to call on it. The bank will simply pay up – and leave it to the trustees and sponsor to dispute it as between themselves if necessary.

This leads to two key follow-on points:

1 If the bank does pay out, the bank will then pursue the sponsor for reimbursement. Hence there will separately be an indemnity or other agreement from the sponsor to the bank, which is a matter for the sponsor alone to agree, not the trustees (although, in practice, if an agreement cannot be reached on this between the bank and sponsor, the arrangements are likely to become unfeasible).

2 There will need to be a separate and clear agreement between the trustees and the sponsor, stating the commercial agreement - such as contribution (or deferral) sums and periods, and triggers/default events for sponsor payment – and hence the trigger point that results in the trustees' ability to call on the bank guarantee or letter of credit. Any debate or dispute between the sponsor and trustees under such agreement would be a bilateral dispute not involving the bank.

Surety bonds

Surety bonds are an arrangement whereby an Obligee (for example, a pension scheme) can recover loss up to the limit of the bond where a Principal (for example, a scheme sponsoring employer) fails to meet its obligations. The "surety" is typically an insurance company. Premiums payable for the bonds will depend on a range of factors – including the financial condition of the Principal – and will be determined by underwriters.

Surety bonds can be issued for multiple purposes and are common within the construction, travel and defence industries. Their duration is usually linked to the term of a specific project or contract. Where issued in relation to a pension scheme, they may provide that an insurer pays the scheme a prescribed amount should, for example, a scheduled contribution not be made.

Surety bonds may help sponsors free up capital as they may not form part of banking credit limits.

Whilst a bond may be renewed or extended when approaching expiry, this will be subject to a revised assessment by underwriters.

Whilst surety bonds may provide valuable collateral to support the specified obligations, care is needed in considering their duration when assessing how they form part of any long-term funding support package.

Worked example

Brickbybrick Limited is a mid-market housebuilder sponsoring a Defined Benefit pension scheme where the actuarial valuation is ongoing.

It has significant financial leverage (unsecured and pari passu to the scheme) due to a series of landbank acquisitions.

There is a proposed schedule of contributions from Brickbybrick to settle the valuation over five years which, all other things being equal, would take the scheme to a "low dependency" basis of funding using a discount rate of Gilts plus 50bps. However, the trustees are concerned over Brickbybrick's financial leverage and are seeking further covenant support – failing which they are insisting on a negative pledge around further borrowings which Brickbybrick's management believe will unduly constrain the growth of the business.

Given that Brickbybrick is a stand-alone company with no parent to provide a guarantee; Brickbybrick's management negotiate surety bonds to underwrite the proposed schedule of contributions in exchange for the trustees relaxing their demand around a negative pledge.

Escrow accounts and similar holding structures

Introduction

There can be a number of occasions when both scheme trustees and sponsors would like monies to be set aside to be available to respond to an uncertain event. From the trustees' perspective, knowing that the "money is there" is reassuring; from the sponsor's perspective, knowing that monies which may not be needed by a scheme are not paid and "lost" to the scheme (and can be returned) is also helpful.

Examples of situations where having monies set aside – rather than paid into a scheme – can be of mutual benefit include structured funding arrangements where the monies are only transferred should a scheme's funding position fall short of an agreed target; or transactional mitigation where the outcome of a transaction may not be certain – for example, mitigating a pre-sale dividend by a subsidiary within a sponsor sub-group prior to a disposal, but where the proceeds are not known.

As a development of the former example – monies held aside to address a funding shortfall – there has been an increasing level of schemes and sponsors looking to use holding structures to seek to avoid a "trapped surplus".

Against this backcloth, this section explores escrow accounts and similar holding structures – emphasising that (i) sometimes the use of language such as "escrow" can be ambiguous – with differing implications from different structures; and (ii) care is needed to choose the right "horse for the right course".

What is an "escrow"?

There is not one clear legal definition of "escrow", though. In essence, it is any arrangement (account, trust, SPV, for example) that keeps the "escrow" funds in a separate place legally outside the pension scheme. Indeed, the term is often used loosely as an umbrella to cover two main scenarios:

1. First, a "proper" escrow in its traditional sense will involve an escrow agent – a third party to the trustees and sponsor. The agent could be a specialist escrow service, such as from a custodian bank, or an independent service from a trustee house, or potentially provided by a law firm. The role of the agent is typically to administer and hold cash or assets that will be placed by it into a relevant account of its choosing, for a period of time – for example, the occurrence of a scheme funding requirement or a corporate event. There is potential counterparty covenant exposure to the escrow agent over and above the covenant exposure that exists with the financial institution that holds the deposits. Due diligence over the escrow agent and its banking arrangements will usually be required.
2. Secondly, what might more loosely be termed "escrow" but is "simply" a designated account or accounts - which could be as simple as a deposit account - in the sponsor's name with its usual bank (but usually separate from the sponsor's main trading account to allow for clear identification of assets). The bank itself is then acting as the escrow agent, with this being an additional service to its regular deposit taking.

