



# Advising the Board on **Pension Risk**

Reports looking at the full range of commercial risk



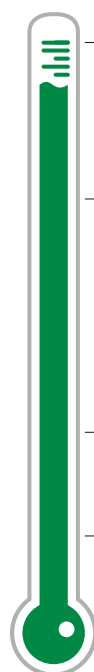
Risk, Resilience  
and Reputation

# Directors' risk report

Following a number of high-profile pension scheme failures, the Pensions Regulator ("TPR") has been given a greater arsenal of powers to bring companies and individuals into line, and to make sure that defined benefit pension schemes are front and centre in corporate decision-making. Board decisions that are seemingly unrelated to pensions need to be viewed through the filter of those powers – or the companies and individuals taking them run the risk of significant civil and criminal sanctions.

Some of the risks relating to defined benefit pensions will be familiar to directors because TPR has had some powers since 2006. However, the changes in October 2021 and April 2022 have the effect of increasing those risks and expanding the scenarios in which defined benefit pension schemes could impact business activities. In this report we look at the detail of some of those changes and how they may affect your decision-making and implementation of corporate activity.

## Risk thermometer



**Direct payments into the pension scheme** – imposed by the Pensions Regulator and requiring significant sums to be paid into a pension scheme

**Fines** – scope for unlimited criminal fines and increased civil fines for companies and individuals

**Directors' Duties** – early consideration of the effects of corporate activity is essential

**Criminal offences** – potential for a custodial sentence of up to 7 years

**Political** what would be the impact of increased political scrutiny or criticism?

The risks for companies, their directors, employees and shareholders include:

	When?	Common risk scenarios
<b>Significant direct payments into the pension scheme</b>	<p>Actions reducing the amounts due to the pension scheme or avoiding payment.</p> <p>Reducing the resources of the sponsoring employer.</p> <p>Risking the likelihood of pensions being paid in full.</p>	<p>Restructuring – solvent or insolvent.</p> <p>Material acquisitions or disposals.</p> <p>Deciding to discontinue business areas.</p>
<b>Unlimited criminal fine</b>	<p>Actions reducing the amounts due to the pension scheme or avoiding payment.</p> <p>Risking the likelihood of pensions being paid in full.</p> <p>Failure to make a direct payment into the scheme when required to by TPR.</p> <p>Failure to provide information to TPR when required to do so.</p>	<p>Intentionally causing harm to the pension scheme.</p> <p>Refusing to pay into the scheme when able to.</p>
<b>Civil fine up to £1m</b>	<p>Actions reducing the amounts due to the pension scheme or avoiding payment.</p> <p>Risking the likelihood of pensions being paid in full.</p> <p>Knowingly helping with such actions.</p>	<p>Intentionally causing harm to the pension scheme.</p> <p>Refusing to pay into the scheme when able to.</p>
<b>Statutory fines</b>	<p>Providing false or misleading information to TPR.</p>	<p>Intentionally misleading or deceiving TPR.</p>
<b>Prison for up to 7 years</b>	<p>Actions reducing the amounts due to the pension scheme or avoiding payment.</p> <p>Risking the likelihood of pensions being paid in full.</p>	<p>Intentionally causing harm to the pension scheme in a very significant way – likely involving deception.</p> <p>Refusing to pay when able to.</p>
<b>Prison for up to 2 years</b>	<p>Providing false or misleading information to the Regulator.</p>	<p>Intentionally misleading or deceiving TPR in a material way.</p>

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## Statutory defence

The purpose of these powers is to make employers, former employers and decision-makers think about the effect of their actions on pension schemes – and mitigate the impact if that effect is negative. If the statutory process is followed prior to making a decision then, in principle, it may be possible to claim a statutory defence, preventing TPR from issuing a Contribution Notices (“CN”).

This process must be completed in advance of the relevant deal completion. Decision-makers must give due consideration to any potential detriment to the pension scheme, as a reasonably diligent person would have done in the same circumstances, and mitigate the detriment where appropriate.

In our opinion it is vital to take advice, not least because it will reinforce the reasonableness of any decision reached if it can be shown that professional advice was received and considered. Furthermore, it is important to keep a paper trail of both that advice, and the minutes of meetings where the issues were considered and decisions reached.

These risks may also be mitigated by seeking clearance from TPR (“Clearance”) that the actions being taken would not result in TPR issuing a CN or Financial Support Direction (“FSD”). This is not compulsory and will not directly cover the risk of any criminal offences.

### Significant Payments or Support for the Scheme

TPR has two key powers to require either a significant direct payment into, or support to be put in place for, the pension scheme: Contribution Notices and Financial Support Directions.

