Negotiation in the perfect storm: COVID-19 and defined benefit pension schemes

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This article considers the impact of COVID-19 on relations between corporate employer groups and defined benefit (DB) pension scheme trustees, outlining the key factors that may influence negotiations regarding the "employer covenant" (broadly, an employer's legal duties and financial ability to fund a pension scheme). Issues covered include the types of negotiation triggered by COVID-19, the management of information flow, directors' duties, the balance of negotiating power, forms of mitigation and the roles of the Pensions Regulator and the Pension Protection Fund (PPF).

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Introduction

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The pensions industry often tries to predict the future: of investments, employer businesses, how long people will live. However, the COVID-19 pandemic has thrown many of these predictions into disarray, making even the most basic of assumptions extraordinarily difficult to formulate with confidence.

For many defined benefit (DB) schemes and their sponsoring employers, this has created a perfect storm. Many businesses, battered by the virus, are facing immediate cashflow problems. Others may seem to be weathering the storm better, but their current relative stability may mask deeper-seated problems arising from the virus; will their businesses still be relevant and competitive in the "new normal"?

COVID-19 prompts urgent and frequently difficult discussions between employer groups and their DB scheme trustees. The longer the pandemic goes on, the more urgent and difficult these will become.

In this article we:

- Consider the kinds of negotiations that COVID-19 has imposed on employers and trustees.
- Examine the crucial issue of information and how it flows.
- Set out various drivers for negotiations, including the involvement of the Pensions Regulator and the Pension Protection Fund (PPF).

What is employer covenant?

Employer covenant is the legal obligation of sponsoring employers to fund the scheme and their financial ability to do so. The strength of this covenant depends on the strength of those legal obligations and the financial position of the relevant employer (or other relevant entity).

The covenant can be strengthened in many ways, for example, by providing security to the trustee to prioritise the scheme's claim ahead of other creditors, or by group companies providing guarantees of the employers' funding obligations.

Conversely, the covenant can be weakened in many ways, such as the employers weakening their financial position by selling businesses and returning the proceeds to shareholders, by incurring liabilities (such as bank debt) that will compete with the scheme or by granting security to other creditors so that they rank ahead of the scheme.

What kinds of negotiation is COVID-19 triggering between employers and trustees?

Negotiations between employers and trustees are always fact-specific but some themes have emerged. Whether or not employers need trustee consent to their proposals will vary depending on scheme rules and other factors. All of the examples below could affect the employer covenant:

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- **Deferral of contributions.** Facing cashflow problems, many employers have asked trustees to agree to defer payments that they had already committed to pay to their schemes.
- **Other funding discussions.** Employers may seek a longer or reshaped (for example, back-end loaded) recovery plan. Cashflow concerns are dominating many valuation and funding discussions.
- **Corporate reorganisation.** A reorganisation (such as a demerger, sale of a business or companies). COVID-19 may also prompt strategic acquisitions by employer groups.
- **Impact of new finance or of refinancing terms.** Many employers have needed financial support from lenders such as new debt facilities, a refinancing of existing debt or the resetting of the terms of existing facilities.
- **Security over assets.** Many schemes will be unsecured creditors, but some trustees have negotiated security rights over employer assets or veto rights over disposals or the granting of security. If the employer group is looking to sell the relevant assets or grant security over them in order to raise funds, the employer will need the trustee's consent.
- **Rescue talks.** Distress scenarios often require emergency action, such as financing or refinancing on aggressive terms, forced disposals and urgent group reorganisations, which may involve insolvency measures such as company voluntary arrangements under the Insolvency Act 1986 (see *Practice note: overview, Company voluntary arrangements (CVAs)*). The trustee will expect to be involved. Rescue talks, at least for larger schemes, are also likely to involve both the Regulator and the PPF. And both employers and trustees will have to consider the impact of insolvency law, which was recently changed by the Corporate Governance and Insolvency Act 2020 (CIGA 2020) (see *Practice note, Corporate Insolvency and Governance Act 2020: pensions aspects*).

