Hogan Lovells

Multi-employer pension schemes: options for dealing with statutory debts

November 2012 Pension briefing

HIGHLIGHTS

Section 75 of the Pensions Act 1995 forms part of the statutory scheme funding regime. It imposes a debt (a "**Section 75 Debt**"), payable to the pension scheme, on employers (and former employers) of a defined benefit pension scheme if certain trigger events occur, notably when an employer withdraws from an on-going multi-employer scheme as a result of a corporate transaction or restructuring. This debt is calculated by reference to the cost of securing benefits on a buy-out basis.

There are, however, various alternative methods of calculating and dealing with Section 75 Debts and this note provides an overview of the rules and the options for trustees and employers.

WHEN DOES A SECTION 75 DEBT ARISE?

Section 75 of the Pensions Act 1995 and the Employer Debt Regulations, enforced by the Pensions Regulator, apply to pension schemes with defined benefit (DB) liabilities. They require the sponsoring employer of a DB occupational pension scheme to pay an additional contribution (the "**Section 75 Debt**") to the scheme trustees if:

- the employer becomes insolvent or enters voluntary winding-up;
- the scheme goes into winding-up; or
- where the scheme is a multi-employer scheme, an **"employment-cessation event" (ECE)** occurs in relation to the employer, that is:
    - the employer ceases to have any employees who are active members of the scheme when another employer continues to employ at least one active member; AND
    - that other employer is responsible for some DB liabilities under the scheme.

In practice, most Section 75 Debts arise when an employer undergoes an ECE (rather than on an insolvency or scheme wind-up) and so this note focuses primarily on ECEs.

An ECE may occur when a participating employer is sold out of a corporate group (or all its workforce transfers to a new employer under a TUPE business transfer) or when the last remaining active member employed by that employer leaves pensionable service or dies.

The default Section 75 Debt will be, broadly, the employer's pro-rata share of the deficit of the scheme, where that deficit is calculated based on the cost of buying annuities with an insurance company to provide the benefit accrued in the scheme. However, there are five variants for calculating the Section 75 Debt:

- Scheme Apportionment Arrangement;
- Withdrawal Arrangement;
- Approved Withdrawal Arrangement;
- Regulated Apportionment Arrangement; and
- Flexible Apportionment Arrangement.

The Regulator's guidance on multi-employer schemes and employer departures emphasises that, as a starting position, trustees should always consider whether it is appropriate for the withdrawing employer to pay the Section 75 Debt in full under the default basis. Trustees must also ensure that the chosen method is in the best interests of the members.

WHEN DOES A SECTION 75 DEBT NOT BECOME DUE?

A Section 75 Debt will not become due when an ECE occurs if the employer provides a "period of grace" notice, or an easement applies. These are considered at the end of this note.

CALCULATING THE SECTION 75 DEBT ON AN ECE – THE DEFAULT POSITION

The default position, known as the "**Liability Share**", is that an employer's Section 75 Debt is calculated based on the liabilities of the scheme which relates to employment with that employer, together with a proportionate share of "orphan liabilities" (the liabilities of a scheme which relate to employment with an entity which is no longer counted as an employer for the purpose of the Regulations). In other words, the employer's Section 75 Debt is a proportionate share of the total buy-out deficit of the scheme as a whole.

Responsibility for calculating the Liability Share is divided between the trustees and the actuary under the Regulations. In practice, the trustees will determine the method for calculating the assets and the liabilities, and the actuary will actually undertake those calculations.

The actuary estimates the costs of buying annuities on terms considered "consistent with those in the available market" or, if that is not practicable, in such a manner as the actuary considers appropriate in the circumstances.

A departing employer's liability share is related to liabilities attributable to "employment with that employer". This means that if, for example, an employee had been a member of the scheme for 25 years, and worked for three different employers during that time, in order to calculate the Section 75 Debt for a departing employer it is necessary to establish exactly which employer the employee had been employed by and for how long.