These powers can only be used against someone connected or associated with an employer participating in the relevant defined benefit pension scheme. Those who are connected or associated include directors and significant shareholders.

Although either power can only be used where TPR thinks it is reasonable to do so, its view of reasonable does not always match commercial reasonableness.

## I. Contribution Notices ("CN")

This power can be used in relation to an act, or deliberate failure to act in the previous six years that:

- is materially detrimental to the pension scheme;
- results in a debt due to the pension scheme not being recovered or being reduced;
- materially reduces the resources of a sponsoring employer of the scheme in question; or
- would have resulted in an underfunded scheme recovering a lower amount from the employer, had the employer suffered an insolvency event immediately after that act.

These tests could be triggered by acts that a board of directors perceives to be 'normal' corporate activity. These are tempered by a statutory defence (see below) – but that is only available if the effect on the pension scheme has been considered in advance of the relevant act.

Relevant acts could also catch the activities of companies in the wider group that are not participating in the pension scheme. For example: where a parent company provides a guarantee to a participating employer in the pension scheme, actions that weaken that parent company (so that it may not be able to meet payments that fall due under the guarantee) may fall into the scope of the power.

## II. Financial Support Directions ("FSD")

These allow TPR to insist that financial support is put in place by a company that does not participate in the pension scheme. In order to do this, TPR must believe the scheme's employer:

- is a service company; or
- is insufficiently resourced under the statutory definition.

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## Political angle

There is an increased politicisation of pension issues as a result of a number of high profile failures.

Parliamentary select committees have investigated a number of high profile individual pension scheme failures and required company directors to defend their actions in full view of the media and public. They are particularly difficult to deal with in light of the committee's information and evidence gathering powers. Failure to comply with a request for documents or to appear as a witness may result in the sanction of contempt of Parliament. No one has recently been convicted of such an offence, so the exact nature of such a sanction is unclear. The potentially more

important sanction is that of public censure. This means that requests from parliamentary select committees are regularly complied with – but at what cost to a company's reputation? Select committees are generally conducted in public and may ask any question or make any allegation covered by absolute parliamentary privilege

While you can never fully prepare for the unexpected, having the necessary procedures in place and advisory team on standby can minimise the reputational risk and help maintain the corporate narrative. In particular, in contrast to giving evidence in legal proceedings in the UK, it is permitted to be prepared to give evidence to Select Committees and to run mock sessions in advance.

## Keeping TPR Informed – The Need to Provide Information

Employers and trustees are required to tell TPR when certain events, known as “notifiable events”, occur. These events and associated requirements are to be expanded and the new requirements will apply to both employers and a wider group of persons connected or associated with the employer (including companies outside of the group of sponsoring employers).

We are also expecting new regulations that will require a “declaration of intent” to be provided to TPR and copied to the pension scheme trustees. We expect the scenarios that will require such a declaration to include:

- the sale of a controlling interest in a scheme employer;
- the sale of the business or assets of a sponsoring employer; and
- the granting of security in priority to the scheme.

These declarations will have to be given not just on the happening of a notifiable event, but also possibly where there has only been a decision in principle and when there is a later, material change in the event or if it does not in fact take place.

Importantly, it is not possible to argue that an event cannot be notified to TPR because it is confidential (for example a corporate transaction subject to an NDA), or

the person is in some way subject to another duty (other than certain types of legal privilege).

A failure to comply could lead to fines and criminal offences as summarised in the table above. It is therefore vital to understand what events are notifiable and will require a declaration of intent and to consider these matters at the start of any corporate/banking activity.

The introduction of these new requirements was delayed and is now expected early 2023.

### TPR investigation powers

TPR has significant powers to investigate which allow it to obtain any relevant information it needs (although privilege still applies). Its powers include:

- issuing s72 notices which can require existing documents to be provided and new documents to be created setting out specific information;
- mandatory interviews of anyone who may have relevant information; and
- entering premises to obtain information.

Non-compliance risks criminal offences and significant fines as summarised earlier.

## Preparing for the worst

There are a number of steps you can take to ensure your company is prepared to deal with a Pensions Regulator investigation, should one arise:

### Prepare crisis response protocols

Ensure that your company has a clear understanding of what types of issues require escalation and establish clear reporting lines, stakeholder involvement and decision-making processes. These processes should include what employees are required to do in the event of a dawn raid and you may wish to consider a practice session.

### Insurance

Check to see whether the risks of non-criminal pensions regulatory intervention are covered by your existing insurance or could be insured and the value that insurance may provide, particularly in meeting the potentially significant costs of dealing with the investigation (even if that investigation is ultimately dropped).