For more information about the funding issues that may arise, see *Practice note, COVID-19: issues for pension scheme trustees and employers: Funding issues*.

Provision of information

A key consideration is the flow of information about the employer's business and its projected performance in the light of COVID-19.

The unprecedented impact of COVID-19 has made it difficult for many organisations to generate reliable information about their businesses; it is difficult to formulate reliable assumptions on which to base projected earnings and cashflows. This makes it hard for stakeholders, including trustees, to assess the position with confidence. Poor information endangers constructive negotiations.

Scope of information needed

A well-advised trustee will have a clear idea of the financial information and reports that it needs to inform its decision-making (such as sensitised cashflows, business plans and estimated outcome statements on an insolvency). Trustees will normally wish to take covenant, actuarial and legal advice in identifying their requirements. Early engagement between the trustee and the employer group to agree the scope of the information to be provided is important.

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The Regulator has always encouraged employers to share covenant information with trustees and current messaging is clear that the Regulator expects trustees to engage early and effectively. The Regulator has also provided COVID-19 guidance to trustees identifying the specific information that they should be reviewing when considering requests from employers in distress situations (see *Practice note, COVID-19: key legislation and guidance: Dealing with DB scheme sponsoring employers in financial distress*).

Quality of information

Generally, well-run businesses can generate the necessary reports and projections, but there are lots of employer groups whose finance functions are struggling to assess the impact of COVID-19.

Employer groups will need to think carefully about the quality of the information that they share, and how it is presented.

Flow of information

Negotiating dynamics can lead to a risk of some stakeholders (for instance, lenders) being given key information quicker than others. Sometimes this is justifiable, but trustees should push against being kept in the dark.

The Pension Schemes Bill 2019-21 is due to require employers to provide more information earlier to both trustees and the Regulator. The Bill also contains tougher sanctions for acts that are detrimental to DB pension schemes in certain ways (see *Pension Schemes Bill 2019-21* below). Even before these changes come into force, employers who share good quality information at an early stage may be able to mitigate the risks of future sanctions.

It is also important to note that the Regulator already has wide powers to require the disclosure of information that is not subject to privilege (see *Practice note, Pensions Regulator: Provision of Information*). Ultimately, trustees, the Regulator and the PPF all want to be able to see that the scheme is being treated fairly when compared with other creditors and shareholders.

Agreements relating to information provision

Trustees and employers commonly agree information sharing protocols or agreements as well as confidentiality agreements, and trustees may sign "hold harmless" letters to secure the release of copies of professional advice given to the employer. For an example of a confidentiality agreement, with drafting notes and related content, see *Standard document, Trustee confidentiality agreement*.

Factors that commonly influence negotiations

Each situation is fact-specific, but several factors underpin most negotiations between an employer and a trustee.

Legal scope of the employer covenant

- There is generally no statutory or trust law obligation for an employer group as a whole to support a scheme (unless and until the Regulator uses its "moral hazard" powers to create such an obligation). The precise scope of the recourse that the trustee has to group entities is critical.

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A scheme with direct rights against a wide range of valuable group companies (for instance, because these are the "statutory employers" is usually in a better position). For more information, see *Practice note, Statutory debt on the employer: overview*.

- The Regulator's recent distress guidance (*Pensions Regulator, Protecting schemes from sponsoring employer distress*) emphasises the importance of trustees identifying employers' legal obligations to the scheme including in insolvency, as well as insolvency outcomes for the scheme, long before the employer shows any signs of distress. This is in line with much of the Regulator's longstanding guidance, but is notably more robust than its 2015 Employer Covenant guidance (*Pensions Regulator, Assessing and monitoring the employer covenant*), which is still in force and referred to in its new guidance.

For more information, see *Practice note, COVID-19: key legislation and guidance: Dealing with DB scheme sponsoring employers in financial distress*.

