



Extracting pension scheme funding from third parties: overview

THE PENSIONS REGULATOR: MORAL HAZARD POWERS

EMPLOYMENT, PENSIONS AND BENEFITS BRIEFING 199

The Pensions Act 2004 gave the Pensions Regulator (TPR) far-reaching powers to make third parties connected with an employer liable to contribute to or support an underfunded defined benefit pension scheme.¹ The 2004 Act gives TPR powers to issue a contribution notice or financial support direction in some circumstances. These powers are often referred to as TPR's 'moral hazard' powers.

These powers are aimed at discouraging the abuse of corporate structures to avoid pension liabilities, or entry into material transactions without taking into account the potential impact on the pension scheme. They are also aimed at reducing the risk of employers shifting their pension liabilities onto the pension protection fund.²

Which pension schemes can give rise to a claim?

Generally, the Pensions Regulator's (TPR) powers will only apply if the scheme can potentially fall within the pension protection fund (PPF), and is one to which the employer debt obligation in section 75 of the Pensions Act 1995 (the so-called 'section 75 debt') can apply. The schemes below are excluded.

Excluded schemes

- money purchase schemes (ie providing only money purchase benefits, ignoring death benefits);
- schemes not registered with HM Revenue & Customs under the Finance Act 2004;
- most public sector schemes; and
- schemes for overseas employees (section 615 schemes).

Maximum liability

When assessing a person's maximum potential liability under a contribution notice (CN) or financial support direction (FSD) to provide funding towards a scheme's deficit, this deficit is measured on a buy-out basis – the basis on which an employer's section 75 debt liability is calculated. Broadly, this tests whether there would be sufficient assets to secure the benefits with matching insurance policies.

The liability on a buy-out basis is usually significantly greater than the liability assessed on other measures –

for example the funding basis used under the scheme-specific funding regime for ongoing schemes, or the accounting basis reflected in company accounts under international accounting standard (IAS) 19 or financial reporting standard (FRS) 17. Schemes are only rarely funded at the buy-out level, so this basis will usually reveal a substantial deficit in the scheme. As a consequence, the potential exposure under a CN or FSD can be large.

Conditions for issuing CNs and FSDs

Liability under a CN or FSD is not automatic. Whether one is issued will depend on an essentially discretionary judgment by TPR. There are three tests that need to be met for a CN or FSD to be issued:

- the target must be connected or associated with an employer (or former employer) in relation to the pension scheme;
- the relevant test for a CN (an act with a main purpose of avoiding a pension liability or act that has detrimentally affected the security of the scheme benefits) or an FSD (the employer is insufficiently resourced or a service company) must be met; and
- TPR must consider that the issue of a CN or FSD is 'reasonable'.

This briefing looks further at each of these tests below.

¹ Consequently any reference to a 'pension scheme' or a 'scheme' in this briefing is a reference to a defined benefit pension scheme.

² For a summary of the role of the PPF and the compensation it would provide to scheme members in the event of employer insolvency, see our employment, pensions and benefits briefing 117: [The Pensions Act 2004 – PPF protected benefits](#).

Connected or associated

FSDs and CNs can be used (in some circumstances) to make the employer or a third party who is ‘connected’ or ‘associated’ with the employer (or former employer) liable for all, or some of, the deficit in an underfunded pension scheme.

The test for when a company or individual is connected or associated is taken from the Insolvency Act. It is widely drawn and will, for example, catch other companies in the same corporate group as the scheme’s employer or a 33⅓ per cent shareholder (with voting rights) in the employer’s parent company. The target of a CN or FSD does not need to be directly linked to the scheme.

For more information see our employment, pensions and benefits briefings [Who is ‘connected’ or ‘associated’?](#) and [TPR: who is within reach?](#)

What is the test for issuing a CN?

TPR can issue a CN if it believes a person has been a party to act or failure to act that is set out in the table below.

Timing	Type of act or omission
<ul style="list-style-type: none"> □ Occurred on or after 27 April 2004. 	The ‘main purpose’, or one of the main purposes, of the act or omission was to prevent the recovery of any part of an employer’s section 75 debt, to prevent the debt from becoming due or to compromise or otherwise settle or reduce the amount of such a debt that would otherwise become due.
<ul style="list-style-type: none"> □ Occurred on or after 14 April 2008. 	Irrespective of intention, the act or omission has detrimentally affected in a material way the likelihood of accrued scheme benefits being received.

In either case, the recipient can only be issued with a CN in respect of an act or failure to act that occurred in the six years prior to the issue of the CN.

A person is treated as being party to a relevant act or failure to act if he knowingly assisted in it.

What is the test for issuing an FSD?

In contrast to CNs, FSDs are not event-driven. TPR can issue an FSD against a person even if there is no specific

act or failure to act to which it would relate. Broadly, FSDs allow TPR to find a third party to financially support a scheme if the participating employer does not appear able.

An FSD can be issued against a person if a participating employer in the scheme is either of the two categories in the table below.

