UK Pensions Briefing

Moral Hazard, Enforcement and Clearance

December 2021

Introduction

This briefing sets out the purpose of the moral hazard or anti-avoidance powers of the UK Pensions Regulator under the Pensions Act 2004. It also examines certain civil and criminal sanctions which significantly expanded the Regulator's enforcement powers from October 1, 2021.

This is an update to our previous briefing notes on this subject and examines the circumstances in which the various powers apply and the persons who may be affected by them. It also looks at the Regulator's voluntary clearance procedure. The Regulator's information-gathering powers are outside the scope of this note.

Purpose of the framework

The 2004 Act gives the Regulator wide-ranging powers aimed at preventing employers from avoiding their funding obligations in respect of under-funded defined benefit pension schemes (collegiately called moral hazard provisions). The framework includes powers for the Regulator to issue contribution notices and financial support directions. From October 1, 2021, the Regulator also has the power to pursue criminal offences or issue civil penalties of up to £1m.

Contribution notices and financial support directions allow the Regulator to impose liabilities not only on employers participating in schemes but also to pierce the corporate veil and impose liabilities for under-funded DB pension schemes on other group companies, controlling shareholders and individual directors.

Criminal sanctions and penalties are intended to deter companies and individuals from intentional or reckless behaviour that harms DB pension schemes and to punish such behaviour.

This framework is a key area for employers and trustees to consider in relation to:

- Sales and acquisitions of companies.
- Financial or corporate restructuring.
- Banking transactions.
- Dividend payments.
- Share buy-backs.
- Any other transaction which may result in an employer (or group of companies) being less able to meet its funding obligations to a DB pension scheme.

A voluntary clearance procedure is available to give employers and potential purchasers engaged in such activities comfort that they are less likely to receive a contribution notice or financial support direction. However, clearance is not available in relation to criminal sanctions or penalties.

Contribution Notices

What is a contribution notice?

The Regulator can issue a contribution notice requiring a person to pay either the whole or a specified proportion of the funding shortfall in a DB scheme. A contribution notice can relate to a series of acts as well as to a single act.

When can a contribution notice be issued?

The Regulator has the power to issue a contribution notice to a person only if it is of the opinion that the following conditions (under section 38 of the 2004 Act) are satisfied:

- The person was a party to an act or a deliberate failure to act.
- The act or failure to act meets one of the following tests:
  - The main purpose or one of the main purposes of that act (or failure to act) was to prevent the recovery of the whole or any part of a section 75 debt[1] which was due, or might become due, from the employer or to prevent such a debt becoming due, to reduce it, compromise or otherwise settle it.
  - The material detriment test: the act or failure to act has detrimentally affected in a material way the likelihood of accrued scheme benefits being received.
  - The employer insolvency test: this is aimed at acts or failures to act which would materially reduce the scheme's recoveries if there were an employer insolvency (see below).
  - The employer resources test: this is aimed at acts or failures to act which materially reduce the employer's resources (see below).

What would count as material in any of these three tests is not explained in the legislation nor in any regulatory code or guidance.

The employer insolvency and employer resources tests only apply to acts or failures to act occurring on or after October 1, 2021. They were introduced because the Regulator felt that the material detriment test (which has been available since April 2008) was potentially problematic in that it focusses on the impact on the scheme rather than the employer and requires the Regulator to show what would have happened to benefits in the future. This could make it difficult for the Regulator to prove its case.

The Regulator wanted a simpler snapshot test, focussed on the immediate impact of an action on the employer.

The Regulator also has the power to issue a contribution notice (under section 47 of the 2004 Act) where there has been non-compliance with a previously issued financial support direction.

The employer insolvency test

This is where, broadly, in the opinion of the Regulator:

- The scheme was underfunded on a buy-out basis immediately after the act (or failure to act).
- If (hypothetically) the employer was insolvent immediately after the act (or failure to act) and had triggered a section 75 debt, the act (or failure to act) would have materially reduced the amount of the debt likely to be recovered by the scheme.

The Regulator has the discretion to estimate the value of the assets and liabilities of the scheme as well as the section 75 debt.

This test is aimed at actions which would worsen the scheme's position in an employer insolvency scenario, such as creating new security that ranks ahead of the scheme. As the test looks at a purely hypothetical insolvency scenario, the test is relevant for strong employers too, not just those for whom insolvency is likely.