Directors' duties

- The directors of the employer companies should be considering their legal directors' duties at all times. In particular, if there is a risk that their company will go into a terminal insolvency process then their legal duties realign so that they must act in the interests of their creditors rather than their shareholders.
- This is a complex area on which directors need careful legal advice. Key issues are likely to be risks around actions that may constitute:
    - wrongful trading (which has temporarily been somewhat relaxed to allow for the pressures of COVID-19) (see *Practice note, Corporate Insolvency and Governance Act 2020: pensions aspects: Suspension of liability for wrongful trading*);
    - granting preferences to creditors; or
    - transactions at an undervalue.
- Compliance with these duties should frame the approach that the employer directors take and the solutions that they should explore.

For more information, see *Practice note, Insolvency and considerations for directors*.

Trustees' duties

- Trustees must consider their own legal duties during negotiations. Trustees must exercise their powers (whether under the trust deed and rules, under contract or otherwise) in accordance with their duties to scheme beneficiaries.

For more information, see *Practice note: overview, Pension trustees' duties of care and skill*.

Who holds the balance of negotiating power?

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- The employer and the trustees need to identify whether the scheme's rights give it a particular standing (beyond the standing of other creditors of that company).
- If the employer group needs the trustee's agreement to a proposal (for instance, to vote in favour of a company voluntary arrangement) then that gives the trustee considerable negotiating leverage.
- In some cases, a trustee may have unilateral or strong powers under the scheme's deed and rules, for example, to set employer contributions or wind up the scheme, which provide significant negotiating leverage.
- In other cases, including some corporate transactions, employer debts may be triggered under section 75 of the Pensions Act 1995, which trustees may choose to call in or agree with the employer to modify - if it is appropriate to do so and relevant legislative tests are met. For more information, see *Practice note, Statutory debt on the employer: overview*.
- If the relevant proposals risk material detriment to the employer covenant, that engages the risk of the Regulator exercising its powers (see *Pensions Regulator* below), which often compels the employer group to discuss appropriate mitigation.
- Sometimes, however, a trustee will have limited negotiating leverage in which case the trustee may need to consider notifying the Regulator of its concerns.
- As with any negotiation with employers, trustees will need to consider carefully whether there are any conflicts that need to be addressed. Conflicts can become more acute in a distress situation. Trustees need to be prepared to explain their analyses and conclusions about conflicts to the Regulator. For more information, see *Practice note: overview, Pensions: conflicts of interest toolkit*.

Pensions Regulator

- The level of the Regulator's involvement in negotiations may be a significant factor.
- Many of the sorts of events prompted by COVID-19, including refinancing, restructuring, returns of capital and disposals of assets could prompt the Regulator to consider its powers, which are soon to be strengthened by the Pension Schemes Bill (see *Pension Schemes Bill 2019-21* 2019-21 below).
- The Regulator has statutory objectives to protect member benefits and reduce the risk of calls on the PPF. Although it also has a statutory objective to minimise adverse impact on the sustainable growth of an employer, that only applies to its ongoing funding powers.
- The Regulator's funding powers are likely to be strengthened soon (see *Pension Schemes Bill 2019-21* below) and it is consulting on a new funding code. The Regulator's information gathering powers are also soon to be strengthened. And the Regulator has a limited power to wind up schemes.
- The Regulator does not have a statutory objective to protect jobs, but whether an act had a job protection motive can be a relevant factor when the Regulator considers using its contribution notice power. More generally, as a public body, the Regulator is likely to have some regard both

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for the impact on jobs and the wider economy of both its stance in negotiations and its more formal use of powers.

- The Regulator has issued guidance specifically about COVID-19 (see *Practice note, COVID-19: key legislation and guidance: Guidance for trustees, employers and administrators*), which has been updated since the start of the pandemic. The Regulator has also issued guidance for trustees about employer distress, including due to COVID-19 (see *Practice note, COVID-19: key legislation and guidance: Dealing with DB scheme sponsoring employers in financial distress*).
- The Regulator expects employers to be able to share financial information about the effects of COVID-19 with trustees, albeit possibly based on a range of scenarios. Accordingly, the Regulator expects trustees to do significant due diligence before agreeing to employer proposals, and to seek mitigation for any detriment. Ultimately, however, what trustees are able to demand may depend on the balance of negotiating power (see *Who holds the balance of negotiating power?* above). If trustees have limited power to negotiate, they may choose to involve the Regulator at an early stage.