<ul style="list-style-type: none"> □ A service company. 	The employer’s turnover, as shown in its latest accounts, is solely or principally derived from providing services to other companies in its corporate group – probably an indication that the employer will not have sufficient assets.
<ul style="list-style-type: none"> □ Insufficiently resourced. 	The assets of the participating employer are less than 50 per cent of its share of the buy-out deficit in the scheme, in circumstances where one or more other companies that are connected or associated do have sufficient assets to meet the difference.

Reasonableness

Even if the specific tests for issuing a CN or FSD (discussed above) are satisfied, for example if an act has caused a material detriment to scheme benefits, TPR may still not decide it ‘reasonable’ to exercise its powers.

The Pensions Act directs TPR to consider a number of factors in deciding whether or not issuing a CN or FSD would be reasonable – see our separate employment, pensions and benefits briefing [The reasonableness test – what are the factors that affect liability?](#) In brief, these factors include the degree of connection an entity has had with the scheme, any benefits the person has received from an employer or the scheme and (in the case of CNs), the purpose of the particular act or failure to act.

Process

The likelihood of a person becoming the target of a CN or FSD is largely dependent on whether, on the individual facts of the case, the following apply.

- TPR needs to investigate the position. It may be alerted by the pension trustees or investigate following a notification of a notifiable event or breach of law. Alternatively, it may act on its own volition (it is known to monitor developments affecting corporate groups with major pension schemes).

- Having considered the position and gathered information (for this purpose it may use its statutory powers to obtain information from interested parties) TPR then decides whether or not to seek a CN or FSD. It must then issue a ‘warning notice’ of its intention to issue a CN or FSD. This is issued to interested parties (including the trustees). It gives details of TPR’s reasons why the CN or FSD should be issued.
- The decision as to whether to issue the CN or FSD must then be made by TPR’s determinations panel. This is a statutory body within TPR that operates separately from TPR’s investigatory function, and functions much like a tribunal. TPR’s investigatory staff must make the case to the panel for the issue of the CN or FSD.
- The parties can make representations to the panel about the contents of the warning notice and TPR’s arguments for issuing the CN or FSD. An oral hearing can be requested. The panel will then consider the warning notice and the representations of the parties, and decides whether or not it is reasonable to issue the CN or FSD.
- The decision is then made by the determinations panel at TPR (a separate body from the investigatory function at TPR). It considers the warning notice and the representations of the parties and decides whether or not it is reasonable to issue the FSD or CN.
- An appeal to the Upper Tribunal (Chancery and Tax) can be made. This operates as a new hearing. The arguments for and against can be made again and new evidence produced.

Clearance

TPR is able to issue ‘clearance’ under a statutory process that confirms it will not issue a CN or an FSD to an applicant in relation to a particular action or set of circumstances.

However, TPR will only generally give clearance where it considers there has been what it refers to as a ‘type A’ event. Broadly, this is an event that has a materially detrimental effect on a pension scheme’s ability to meet

	Contribution notice	Financial support direction
Is fault on the part of the recipient a necessary precondition?	No. The recipient of the CN must have been a party to an act or failure to act. This includes knowingly assisting the act. But since 14 April 2008 the act or failure to act need not have been motivated by the purpose of avoiding pension liabilities.	No. An FSD is not based on any specific act or omission. It can potentially be issued if the employer is a service company or insufficiently resourced. But under the reasonableness test the actions of the FSD target can have an important bearing on whether the FSD will be issued.
Must the recipient be connected or associated with the employer?	Yes	Yes
Can an individual be targeted?	Yes. But an insolvency practitioner is exempt if ‘acting in accordance with his functions as an insolvency practitioner’.	No, unless the targeted individual is a participating employer in the scheme (though a non-corporate employer will be rare in large transactions and restructurings).
Does the ‘reasonableness’ test apply?	Yes. The list of factors that must be considered by TPR under the reasonableness test for CNS is different from those that must be considered under the test for FSDs (though some common factors apply).	Yes. The list of factors that must be considered by TPR under the reasonableness test for FSDs is different from those that must be considered under the test for CNS (though some common factors apply).
Is there a look-back period?	Yes. Even if the recipient has ceased to be connected or associated, TPR can issue a CN for acts or failures to act that occurred within the previous six years and either: <ul style="list-style-type: none"> □ on or after 27 April 2004 under the ‘main purpose’ test; or □ on or after 14 April 2008 for ‘material detriment test’. 	Yes. TPR can issue an FSD for up to two years from the time when the recipient ceases to be connected or associated. TPR may select a time in the look-back period that allows it to issue an FSD (eg it may choose a reference time at which it knows the relevant employer was insufficiently resourced).

its liabilities. Type A events can include large returns of capital, inter-company loans or asset transfers that are not on arm's-length terms or a change to the structure of the corporate group that has the effect of reducing the covenant strength of a participating employer.

TPR will usually require the trustees of the scheme to support an application for clearance. For them to do so, they must often have taken independent financial advice. It is also our experience that TPR will usually require some 'mitigation' for the impact of a type A event, eg increased funding or financial support for the scheme, before it will give clearance. In other words, there is usually a 'price' for obtaining clearance.

TPR's guidance on clearance is available on its website at www.thepensionsregulator.gov.uk/guidance/guidance-clearance.aspx.

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