### Prepare for investigation of facts

Ensure that your IT and document management systems are equipped to undertake searches of documents quickly. Consider which external team you may turn to in order to undertake or lead an investigation.

### Privilege

Ensure that you know who will be in your privilege circle with pre-agreed strict lines of communications especially during the investigation stage as it is unlikely that all communications relating to the investigation will be covered by privilege.

# Expert perspective



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## **What scenarios which are likely to arise in practice now need to be viewed through a pensions lens that did not need to be before the PSA 21 came into force?**

While big ticket M&A activity has always been a catalyst for engagement with pension trustees and TPR, the new requirements of PSA21 have brought a wider range of corporate activity into scope and increased the risks for corporate sponsors. The new Employer Insolvency and Resources tests are designed to make it easier for TPR to take enforcement action and corporates will need to explicitly consider all corporate activity against them.

The Employer Insolvency test is putting greater emphasis on understanding where value is located in a corporate structure, and how this would flow to competing creditor claims (including the pension scheme) in an insolvency scenario. This is leading to more focus on internal reorganisations (such as tax-driven restructurings) given the risk that value could be extracted from the covenant. Refinancing arrangements will also be scrutinised, including whether the fine print (for instance, around cross-guarantees or mandatory prepayment requirements) could contain potentially detrimental aspects.

In a similar vein, the Employer Resources test will put more focus on intra-group trading arrangements. Changes to transfer pricing arrangements will need to be explained by reference to market and industry practice, while cost recharges will need to be justified by the underlying activity and its benefit to the sponsor.

Finally, the recent and upcoming new pensions legislation and regulation is itself leading to corporate activity. Faced with increased reporting requirements for each employing entity, corporates have complex covenant structures in their sights and some are exploring what actions they can take to simplify future pensions governance requirements.

## **What practical steps can boards take to prepare for the worst?**

The new requirements of PSA21 are not intended to prevent responsible corporate activity, but do increase the need to identify and proactively manage scheme risks.

The first step is to understand how the pension trustees assess their covenant – what support does the scheme need and when, which employers will be expected to provide it, and what trading activities and assets hold the value to deliver it?

Using this knowledge, corporates can ensure that the right stakeholders in the organisation are aware of the pension dynamic and the need to engage with the area of the business responsible for the scheme (e.g. the finance or HR functions). One option is to 'red flag' key employers, assets and trading relationships that underpin the covenant so that events impacting them are spotted quickly, notified accordingly to the trustees and the pensions risk is adequately managed

Finally, formalising information sharing arrangements with the pension trustees can provide a clear audit trail of what potential corporate activity (in terms of nature and/or size) could materially impact the covenant and reduce the risk of a surprise intervention after an event.



## Crime And Punishment

As well as the criminal offences relating to the provision of information, there are two additional criminal offences that could be committed as part of a business transaction:

## I. Avoidance of an employer debt

Preventing the statutory debt that is owed by a sponsoring employer to a pension scheme from being paid, becoming due, or reducing it in some way (other than payment) is a criminal offence if it was carried out intentionally and without reasonable excuse.

For example: This might include structuring a sale to avoid a debt on an employer being triggered.

## II. Conduct risking accrued scheme benefits

Detrimently affecting in a material way the likelihood of pension benefits being received in full is a criminal offence if the person knew (or should have known) that what they did would have that effect and did not have a reasonable excuse for doing it.

For example: This could include something as routine as changes in the sponsoring employer's business model or moving a sponsoring employer out of the jurisdiction.

Both offences can attract a criminal sanction (with an unlimited fine and/or up to seven years in prison) or a civil penalty of up to £1 million.

## Summary

## Practical risk management for directors

The approach you take to managing transactions and the relationship with the pension scheme on an ongoing basis can reduce the risk of any regulatory action.

There are some overarching principles to keep in mind as part of your regular business practices:



## Think Pensions

There is now a wider range of situations in which the impact on the pension scheme will need to be factored into the analysis of your approach to transactions. Running training for decision makers on the circumstances in which the pension scheme needs to be considered will help keep this at the forefront of decision making.

Ensure that it is clear to everyone involved in transactional decision-making what transactions may need notification to TPR and the trustees.



### Maintain good lines of communication with the trustees

Ensure that decision makers and the trustees know who the key contacts are and communicate regularly regarding business plans and intentions towards the pension scheme.



## Ensure that decision makers receive the right advice

Decision makers need to understand the potential covenant, funding and legal impacts of a proposed transaction on the pension scheme. Identifying risks at the start of a transaction will make the process smoother and will help make sure that decision makers have all the factors relevant to the risk/reward analysis before committing to a transaction.

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