Absent the existence of a fixed charge or a valid trust arrangement, in the event the sponsor was to enter into an insolvency process, any monies standing to the credit of any account in its name would form part of the sponsor's insolvency estate, to be controlled by the appointed insolvency officeholder. Therefore, in order to ensure the scheme has access to the funds when most required, trustees will want a fixed charge over these accounts. Whether obtaining such a charge is feasible will depend on a number of matters: for example, a fixed charge will require trustee control over the removal of any assets from the account.

The most informal (and least secure, from the trustees' perspective) end of the "escrow" spectrum would therefore be a company account holding cash which is only notionally ring-fenced for the pension scheme (through no more than a simple company comfort statement to the trustees that it would be available if needed) but under which there are no formal constraints on company access (no fixed charge, no floating charge, and no designation of trust over the assets). One might question whether that is really an escrow account at all.

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Commercial and legal considerations

As with many contingent asset arrangements, there will be several commercial and legal factors to take into account when agreeing an appropriate structure, including (non- exhaustively):

- The degree of **trustee security versus sponsor unfettered access** (which the sponsor might want for accounting reasons, for example, to retain the assets on the "company's books"):
- **Duration:** the longer the term, the greater security trustees will want. The minimum period for a company deposit account type of escrow would typically be three months; it could be shorter for an escrow account that essentially parks cash for a very short period of time pending payment to trustees of mitigation following a deal, for example;
- **Simplicity v greater complexity - and form of assets:** simple escrow accounts could be a new company cash deposit account, set up in a matter of days with the sponsor's usual bank. However, unlike bank guarantees, the banks under these arrangements are not taking counterparty risk, so setting this up afresh with a new banking arrangement is achievable in two to three weeks.

Setting up escrow accounts with banks

Some banks have developed their normal deposit account service into an "escrow" offering, with personnel experienced in their use for pension funding purposes to cover short-term matters (such as pending completion of a deal or refinancing) with the "price" simply being built into an agreed bespoke deposit interest rate. Conversely, a longer-term arrangement could be entered into.

As with bank guarantees and letters of credit, the escrow agent or bank will require relative simplicity – clear triggers, a very simple agreed form of notice for any release of funds to the trustees (or indeed potentially back to the company where there is surplus), leaving no role for the escrow agent or bank to need to exercise any discretion.

Nature of the arrangements

An escrow vehicle may be established such that funds are available to address a shortfall arising if the funding level at a subsequent scheme valuation shows a gap between the actual funding level (excluding the escrow) and a target funding level. Key to this will be an underlying escrow arrangement (typically a deed) between the trustees and company (to which the escrow agent or bank will not be party) setting out the triggers for company payment into the escrow; triggers and timing for release into the pension scheme – such as immediately on sponsor insolvency or missed regular payments. Alternatively, there may be no release from the escrow until a funding gap against a target arises several valuations later.

There may also be triggers for release back to the company where there is a surplus over a scheme funding target such as a buyout level – seeking to avoid a "trapped surplus".

Escrow structures as part of investment arrangements

Escrow arrangements may be set up to run alongside a pension scheme as a notional additional "scheme fund" for asset allocation and funding purposes – perhaps containing assets of a defined class(es). These arrangements will require custody services – perhaps provided by the trustees' usual custodian – albeit technically in a third party escrow account.

Documentation

Naturally the extent of legal documentation and negotiation (and time required to effect this) will depend entirely on the commercial deal. As discussed above, the spectrum of arrangements could range from:

- a simple deposit account with the sponsor's bank and a short agreement between the trustees and the sponsor stating what and when agreed cash in escrow will be released to the pension scheme; all the way to
- a relatively complex Escrow or Charged Account Deed between the trustees and sponsor (governing a contingent funding vehicle and potential contingent payments over ten years or more; accompanied by a Custody Deed (tripartite, with the custodian too); with a Security Deed (granting fixed and floating charges in favour of the trustees over any assets in the relevant cash or securities accounts; limiting action the company can take where accounts are in its name (so joint control over investment changes), and setting out triggers like insolvency and credit rating downgrades of the sponsor or indeed parent which allow the trustees to call on the assets), together with any changes to the scheme funding documents.