For more information on the Regulator's powers and role, see *Practice note: overview, Pensions Regulator: overview*. For more about the practical issues for company directors arising from these powers, see *Practice note, Pensions Regulator powers: practical issues for company directors*.

Forms of mitigation

- What will constitute appropriate mitigation will depend on the circumstances.
- In practice a wide variety of covenant enhancements and mitigations can be used, including:
  - cash payments to the scheme;
  - guarantees from valuable companies;
  - security over valuable assets granted to the scheme, including escrow structures;
  - subordination arrangements under which other creditors agree to rank behind the trustee's claims;
  - the provision of bank letters of credit; and
  - arrangements under which the trustee shares in any "upside" of improved profits in the future.
- These are often accompanied by other legal provisions improving the scheme's position, such as information provision protocols (see *Provision of information* above), negative pledges and contractual limitations on the incurrence of further debt or disposals.
- Where a pension scheme is agreeing to reduce or postpone contribution payments, the Regulator has given guidance around some of the mitigation it would expect trustees to seek, including the suspension of dividends at least for the period that the pension scheme contributions are altered. This reflects that the pension scheme is a creditor ranking ahead of shareholders' equity interests in an insolvency. The Regulator also expects trustees to seek to put in place legally enforceable means of securing fair treatment compared to other creditors, for example, security for deferred

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contributions. For more information, see *Practice note, COVID-19: key legislation and guidance: Suspending or reducing pension contributions*.

Pension Schemes Bill 2019-21

- The Pension Schemes Bill introduces new sanctions and strengthened powers for the Regulator, applying where behaviour by employers or other parties has been detrimental to pension schemes. These include:
  - new criminal offences and civil penalties for employers and third parties (who may not be associated with employers);
  - new grounds for the Regulator's contribution notice power (that can be issued to employers or associates); and
  - new requirements for employers and associates to provide information about notifiable events to both the Regulator and trustees.
- The new criminal and civil sanctions are significantly more wide-ranging, in several respects, than the Regulator's existing moral hazard powers.
- These changes may shift the balance of powers further in negotiations and help give trustees a seat at the table at an earlier stage if employers are making any plans that could affect the pension scheme.

For more information, see *Practice note, Pension Schemes Bill 2019-21: key points: Extension of Regulator's powers and new offences*.

Pension Protection Fund

- The part the PPF plays in any negotiation depends, in particular, on whether the employer is distressed and considering restructuring options (because these may trigger a PPF assessment period so that the PPF's powers are directly engaged).
- Other factors include whether the scheme has a deficit on the PPF basis and whether the Regulator is considering its moral hazard powers.
- Broadly, there tends to be alignment between the PPF's and the Regulator's objectives in any negotiation.

For more information about the PPF, see *Practice note, Pension Protection Fund: overview*.

CIGA 2020

- The Corporate Insolvency and Governance Act (CIGA 2020) introduces new options for company restructuring and rescue, some of which could have a significant impact on a pension scheme (or

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the PPF) as a creditor of a sponsoring employer. The new options include a moratorium for 20 business days as well as a new restructuring plan.

- There is potential scope for CIGA 2020 to be used to compromise pension scheme liabilities. The provisions are complex but the Act allows for the "cramming down" of creditors via a restructuring plan, which could potentially include the pension scheme.
- In addition, the new statutory moratorium may alter the ranking of some kinds of unsecured debts so that they rank in priority to the unsecured claims of the pension scheme.
- Trustees will need to consider the potential impact of CIGA 2020 on their ongoing covenant assessment.

For more information, see *Practice note, Corporate Insolvency and Governance Act 2020: pensions aspects*.

Summary

Although it may be difficult to predict how and when COVID-19 will affect employers, trustees and employers can and should be actively considering the position with the benefit of legal, actuarial and covenant advice. The insolvency and restructuring aspects of covenant assessment have never been more important.

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