The trustees have the responsibility for determining the liabilities to be attributable to each employer. If they are unable to determine to which employer a particular employee's liabilities should be apportioned because either the employee's full employment history is not available, or it cannot be obtained without disproportionate costs being incurred, the trustees can either:

- determine that the employee's liabilities cannot be apportioned to any particular employer (and hence all the liabilities become orphan liabilities); or
- determine that all the employee's liabilities are in fact apportioned to whichever employer is his or her last (or current) employer.

It is not necessary for a full audit of assets and a full valuation of liabilities to be undertaken in respect of ECEs. The trustees may, after consulting the employers, decide to use an unaudited update to the asset figure for the scheme set out in the most recent trustee report and accounts. The trustees may also, again after consulting the employers, decide to determine the liabilities by using the solvency (buy-out) numbers from the last actuarial valuation, updated to reflect the actuary's assessment of changes between the valuation date and the ECE.

Former employers

If a scheme closes to further accrual, no ECE has taken place and, consequently, no Section 75 Debt will take place in respect of employers of active members in the scheme immediately prior to closure. However, the Regulations provide that a "former employer" will remain liable for a Section 75 Debt if the scheme subsequently winds up or the remaining employers become insolvent.

In addition, complex cases can arise where an employer stopped employing members in the past. Depending on the legislation this may or may not have triggered a Section 75 Debt (which could still be owed to the scheme). The legislation has been amended several times and been interpreted by the courts, meaning that a former employer's on-going connection to a pension scheme may have gone unnoticed. Buyers of UK companies should be aware of the potential liability to pay a Section 75 Debt if the company being purchased has ever participated in a DB pension scheme. For more information, please see our Client Briefing: "*Trustees: TPR wants to know who your statutory employers are*."

OPTIONS FOR CALCULATING SECTION 75 DEBTS ARISING ON AN ECE-SCHEME APPORTIONMENT ARRANGEMENTS

Conditions

In order to have a Scheme Apportionment Arrangement (SAA), four conditions must be met:

- An SAA must be an arrangement under the scheme rules. If it is proposed to use an SAA then we recommend that a generic rule permitting their use should be inserted into the rules. The employer and trustees may then enter into a separate agreement outside the rules (for example a joint resolution or deed) which documents how the power will be exercised in a specific situation.
- The SAA must provide the amount of the Section 75 Debt that the withdrawing employer pays (the SAA Share). The Regulations do not contain any restrictions on how large or small the SAA Share can be. The resulting Section 75 Debt can therefore be a nominal amount (£10, for example).
- Where (as in nearly all cases) the SAA Share is less than the Liability Share, the difference must be apportioned to one or more of the other employers in the scheme. The relevant employers (and the shares apportioned to them) have to be specifically identified in the SAA.
- The SAA must meet the "**Funding Test**" (see box below).

The Funding Test

The Funding Test is met if the trustees are reasonably satisfied that:

- when the arrangement takes effect, the remaining employers will be reasonably likely to be able to fund the scheme; and
- the arrangement will not adversely affect the security of members' benefits as a result of any material change in circumstances which would justify a change to the valuation assumptions or any recovery plan in force.

SAAs can be entered into before, on, or after an ECE. Entry into an SAA (including entering into it after the ECE event) will not prevent the scheme from being eligible for the Pension Protection Fund (PPF) should the remaining employers later become insolvent.

Consents

An SAA requires the consent of the trustees and the employers to whom any of the withdrawing employer's liabilities are being apportioned.

Clearance

According to the Pension Regulator's guidance, both the amending of a scheme's rules to introduce an apportionment rule and the exercise of that apportionment rule are events (so-called "Type A" events) in respect of which the employer should consider applying for clearance (see box below on the Pension Regulator's moral hazard powers) . There are only three exceptions to this:

- if the amount paid under the SAA is more than the Liability Share;
- if the amount paid is the actuary's best estimate of what the Liability Share is; or
- if there is no net reduction in the employers' combined covenant (for example if the apportionment is as a result of a group reorganisation).

Is it necessary to calculate and certify the buy-out deficit of the scheme?

Yes, under a SAA it is necessary for the actuary to calculate and certify the buy-out deficit of the scheme – even if it is known that the Section 75 Debt of the withdrawing employer will be a nominal amount (eg £10) it is necessary to know what amount has been apportioned to the remaining employers.