The employer resources test

This test will be satisfied where the Regulator concludes that an act reduced the value of the employer's resources and that the reduction was material relative to the employer's section 75 debt.

Regulations clarify that this is aimed at actions that reduce the employer's profits before tax. This could include, for example, a sale of all or part of an employer's business.

Employer resources will be calculated by looking at the employer's profitability as follows:

- **Step 1** Using the last available accounts, calculate the employer's normalised annual profits before tax (excluding exceptional items).
- **Step 2** Calculate the impact of the act on normalised annual profits before tax.
- **Step 3** Compare the amount of the impact to the section 75 debt – is it material?

1 This is a statutory debt that is triggered and becomes payable by an employer under section 75 of the Pensions Act 1995 in certain circumstances, including where (broadly) the employer is insolvent, exits a multi-employer pension scheme or where the scheme winds up. It is an employer's share of the deficit in the scheme, measured on the conservative buy-out basis (the cost of securing benefits with an insurer).

In what circumstances might the contribution notice tests be engaged?

The Regulator has issued an updated code of practice (in force from November 2021) and code-related guidance setting out the circumstances in which it expects to issue a contribution notice under the material detriment, employer insolvency or employer resources tests set out above. These include:

- Cases where the employer covenant is removed, substantially reduced or becomes nominal (any of the tests).
- Significant weakening of the scheme's creditor position (material detriment and/or employer insolvency).
- Some instances of paying a cash dividend or a return of capital by the sponsoring employer (material detriment and/or employer insolvency tests).
- Early redemption or repayments of other significant creditor balances, before they are contractually due, that favour other creditors to the employer over the scheme (material detriment and/or employer insolvency tests).

Defences

A statutory defence is available for parties to use against the issue of a contribution notice under each of the above three tests.

Broadly, the defence requires the target to demonstrate to the Regulator's satisfaction that it appropriately considered the impact of its actions on the scheme and then took all reasonable steps to minimise or eliminate the detrimental impact identified.

A good audit trail will be very important, so the steps taken and rationale should be carefully documented. The Regulator has highlighted the importance on contemporaneous evidence.

The imposition of a contribution notice must be reasonable

Before issuing a contribution notice, the Regulator must be of the opinion that it is reasonable to do so.

The Regulator must have regard to the extent to which it was reasonable for the person to act or fail to act the way they did. In addition, the Regulator must, where it considers relevant, consider a number of other factors. These include the person's degree of involvement in the act or failure to act and the relationship between the person and the sponsoring employer.

Who can be caught by a contribution notice?

The Regulator may issue a contribution notice against:

- Any person who is both
  - A party to the act or omission.
  - An employer in relation to the scheme.
- Any person who is both
  - A party to the act or omission.
  - A person connected with or an associate of the employer, including group companies, controlling shareholders and directors.

For these purposes, "person" includes both individuals and corporate entities. The concept of being connected or associated with an employer is a wide net and generally includes – at a minimum – all companies in a corporate group and their directors.

Time-frame for imposing a contribution notice

The Regulator may review any act or failure to act up to six years after that act or failure to act, except that the employer insolvency and employer resources tests can't be applied to events occurring before October 1, 2021.

However, following a Court of Appeal decision in the *Box Clever* case in June 2019, it seems likely that the Regulator will on occasion look back beyond the six-year timeframe when deciding whether it would be reasonable to issue a contribution notice.

Sum specified in a contribution notice

The sum specified by the Regulator in a contribution notice may be either the whole or a specified part of the scheme's funding shortfall (measured on the buy-out basis).

From October 1, 2021, the shortfall sum will be estimated as at the scheme year end which is closest to when the Regulator issues its determination notice in respect of an intended contribution notice.

Financial Support Directions

What is a financial support direction?

The Regulator may issue a financial support direction to require other group companies who have sufficient resources to support a DB scheme in circumstances where one company in the group participates in that scheme but is unable to meet its funding liabilities. This could be by becoming liable for the whole or part of the employer's pension liabilities. In addition, other forms of support, such as bank guarantees, can constitute financial support.

When can a financial support direction be issued?

The Regulator may issue a financial support direction if it is satisfied that an employer sponsoring or participating in a DB scheme is either a service company or is insufficiently resourced at any time during a two year look-back period.