Reservoir trusts

A further variation on a similar theme to an escrow account (which could occupy a section of its own) are forms of separate contingent funding vehicles, sometimes termed "Reservoir Trusts".

As the name suggests, legally they are set up as a trust (and therefore with separate trustees) by deed. Such arrangements are flexible. The commercial and legal terms will be bespoke. They might be used, for example, as a structure to hold and later allocate funds on agreed terms across several group occupational pension schemes.

All of the above arrangements might be linked with further contingent assets, such as a parent company guarantee, as part of a wider contingent funding arrangement rather than being viewed as isolated contingent assets.

Contingent funding arrangements

Many of the discrete arrangements and mechanisms discussed earlier in this paper largely ensure that a pre-agreed obligation – or Section 75 deficit – is met either by a third party or from the proceeds of realisation from an asset – whether upon payment default or insolvency or upon other agreed financial triggers.

Mechanisms are also available whereby additional funding may be injected into a scheme by either an employer or third party (such as a parent company) upon the occurrence of an event such as sustained underfunding; achieving a defined level of employer profitability; upon payment of a dividend; or upon an event such as an asset disposal. These mechanisms may use other structures outlined in this paper – including, for example, "holding" arrangements such as escrow accounts or reservoir trusts.

Contingent funding structures linked to employer profitability or dividend sharing may seem ostensibly simple – and a means of pre-agreeing the provision of additional funding to a scheme as and when an employer has the financial capacity to do so.

In practice, they can be subject to very considerable drafting challenges around, for example, the determination of "profit" (or other chosen metric) including choices of accounting policies and items which may or may not be deductible in arriving at "profit". Further, they are not able to be taken into account in a Schedule of Contributions (given their uncertainty).

Mechanisms linked to asset disposals – whereby a scheme shares in a defined amount or proportion of the proceeds of an asset sale – can be valuable where it is known that an asset is to be disposed of and what the likely implications on covenant are (including any impact on structural priorities where the asset is a fellow subsidiary). However, care needs to be taken to avoid "boxing a scheme in" to a fixed level of proceeds where there is a risk that an asset's value may materially escalate before realisation; or where realisation may not take place for some time such that what might be an appropriate share for a scheme has moved on.

Mechanisms linked to scheme funding may result in additional funding being provided to a scheme should certain agreed funding "triggers" not be met; or scheme funding levels fall outside an agreed "corridor".

Complexities with these arrangements include the determination of triggers or corridor width; and for how long any metric needs to be met so as to avoid "tripping" a requirement for additional funding solely as a result of short-term market volatility which recovers shortly afterwards.

Asset-backed contributions structures

Asset-backed contribution structures ("ABCs") are a form of contingent funding arrangement whereby, in summary, monies derived from an asset or class of assets owned by the sponsor are paid to a scheme. Unlike escrow, for example (which can be used equally in isolation or as part of a longer-term contingent funding vehicle), ABCs would be highly unlikely to be used in isolation just as a short-term or simple contingent asset structure to cover "event driven" matters like a deal or refinancing completing. This is because they are complex and relatively expensive to set up.

ABCs involve (by no means exhaustively):

Careful consideration of the underlying asset(s) – which must be income-producing, but which could range hugely from (say) a property receiving rental income (such as a group company using commercial or manufacturing premises); income rights under intangible assets like intellectual property; or, indeed, a new loan note from a group company (on which interest payments are the income flow). Specialist valuation of the asset both on the establishment of the structure and periodically, as well as the income rights, may be needed.

Addressing a range of commercial and other issues: many of the commercial issues discussed elsewhere in this paper – including duration and triggers for payment – also apply to ABC structures. However, these structures have a range of additional legal and other considerations – including tax and accounting.

Voluminous legal documents and opinions in broadly two areas. First, the set-up of the ABC legal structure itself, typically a limited partnership, with separate advice required under Scots law; together with related commercial and fiduciary considerations. Second, the various documents linked to the form of underlying asset (whether it be the issuance and transfer of loan notes, for example, or real estate property matters).

ABCs may offer PPF levy benefits.

Unlike other contingent funding arrangements, ABCs should not be used to support taking additional funding or investment risk. This is because the value of an ABC arrangement will already be reflected in the scheme's funding position as it will be accounted for as a scheme asset.

Although ABCs have become less mainstream, they demand the brief treatment above given the important place they have held (in terms of profile and value) in contingent funding arrangements over the years and the possibility they could still be used today.

Temporary, semi-permanent or permanent? Individual tool or package?