The Pension Regulator's moral hazard powers

- The Pensions Regulator has anti-avoidance powers to issue contribution notices (CNs) and financial support directions (FSDs) against persons who are associates of or connected with pension scheme employers. CNs and FSDs may require additional contributions to the pension scheme or additional support, such as a guarantee.

- CNs can be issued where there is an act or omission the main purpose of which was to prevent a Section 75 debt becoming due or being paid (or reduce its amount) or that was materially detrimental to a scheme's ability to pay members' benefits.
- FSDs can be imposed if the sponsoring employer is a service company or is otherwise "insufficiently resourced".

Concerned parties can seek "clearance" from the Pensions Regulator that it will not use its powers against them in particular circumstances.

OPTIONS – FLEXIBLE APPORTIONMENT ARRANGEMENTS

A Flexible Apportionment Arrangement (FAA) is very similar to an SAA but allows a withdrawing employer to apportion its scheme *liabilities* instead of its share of the Section 75 Debt. This means no formal employer debt calculation is required. FAAs were introduced under amendments to the Employer Debt Regulations which came into effect on 27 January 2012.

Under an FAA, one or more replacement employers in the scheme become responsible for the withdrawing employer's scheme liabilities (actual and contingent) under a legally enforceable agreement. An exit payment of any amount (nominal or substantive) can, but does not have to be, paid to the scheme by or on behalf of the withdrawing employer.

Conditions

The conditions for FAA are:

- the withdrawing employer must not be in a period of grace;
- the FAA must have the consent in writing of the withdrawing and replacement employers and of the trustees;
- the FAA meets the Funding Test (see box above); and
- the scheme must not be in a PPF assessment period or being wound up and the trustees must believe the scheme is unlikely to enter an assessment period within the next 12 months after the FAA takes effect.

A FAA can be entered into after the ECE occurs. It can also be entered into in advance of an ECE occurring but can only be entered into 28 days before the ECE occurs. If the ECE actually occurs more than 28 days later, the FAA will not have effect.

Whilst not strictly necessary, we recommend that trustees should have a specific power under the trust deed and rules to permit them to enter into an FAA (and any such provision could include express provisions covering other types of apportionment arrangements as well).

OPTIONS – WITHDRAWAL ARRANGEMENTS

Withdrawal Arrangements are essentially a combination of parts of an SAA and an Approved Withdrawal Arrangement (see below). In summary, a Withdrawal Arrangement (WA) requires the withdrawing employer to pay a Section 75 Debt calculated as its proportionate share of the scheme's deficit on the scheme specific funding valuation method rather than the buy-out method. This sum is termed "Amount A". A further sum ("Amount B") is guaranteed by a suitable guarantor.

The guarantee: Amount B

There are no formal requirements as to who can be the guarantor (for example the guarantor does not have to be a participating employer in the scheme, and could be an overseas parent company). It is possible to have more than one guarantor. If there are multiple guarantors, all the guarantors must have joint and several liability.

Amount B can either be fixed or floating:

- fixed – Amount B is calculated at the time of the WA and is the difference between the withdrawing employer's Liability Share (which is calculated on the buy-out basis) and Amount A (the amount the withdrawing employer actually pays);
- floating – Amount B is not actually calculated until the time it becomes payable. At that time it is calculated as the amount the withdrawing employer's Liability Share would have been if the withdrawing employer's ECE occurred at the time Amount B was payable (and so depends on the size of the buy-out deficit at that time, not when the WA was entered into). Where Amount B is floating, Amount A is essentially ignored.

Amount B must become payable when:

- the scheme winds up; or
- where the last remaining employer of the scheme becomes insolvent.

The guarantor may agree with the trustees that Amount B can also become payable in other circumstances.

Conditions

The trustees have to be satisfied that, at the date the WA is entered into, the guarantor(s) have sufficient assets to pay Amount B. Additionally, the trustees have to be satisfied that part (a) of the Funding Test (see above) will be met; the trustees do not need to confirm the part of the test set out in (b).

A WA does not formally need to be approved by the Regulator nor is it necessary to apply for clearance.