An employer is insufficiently resourced if two conditions are met:

- The value of its resources is less than 50 per cent of the scheme's section 75 debt, as estimated by the Regulator.
- The value of the resources of a person or the aggregate resources of persons who are connected with or associates of the employer and each other is at least equal to the relevant deficit (is the difference between the value of the employer's resources and 50 per cent of the estimated employer debt).

In contrast to contribution notices, no act or omission is required. In other words financial support directions are not triggered by someone being at fault. But the Regulator may only issue a financial support direction if it considers it reasonable to do so.

Factors in determining reasonableness

Although the Regulator decides whether or not a financial support direction would be reasonable, in making that assessment the Regulator must have regard to a number of factors. These include the relationship between the person and the sponsoring employer and the value of any benefits received by the person from the employer (directly or indirectly).

Who can be caught by a financial support direction?

The Regulator may issue a financial support direction to an employer participating in the DB scheme or to a person who is connected with or an associate of the employer. The Regulator will not impose a financial support direction on individuals (such as directors), except in limited specified circumstances.

Time-frame for issuing a financial support direction

The Regulator may issue a financial support direction only if it is satisfied that the target was either a service company or insufficiently resourced at the relevant time, and that target was the employer, or associated or connected with the employer, at that time.

The relevant time is a time determined by the Regulator that falls within the two-year look-back period ending when the Regulator issues a warning notice to parties directly affected by the financial support direction under consideration.

Failure to comply

The Regulator may issue a contribution notice, and thus may require an actual contribution to be made, if a financial support direction is not complied with.

Priority of financial support directions in an insolvency

Following the Regulator's decisions to issue financial support directions against companies in the Nortel and Lehman Brothers groups, the groups' respective administrators applied to the courts for directions as to the effect of financial support directions.

The Supreme Court decided that financial support direction liabilities were a provable debt, meaning they rank alongside other unsecured creditors. This means that liabilities under a financial support direction have the same priority as the employer debt to which they relate.

Criminal Offences

What are the criminal offences?

The Regulator can seek to prosecute the following offences:

- Avoiding an employer debt.
- Conduct risking accrued scheme benefits.
- Failure to comply with a contribution notice.

All three offences are punishable by unlimited fines, and the first two can also attract a prison sentence of up to seven years. An offence will only be committed if a person does not have a reasonable excuse for their act or failure to act.

How do they interact with the Regulator's moral hazard powers?

In certain circumstances both regulatory and criminal powers may be available to the Regulator. The Regulator's approach will depend on factors such as the seriousness of the conduct, the potential outcome for the scheme and the public interest.

The Regulator's primary objective will usually be to obtain funds for the scheme. It seems likely that it may therefore prioritise seeking a contribution notice in many cases.

The Regulator's draft overlapping powers policy (expected to be finalised in 2022 following a consultation closing at the end of 2021) states that where the Regulator does pursue both regulatory and criminal proceedings, it will usually seek to exhaust the criminal proceedings first although in certain circumstances it may need to pursue a contribution notice in tandem to the criminal proceedings in order to protect the scheme's finances or to avoid breaching time limits.

Who can be prosecuted?

The range of companies and individuals who are within the Regulator's reach for exercise of the criminal powers is wider even than for contribution notices and financial support directions.

The criminal offences catch any person who takes the prohibited actions. This means that anyone involved in decisions that affect a DB scheme – including company directors, scheme trustees, the employer's lenders and even professional advisers – can potentially be targeted. Only insolvency practitioners are exempted, and then only when specifically carrying out their functions as an insolvency practitioner (so not, for example, if giving advice in advance of that narrow role).

The breadth of the legislation was much debated in parliament and attacked by lobbyists. The government stood firm, wanting to maximise the Regulator's powers and their deterrent effect.

What is 'avoiding an employer debt'?

The offence of avoiding an employer debt will be committed by a person who by their act, conduct (or omission):

- Prevents a section 75 debt from becoming due or reduces the amount that becomes due.
- Prevents the recovery of all or part of an existing section 75 debt.
- Compromises the section 75 debt.

The person must have intended that their actions would have such an effect.

What is 'conduct risking accrued scheme benefits'?

The offence of conduct risking accrued scheme benefits will be committed where a person's actions (or failure to act) have a materially detrimental effect on the likelihood of accrued benefits being received.

The person must have known or ought to have known that their actions would have that effect. In considering what the person ought to have known, the Regulator says it will look at the circumstances as they were at the time of the act, and not with the benefit of hindsight.