The various structures highlighted in this paper can be adapted for use by schemes and sponsors to suit a broad range of situations.

For example, one or more contingent assets might be put in place as a temporary measure pending the outcome of a specific event; or they can be packaged together as part of a complete and long-term scheme funding solution. This might perhaps be alongside other provisions such as Information Sharing Protocols and negative pledges or as part of a much wider package of measures. In some cases, a package may be agreed encompassing several defined benefit schemes within a corporate group and covering a range of matters such as scheme merger consolidation or surplus management and usage.

Where a scheme covenant and funding situation is complex and nuanced, there can be huge value in both sponsors and trustees – with their advisers – "stepping back" to consider:

- What holistically is the best outcome for stakeholders over the longer term?
- What challenges need to be solved? and
- How can the various tools described in this paper be used individually or collectively to solve them in a balanced, proportionate and mutually satisfactory way?

Case study

Planetconserve International is a US-based group developing and selling specialist building supplies for environmentally friendly developments. It is SEC listed with a $3.2bn market capitalisation; and has unsecured bonds of various maturities in issue totalling $2.4bn with a Moody's Baa1 rating.

Its UK subsidiary Planetconserve Limited – built out of a legacy building components firm – sponsors a DB pension scheme with assets of £177m; a TP deficit as at 30 June 2022 of £32m; and a Section 75 deficit at the same date of £84m. The next valuation is due as at 30 September 2023.

Planetconserve Limited has been suffering in a highly competitive market: its pre-tax profits have fallen from £18m in 2021 to an estimated £7m in 2023. However, given gilt yield movements, the latest funding update suggests a TP deficit of only £10m – assuming the same covenant rating and discount rate as for the 2022 valuation; and a Section 75 deficit of £36m.

The discount rate for the last valuation was a SEDR of gilts plus 100bps driven off a Tending to Strong covenant rating. No contingent assets are in place.

Due to the deteriorating trading position, initial indications are that the covenant rating has fallen to Tending to Weak. The trustees are looking to use a Gilts plus 50bps discount rate – leading to a TP deficit of some £22m.

Modelling using the current investment strategy – and assuming a six year recovery plan – shows the scheme achieving buyout in nine years. However, a more cautious investment strategy would extend that to 13 years.

Planetconserve Limited has a development and manufacturing site valued at £11.7m; a debtor book of £3.2m; and stocks of £4.6m.

Planetconserve Limited and its parent would like to maintain the current investment strategy and discount rate. They have signalled a willingness to discuss contingent asset structures – and are concerned over the possibility of a trapped surplus.

Considerations

As a starting point, it seems that the listed parent is very substantial relative to the size of the scheme. However, it is worth noting the scale of financial leverage and sub-investment grade debt. Nonetheless, some form of guarantee arrangement would be worth exploring.

Planetconserve Limited's asset base is very limited compared to the Section 75 deficit: whilst some form of asset security may be worth exploring, in any insolvency the recovery may be very modest. The complexity and uncertainty of asset security, together with its limited value, mitigates against regarding this as a primary support tool.

Whilst bank LC's, bank guarantees or surety bonds might be possible, the trustees consider that their limited duration; and the risks of non-renewal given Planetconserve Limited's financial condition, mean that they are not preferred options given the likely time period over which the scheme will be funded.

In discussion, the parent resists a "look through" guarantee. However, a structure is agreed – targeting a buyout in nine years – comprising the following package:

1. A valuation and investment strategy consistent with the current arrangements.
2. A Schedule of Contributions which will achieve low dependency basis of funding within six years. A profit-related contingent funding mechanism was discussed but rejected on account of profit measurement complexities.
3. An additional contribution mechanism whereby further cash payments are made to the scheme should funding fall outside an agreed "corridor" for three consecutive months.
4. A full Section 75 guarantee which also guarantees both the Schedule of Contributions and additional contribution mechanism in 3.
5. An escrow arrangement to avoid a "trapped surplus" whereby contributions are passed into an escrow account should funding achieve a prescribed level prior to buyout.

Conclusions

The nature, form and use of contingent assets to support DB pension schemes are wide and varied.

Used and drafted effectively, they can provide highly valuable support to a scheme, reconciling the needs of both sponsor (and, where appropriate, owning group) and scheme in a balanced and proportionate way.

However, this paper has illustrated that these mechanisms may not be universally attractive; and may have pitfalls meaning that they are of limited – or no – use just when they are needed.

Nonetheless, used creatively and carefully they can unblock ostensibly intractable funding problems.

However, caveat emptor: experienced advisers and good advice are needed to understand whether they are panacea or empty promise…

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