OPTIONS – APPROVED WITHDRAWAL ARRANGEMENTS

An Approved Withdrawal Arrangement (AWA) is very similar to a WA. The two key differences are that:

- the withdrawing employer pays a Section 75 Debt which is less than Amount A (the Section 75 Debt measured on the scheme specific funding basis); and
- an AWA has to be approved by the Regulator.

As with SAAs, there are no restrictions in the Regulations as to the amount the withdrawing employer pays. Accordingly, the amount paid under an AWA can be a purely nominal amount (£10, for example).

Approval by the Regulator

An AWA has to be approved by the Regulator. The Regulator can approve AWAs if the Regulator is satisfied that it is "reasonable" for it to do so. The Regulations set out a non-exhaustive list of factors that the Regulator should take into account (for example the financial strength of the guarantors, the amount the withdrawing employer is paying and the effect of the proposed arrangement on the security of members' benefits). The Regulator essentially has a wide discretion when considering AWAs.

Amount B for an AWA is calculated in the same way as for a WA (see above); in other words, it can also be either fixed or floating. Amount B is also paid by the guarantor in the same circumstances as for a WA. In addition to these conditions, however, Amount B under an AWA also becomes payable at any time that the Regulator directs. The Regulator may only demand payment of Amount B in this manner if it is "reasonable" for it to do so, and for this purpose the Regulator can take into account the guarantor's financial circumstances and whether it has complied with the terms of the AWA.

The Regulator may also give notice that the AWA is no longer required (and hence the guarantor is no longer liable to pay Amount B).

OPTIONS – REGULATED APPORTIONMENT ARRANGEMENTS

A Regulated Apportionment Arrangement (RAA) is similar to an SAA. There is no guarantor necessary, the amount of liabilities apportioned to the withdrawing employer is specified, and the difference between that amount and the withdrawing employer's Liability Share is apportioned to one or more of the other employers.

There are two key differences between an RAA and an SAA:

- an RAA can only be used when a scheme is in a PPF assessment period, or if the trustees believe that the scheme will enter a PPF assessment period within the next 12 months; and
- an RAA must be approved by the Regulator (and accompanied by a clearance application), and the PPF must confirm that it does not object to the entry into the RAA. The Regulator has said it will not agree to an RAA lightly.

COMPARING THE OPTIONS

The table on the following page briefly sets out the key features of the different arrangements so that they can be compared. Given that a Regulated Apportionment Arrangement can only be used in situations of distress, we have excluded that from the table.

OPTIONS FOR CALCULATING SECTION 75 DEBTS[1]

	LIABILITY SHARE (statutory default)	SCHEME APPORTIONMENT ARRANGEMENT	FLEXIBLE APPORTIONMENT ARRANGEMENT	WITHDRAWAL ARRANGEMENT	APPROVED WITHDRAWAL ARRANGEMENT
Is trustee agreement necessary?	**No**	**Yes**	**Yes**	**Yes**	**Yes**
Is employer agreement necessary?	**No**	**Yes** – either the agreement of the withdrawing employer, or the other employers, depending on the circumstances.	**Yes**	**Yes**	**Yes**
What Section 75 Debt is payable?	The withdrawing employer's share of the scheme's deficit calculated on the buy-out basis.	Any amount (which can be higher or lower than the Liability Share).	No calculation – scheme liabilities are apportioned	The withdrawing employer's share of the scheme deficit calculated on the scheme specific funding basis.	Any amount, but must be less than the withdrawing employer's share of the scheme's deficit on the scheme specific funding basis.
Can the withdrawing employer pay a nominal debt (eg £10)?	**No**	**Yes**	**Yes**	**No**	**Yes**
Is a guarantor required?	**No**	**No** – but balance of the Liability Share must be apportioned to one or more of the other employers.	**No**	**Yes**	**Yes**
Does the Regulator need to be involved?	**No**	**Yes** – not formally necessary but the employer is recommended to apply for clearance.	**Yes** – although no approval required, entering into the arrangement will be a notifiable event.	**No** – not formally involved and it will usually not be necessary to apply for clearance.	**Yes** – the Regulator must formally approve the arrangement.
Do the trustees have to confirm that the Funding Test has been met?	**No**	**Yes**	**Yes**	**Yes**	**Yes**
Does the actuary need to certify the buy-out deficit?	**Yes**	**Yes**	**No**	**No** if Amount B is floating, **Yes** if Amount B is fixed.	**No** if Amount B is floating, **Yes** if Amount B is fixed.