What acts might constitute an offence?

The Regulator has released a criminal offences policy which outlines how it intends to investigate and prosecute the offences of avoiding an employer debt and conduct risking accrued scheme benefits.

Although the wide drafting of the new offences has the potential to capture ordinary corporate business activities, the Regulator understands the powers to be aimed at enabling it to punish the most serious intentional or reckless conduct of the type that was already within the scope of its contribution notice powers (see above).

The policy offers several examples and a detailed case study to illustrate what probably would and would not result in prosecution. For example, in the case study an employer facing a likely insolvency was guilty of an offence when it took out more borrowing and repaid loans to its parent

company knowing that this would substantially reduce the outcome for its unsecured creditors, including the scheme, in any insolvency proceedings.

However these are only examples and each case will be assessed on its own facts.

What is a reasonable excuse?

The Regulator will assess all relevant factors when considering whether there was a reasonable excuse but considers the following three factors to be of particular significance:

Incidental detriment
This is the degree to which any detrimental impact on the scheme was an incidental consequence of the relevant act or failure to act, as opposed to a fundamentally necessary step to achieving the person's purpose. For example, harm done to the employer's business because a supplier or customer terminates a business relationship or a lender refuses to lend could be considered incidental detriment.

Adequate mitigation
This is the degree to which adequate mitigation was provided to offset the detrimental impact. For example, the employer grants security to entities outside the direct covenant but subordinates it to the scheme's liabilities.

Viable alternative
In circumstances where no or inadequate mitigation was provided, this looks at whether there was a viable alternative course of action which would have had a less detrimental impact on the scheme.

The Regulator's criminal offences policy explains that the legal burden of proof will be on the prosecution to establish the absence of a reasonable excuse. However, the Regulator asserts that it does not need to identify and disprove every potential excuse which a person could raise. Instead, it will expect those investigated to put forward a positive, evidenced case. The Regulator also expects the basis for any reasonable excuse to be clear from contemporaneous records such as meeting minutes, correspondence and written advice notes.

Time-frame for prosecution

Actions occurring on or after October 1, 2021, can be prosecuted under the conduct risking accrued scheme benefits and avoidance of employer debt offences. However the Regulator expects that evidence from prior to this may be used in the investigation or prosecution process.

There is no applicable limitation period in relation to prosecution under the new criminal offences (in contrast to contribution notices, where the Regulator only has a six-year look-back period). So in principle, a person can remain at risk of criminal prosecution indefinitely.

Who can prosecute the criminal offences?

The Regulator is not the only prosecuting authority for these offences, which also include the Secretary of State and Department of Public Prosecutions in England and Wales, the Crown Office and Procurator Fiscal Service in Scotland and the Public Prosecution Service in Northern Ireland. Although the Regulator expects to be informed and consulted by these other authorities – and at the time of writing is seeking to agree a memorandum of understanding with these offices – they may have differing approaches and it is ultimately the courts that will decide the correct interpretation of the new laws.

Penalties

As an alternative to pursuing a criminal case, the Regulator has the power to impose penalties of up to £1 million in broadly the same circumstances as the criminal offences. This is if the Regulator concludes it was not reasonable for the person to act (or fail to act) in the way they did.

Penalties of up to this size can also be imposed where the notifiable events regime is breached or where false or misleading information is provided to the Regulator or the scheme's trustees.

The Regulator's draft monetary penalties policy is currently out for consultation. This proposes that there will be different bands of penalty depending on the level of culpability of the person being fined and the degree of harm to the pension scheme. Once the Regulator has decided which band should apply, the starting point for the penalty will be the middle of that band. The penalty will then be adjusted up or down depending on the presence of aggravating or mitigating factors (for example, whether or not the person was dishonest, co-operated with the Regulator or offered mitigation to the scheme).

The Regulator hopes to finalise this policy early in 2022.

Clearance

What is the clearance procedure?

It is possible to apply voluntarily for a clearance statement binding the Regulator not to issue a contribution notice or a financial support direction in relation to a specified event. The statement will bind the Regulator so long as there is no material non-disclosure of fact.

The clearance procedure does not apply to the criminal offences and there is no equivalent procedure available (although a person may seek to rely on the mitigation put forward in any successful clearance application as evidence of reasonable excuse in relation to any potential criminal liability).

