

Re: Spectrum Plus versus the Pensions Act January 2006

Following the House of Lords decision in re: Spectrum Plus, many lenders are implementing invoice discounting as a way of returning their security over book debts to the fixed charge that they previously thought they had. However, in some circumstances converting the original debenture, where the debtors are subject to a floating charge (following Spectrum), into an invoice discounting arrangement may give rise to a reduction in assets available to the pension scheme creditor, necessitating negotiation with the pension trustees and potentially a clearance application to the Regulator.

The charges

The effect of the re: Spectrum Plus ("Spectrum") decision of the House of Lords earlier this year was to overturn thirty years of commercial practice during which lenders had believed that their standard form debentures gave them a valid fixed charge over book and other debts, without materially impeding the borrower's freedom to trade. The House of Lords decision made it clear that the standard form debenture would only be treated as a fixed charge if the debtor monies were dealt with in some form of blocked account arrangement (although they declined to give guidance on exactly what would be effective). The vast majority of standard form debentures entered into pre-Spectrum are now accepted to give only a floating charge over book debts.

In a post-Spectrum administration, where a standard debenture was taken after 15 September 2003, (i.e., the prescribed part applies) the realisations are utilised as shown in the first two columns.

	Standard Debenture		Invoice Discounting	
	Fixed Charge £m	Floating Charge £m	Fixed Charge £m	Floating Charge £m
Realisations (except debtors)	10.0	2.0	10.0	2.0
Debtors	-	4.0	4.0	-
Direct costs of asset realisations	(0.5)	(0.2)	(0.6)	(0.1)
Other costs and expenses of administration (inc. tax)	-	(1.9)	-	(1.9)
Available to preferential creditors	n/a	3.9	n/a	0.0
Preferential creditors	n/a	(1.0)	n/a	-
Available for prescribed part	n/a	2.9	n/a	-
Prescribed part	n/a	(0.4)	n/a	-
Available to charge-holder	9.5	2.5	13.4	-

If, however, the security structure is altered such that debtors are made subject to an invoice discounting facility and the lender takes a new debenture, the realisations would be utilised as shown in the second two columns.

The charge-holder is better off, but the preferential creditors and the prescribed part now receive nothing.

The pension scheme position

The pension scheme is affected in two ways. Contributions which are in arrears are a preferential creditor, and the pension scheme deficit is an unsecured creditor. As shown by the example above, the preferential creditors might be made substantially worse off by the move of debtors to an invoice discounting facility, and the unsecured creditors might lose any chance of a prescribed part.

The consequences

In the example above, the pension scheme creditor has been disadvantaged by the change in the security structure. Here, this is a notifiable event, of which the Regulator should be informed, as it affects more than 25 percent of the assets of the employer. In such a case a clearance application should be considered.

The company and the trustees will have to try to negotiate a deal before applying for clearance. It is likely that the trustees will seek to increase the funding available to the pension scheme before giving their approval to the change in structure, either by requesting a cash payment or an increased level of contributions. Even after this, there is still a risk that on presenting any clearance application, the Regulator will seek to increase further the funding available to the scheme. Lenders and borrowers should be aware of the time that such a negotiation will take and the potential cash cost of doing so.

There is a risk that if a clearance application is not made for the transaction, the borrower and its connected/associated parties may be made subject to contribution notices or financial support directions. The effect of either may be to reduce the borrower's cashflow and thus its ability to service its lending. Failing to notify and/or seek clearance may, in the worst case, result in the directors being penalised.

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Conclusion

Where a lender is requesting the company to agree to altering the security structure to compensate for the effects of the re: Spectrum Plus decision, then the company should investigate whether there is a defined benefit pension scheme which may be disadvantaged. If this is the case, then the trustees will be likely to seek an increase in the funding level of the scheme before they give their consent to the transaction.

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act upon such information without appropriate professional advice after a thorough examination of the particular situation.

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Designed and produced by KPMG LLP (UK)'s Design Services

Publication name: Re: Spectrum Plus versus the Pensions Act

Publication number: 300-082

Publication date: January 2006