[1] Excluding Regulated Apportionment Arrangements

AVOIDING A SECTION 75 DEBT – PERIODS OF GRACE

If an ECE occurs, and a Section 75 Debt would otherwise become due, but the employer intends to employ another active member of the scheme within 12 months, the employer can give trustees a "period of grace" notice. The notice effectively suspends the Section 75 Debt. If the employer does employ another active member within 12 months, the ECE is deemed never to have occurred. If he does not, then a Section 75 Debt becomes due calculated based upon the funding position of the scheme at the time of the ECE, not at the end of the 12 month period of grace.

Period of grace notices can be given before the ECE, or up to two months afterwards. The trustees can agree to extend the period of grace beyond 12 months to a later date (but not more than three years). Any extension must be made by the trustees before the period of grace would otherwise expire. The Regulator will expect the trustees, before agreeing to an extension, to require evidence of the employer's intentions to employ active members again and an explanation as to why it will take so long.

There are two ways in which the employer's Section 75 Debt can become due before the end of the period of grace:

- if the employer decides that it will not, within the period of grace, actually employ any active members during the period of grace – once the employer makes that decision, it must tell the trustees. The period of grace then comes to an end at that point, and the Section 75 Debt becomes due (again, it is calculated based upon the funding position of the scheme at the time of the ECE); and
- if the employer becomes insolvent during the period of grace – if this happens the original Section 75 Debt becomes due and the trustees can claim for it in the insolvency proceedings.

There are two circumstances where periods of grace cannot be used:

- where the employer has no intention of employing active members within the 12 months immediately following the ECE. If this is the case, the full Section 75 Debt becomes payable in the normal way;
- when the employer is aware that it is intended to close the scheme to future accrual within the next 12 months. A period of grace can only occur when it is anticipated that the scheme will still continue to have active members at the end of the period of grace.

AVOIDING A SECTION 75 DEBT – EASEMENTS

There are two other limited easements – the "**General Easement**" and the "**De Minimis Easement**". Unlike the other options for dealing with Section 75 Debts in which a debt would still be payable (albeit smaller than would otherwise have been the case), if the conditions are met for one of the easements no Section 75 Debt will arise.

Broadly, the General Easement is intended to allow restructurings that do not involve a weakening of the employer covenant. The De Minimis easement is designed for small-scale restructurings where (a) either the number of scheme members employed by the withdrawing employer is (i) no more than two persons; or (ii) constitutes no more than 3% of the total DB members of the scheme; and (b) the annual amount of pension in respect of those members is no greater than a maximum amount (£21,000 for the year 2012/13).

The Regulations are highly prescriptive and set out in some detail the steps that must be taken, and conditions fulfilled, for the easements to apply.

The easements are restricted in scope, as they can apply only where:

- The restructuring involves only two employers: an "Exiting Employer" and a "Receiving Employer". An insolvency event must not have occurred in respect of either employer.
- The Exiting Employer and the Receiving Employer both participate in the same multi-employer pension scheme and each employ at least one active member of the scheme.
- The Exiting Employer and the Receiving Employer are "associated" (as defined for the purposes of insolvency), unless special circumstances apply (for example, where the Exiting Employer is a traditional partnership and the Receiving Employer is a Limited Liability Partnership to which the Exiting Employer's business is being transferred).

If an employer decides to take advantage of one of the easements, the trustees or managers of the scheme will be obliged to take various steps. They do not, however, have power to withhold consent or to negotiate increased contributions or greater security – unlike the options for dealing with Section 75 Debts, where trustee consent is needed (and may be given at a price). They do have the power to decide that any costs arising from the easements will be passed on to the Exiting and Receiving Employers.

If it subsequently becomes apparent that any step has not been properly completed, a Section 75 Debt will not be triggered except for certain specified anti-avoidance situations. This is intended to prevent minor inaccuracies from rendering the whole easement ineffective.

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