Who can apply for clearance?

Applications can be made by parties that may be issued with a contribution notice or financial support direction.

The Regulator expects applicants for clearance to have involved the trustees of the pension scheme before applying. The Regulator will ask them for their view of the application and to explain why they hold that view.

When is the clearance procedure available?

The clearance procedure is entirely voluntary. The Regulator has issued guidance (updated in September 2021) as to when it may be appropriate to apply for clearance, but does not prescribe any circumstances where a clearance application is mandatory. The Regulator's policy continues to be that it will only consider clearance applications in relation to so-called type A events.

What are type A events?

Type A events are events that are materially detrimental to the ability of the scheme to meet its pension liabilities. They can be employer-related events affecting employer covenant or scheme-related events affecting the scope of the employer's legal obligations to the scheme.

The guidance sets out a list of examples of situations which could be type A events, but the Regulator stresses that these are merely examples and the list is non-exhaustive. Examples of employer-related type A events include a change in creditor priority, a return of capital (such as share buy-backs) and a change in the sponsoring employer of the scheme. Examples of scheme-related type A events include some apportionment arrangements and compromising scheme liabilities.

What is the "price" for clearance?

Although the clearance guidance is not explicit, in our experience the Regulator is likely to require some form of quid pro quo (cash or contingent support) in return for granting clearance in respect of a given transaction. Trustees may see clearance applications as opportunities to negotiate improved funding terms.

Time-frame to apply for clearance

The Regulator aims to be sensitive to the commercial timescales of a deal and will try to meet any reasonable deadlines the applicant may have. To proceed efficiently, the Regulator recommends that applicants for clearance and the scheme trustees engage with it before submitting a signed application.

Adequate time should also be allowed to collate the detailed information required by the Regulator as part of the clearance application. Unless this information is readily available, this could cause delays. In addition, time allowances should be made for discussions between the employers and trustees of the scheme, which the Regulator will generally expect to have taken place before any clearance application. Clearance applications have declined in popularity over the last 10 years due to the cost and fact that protection is limited to a snapshot in time. Perhaps the new powers will reverse this trend.

Comment

The Regulator has, to date, still only issued contribution notices and financial support directions in a limited number of circumstances. However, this should not be viewed as indicative of a reluctance to act. Ever since the high-profile collapses of first Bhs in 2016 and then Carillion in 2018 the Regulator has come under increased pressure to be more proactive and effective. Nowadays its mission statement is to be "clearer, quicker and tougher".

The moral hazard powers are widely framed, giving a great deal of discretion to the Regulator. The expanded contribution notice tests make this power even more readily available and we may well see it being used more frequently in the future.

We also know from the Regulator's published regulatory intervention reports that it has on occasion influenced transaction structures and outcomes for pension schemes by threatening to exercise its powers without actually having to do so. It is not known how often it has done this.

With the introduction of criminal offences and penalties the Regulator has a significantly expanded toolkit and set of deterrents. While it seems unlikely that the Regulator will seek to bring many criminal prosecutions, it is unclear as yet how the Regulator's new criminal powers will operate in practice. Complying with the Regulator's criminal offences policy will help reduce the risk of a successful prosecution.

Employers should take care when engaging in corporate activity that could negatively affect a DB scheme to ensure that they consider the impact appropriately and in advance, seeking expert advice where necessary. They should consider carefully their strategy for engaging with the scheme's trustees, including when to engage, whether any mitigation should be offered, and whether an application for clearance is necessary or desirable.

Employers should get in the habit (if they are not already) of carefully documenting their decision-making process with particular thought given to the statutory defence for contribution notices and what the Regulator may consider to be a reasonable excuse. The Regulator has highlighted the importance of contemporaneous records.

They should also review and keep updated their existing governance structures and policies in the light of these evolving powers. This is to ensure that all relevant corporate activity is properly considered at an early stage and by the right people.

Employers and trustees will need to be familiar with the relevant regulatory policies and codes so as to be able to assess the transaction with the key principles in mind. It may be sensible to provide training for decision-makers.

Lenders and others who are less directly involved in decisions affecting DB schemes should also consider taking advice on their current governance and decision-making processes to minimise the risk of Regulator action. The Regulator's criminal offences policy provides some helpful example assessments of lender conduct in the context of the offences.

For further information and support, please speak to your usual contact in the Norton Rose Fulbright pensions team.

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