KPMG

CORPORATE RECOVERY

Pensions Act 2004

Clearance - an overview

ADVISORY

May 2005

Clearance from the Pensions Regulator is now required for many corporate transactions within a group – and a group may be wider than previously thought.

The Pensions Regulator ("the Regulator") has issued guidance on the matters to consider when corporate transactions requiring clearance, i.e. those which might materially affect the recovery to a pension scheme if the employer became insolvent, are proposed. Failure to consider whether to seek clearance may result in financial contributions to the company's pension scheme being sought not only from parties to the transaction but also from their associates. This could undermine the commercial justification for a transaction or impose an inflexible cash drain.

When is clearance needed?

The Regulator refers to events requiring clearance as "Type A" events. The effects of these typically fall into any of the following three categories:

- Changes in priority - a change in the level of security given to creditors which results in the pension scheme creditor receiving a reduced dividend in the event of a subsequent insolvency.
- Returns of capital - a reduction in the overall assets of the company (e.g. dividends or demergers).
- Changes in control structure - a change in the group structure of an employer which reduces the quality of the employer's covenant.

The Regulator expects that if any type A event occurs within a group, then clearance will be sought.

Note that clearance may need to be sought where any company within the group is proposing the transaction – not just the employer itself. This potentially threatens SPVs or funding vehicles.

For each of the three main types of transaction we set out a decision tree and some guidance on the thinking behind the decisions. However, each case must be considered on its own merits, and specific advice should always be sought. The Regulator expects that those applying for clearance will consider the spirit of the guidance, not just follow the letter of the law.

AUDIT ■ TAX ■ ADVISORY

General terms used below

What is a pension deficit?

- FRS17 deficit (the current accounting measure);
- The funding level fixed by the trustees, if higher; or
- The full buy-out level of deficit (the "S75 deficit").

If there is any doubt as to whether the employer will continue as a going concern or if there is no FRS17 valuation, the S75 deficit must be used.

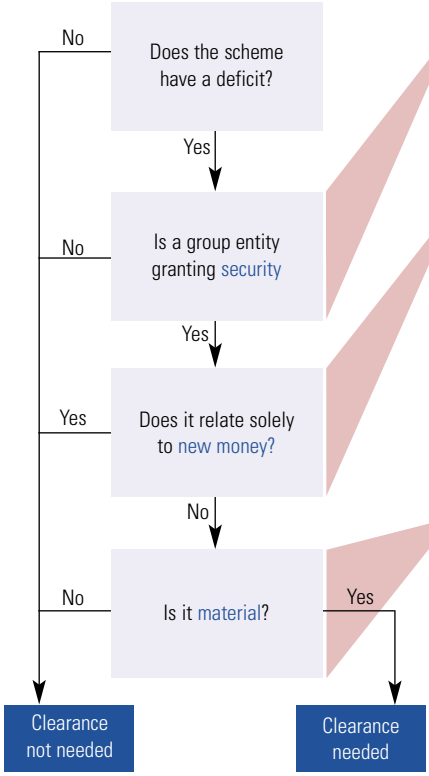
In a group, it is sometimes the case that the FRS17 deficit is only stated on a group wide basis, and is not allocated between the companies participating in the pension scheme. In these cases, if the FRS17 deficit cannot be allocated between the companies, then each company will have to take account of the S75 deficit which the pension scheme actuaries advise that company should bear. This is likely to be greater than the FRS17 deficit.

What is a group entity?

It appears that a group entity is any entity which could be served with a contribution notice or a financial support direction. This encompasses any connected / associated party as defined by S249 and S435 of the Insolvency Act 1986 (as amended), in particular:

- Persons entitled to control one-third of the votes at a General Meeting;
- Companies which are controlled by the same persons; and/or
- Directors (contribution notices only).

The breadth of the definition will, in practice, be limited by the requirement that the Regulator can only issue contribution notices or financial support directions where it is reasonable so to do. Although parties will take a cautious view initially, as a body of experience builds up this will clarify the parameters within which the Regulator will operate.



Source: KPMG LLP (UK)

Granting Security

What is security?

Any fixed or floating charge. However, lenders providing asset based facilities should also include assignments of debts, stock lending, etc; as these will reduce the actual (as opposed to apparent) assets available to unsecured creditors.

What is new money?

Either:

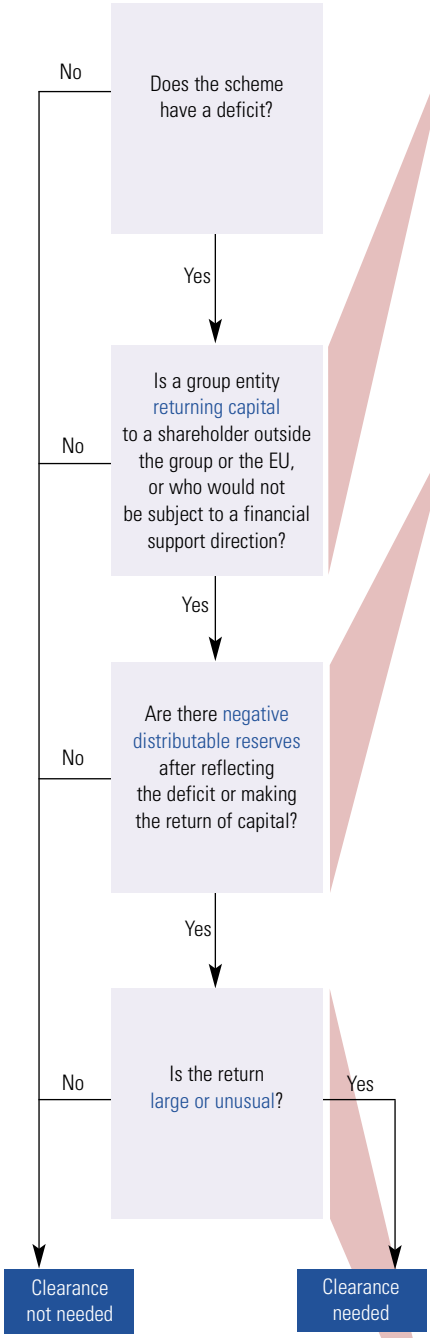
- Advances of funds which have not previously been provided; or
- A new facility repaying an old one which has fallen due.

This test is designed to select cases where security is being granted without further funds being made available. Note that a refinancing might be covered depending on how "new money" is interpreted.

What is "material"?

- Covers 25% of group total assets; or
- Covers 25% of the employer company's total assets.

"Assets" is not defined. At present it is difficult to see how it can be taken to be anything other than balance sheet values from the most recent audited accounts. However, this is not certain and it may be that if other valuations exist then these would be more appropriate.



Source: KPMG LLP (UK)

Returns of Capital

What are returns of capital?

- Dividends;
- Share buybacks;
- Reduction in capital;
- Distributions in specie; or
- Any return of assets to shareholders leading to a reduction in shareholders' funds.

The Regulator will use Companies Act concepts to inform its thinking on transactions constituting a return of capital.

What does "negative distributable reserves" mean?

Distributable reserves = **Accumulated undistributed realised profits** – **Accumulated realised losses not previously written off**

Making a distribution when you have calculated that, if the FRS17 deficit were included now, the employer would have negative distributable reserves may not (yet) be a breach of company law but might be considered risky.

Undistributable reserves include:

- Share premium account;
- Capital redemption reserve;
- Excess of unrealised profits over unrealised losses; or
- Any other reserve which it is prohibited to distribute by law, or by the company's constitution.

Negative distributable reserves therefore occur if accumulated undistributed realised profits are less than accumulated realised losses not previously written off.

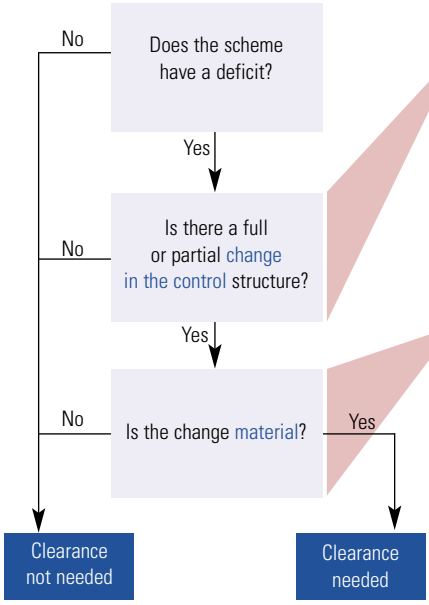
The clearance test involves taking account of the FRS17 deficit, separately taking account of the effect of the return of capital, and establishing whether either would produce negative distributable reserves.

Note that for accounting periods beginning on or after 1 January 2005 FRS17 deficits will be reflected in the balance sheet as an actual asset or liability (unless the entity is taking the multi-employer exemption or prepares its accounts using the Financial Reporting Standard for Smaller Entities).The initial recognition of a pension deficit and subsequent changes in future periods will be realised gains or losses and will therefore affect the amount of distributable reserves.

What is large or unusual?

- More than twice the average of the last three years' return of capital; or
- Reducing dividend cover to less than 1.25 times distributable profits.

Clearly, any company which has not previously paid a dividend will need to seek clearance.



Source: KPMG LLP (UK)

Change of Control

What is a change of control?

- Change in (one of the) parent company(ies) of the employer; or
- Change in connected / associated parties who could be subject to a contribution notice or financial support direction.

Potentially this covers a very wide range of parties.

What is material?

A change that causes a downgrade in the employer's credit rating. This is to be amplified, probably by reference to financial ratios, the level of pension contributions and the ratio of the pension scheme creditor to group assets. The materiality test is intended to ensure that a change of director will not necessarily require clearance. However, where a director has given a personal guarantee of the corporate debt, if that director resigns and is replaced by a director who does not give an equivalent guarantee, then the quality of the employer covenant may be altered and the return to the pension creditor may be impacted.

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