OuterTemple
Chambers

Outer Temple Chambers

“Do the two new triggers for Contribution Notices constitute a regulatory shift? Which corporate activities will be caught?”

Nicolas Stallworthy QC

20.09.21

Caveats and disclaimers

OuterTemple Chambers

- ‘Chatham House Rules’ apply
- Any views expressed are mine alone …
- Nothing I say should be treated as reflecting the views of the Pensions Regulator (“**tPR**”)

Contents –

OuterTemple Chambers

- The existing triggers for Contribution Notices
  - the 'Main Purpose' test
  - the 'Material Detriment' test
- The stated reasons for the new triggers
- The two new triggers for Contribution Notices
  - the 'Employer Insolvency' test
  - the 'Employer Resources' test
  - the defences
- Which corporate activities will be caught?
- Do the new triggers constitute a regulatory shift?
- Draft Code of Practice 12

Existing triggers: their place in the framework

OuterTemple Chambers

- Scheme: s.38(1).
- Connection: the target must have been connected with or an associate of the employer (or an employer itself) at a time between the act or failure to act and the issue of the warning notice: ss.38(3)(b) & (6)(b).
- Party: the target must have been a party to an act or a deliberate failure to act: s.38(3)(a).
- Act: that this act or deliberate failure to act has the characteristics prescribed by s.38(5) – the ‘triggers’.
- Reasonableness: that it is reasonable to impose liability on the target to pay the sum specified in the CN: s.38(3)(d).

Existing trigger: Main Purpose

- Sole trigger under s.38(5) when enacted was the 'main purpose' test; namely that –

  "*the main purpose or one of the main purposes of the act or failure was —*

  (i) to prevent the recovery of the whole or any part of a debt which was, or might become, due from the employer in relation to the scheme under [s.75 PA95], *or*

  (ii) to prevent such a debt becoming due, to compromise or otherwise settle such a debt, or to reduce the amount of such a debt which would otherwise become due".
- Presented tPR with difficulties in proving the mental element.
- Case law draws distinctions between a foreseeable consequence or effect and a desired or intended '<u>purpose</u>'
- *Bonas* [2011] Pens. L.R. 109, *Desmond* (2010 Dn, 2015 s.89); *Carrington Wire* (2015 Dn & s.89); *Silentnight* (2021 s.89).

Existing trigger: Material Detriment

- w.e.f. 29.06.09, the ‘material detriment’ test was added; namely that –

  “*the act or failure has detrimentally affected in a material way the likelihood of accrued scheme benefits being received ...*”: s.38A(1).

- in deciding whether the test is met, tPR “*must have regard to such matters as it considers relevant, including (where relevant) –*

  (a) the value of the assets or liabilities of the scheme ...,

  (b) the effect of the act or failure on the value of those assets or liabilities,

  (c) the scheme obligations of any person,

  (d) the effect of the act or failure on any of those obligations ...

  (e) the extent to which any person is likely to be able to discharge any scheme obligation in any circumstances (including in ... insolvency ...),

  (f) the extent to which the act or failure has affected, or might affect, the extent to which any person is likely to be able to [discharge scheme obligations] …”.

Existing trigger: Material Detriment

Outer Temple Chambers

- Invoked in *Carrington Wire* (2015 Dn & s.89); *BHS* (2017 s.89 & 2018 Dn); and *Silentnight* (2021 s.89).
- Whether "*the act or failure has detrimentally affected in a material way the likelihood of accrued scheme benefits being received* ..." required a sometimes difficult assessment of hypothetical scheme experience and employer covenant over the lifetime of the scheme, usually decades into the future.
- The *Silentnight* s.89 report notes that "*This involved a significant amount of factual and expert evidence to set out the counter-factual position ..., ie what would have happened but for HIG's actions. ... This case involved projections into the future, forecasting what would have happened over the lifetime of employer support for the scheme.*"

Stated reasons for the new triggers: March Consultation & June Response

"*… the 'main purpose' and 'material detriment tests', are scheme focused, whereby an assessment is made on the impact of the act or failure to act on the scheme. In a majority of … past* [CN] *cases, the act or failure to act on which the action is based is something which affects the employer, as opposed to something which damages the scheme directly.*

As a result, [tPR] *is required, in practice, to extrapolate from an employer related act, the impact on the scheme which is evidentially challenging. It was the policy intention therefore to introduce a jurisdictional test in the* [CN] *regime which is assessed by reference to the impact on the sponsoring employer.*

An additional issue faced by [tPR] *is the difficulty in forecasting the medium and long-term performance of a business for the purposes of the existing 'material detriment test'. The 'employer resources test' introduced in the* [PSA] *2021 is therefore designed to assess this on a snapshot basis, removing the need to forecast how the employer might or might not have performed in the future absent the act or failure to act.*"

The two new triggers in s.38(5)(a)

OuterTemple Chambers

- For acts w.e.f. 1 October, the two new triggers will be:
  - the ‘employer insolvency’ test; and
  - the ‘employer resources’ test.
- In contrast to the ‘main purpose’ test, they don’t require tPR to establish any mental element on the part of the target.
- In contrast to the ‘material detriment’ test, they don’t require tPR to establish long-term <u>future</u> counter-factuals about hypothetical scheme experience or employer covenant: they assess impact on a ‘snapshot’ basis.
- They remain threshold ‘triggers’ to jurisdiction: it still has to be reasonable to impose the CN.

‘Employer Insolvency’ test: s.38C

- Where “*(a) immediately after the relevant time, the value of the assets of the scheme was less than the amount of the liabilities of the scheme, and*

  (b) if a debt under [s.75 PA95] *had fallen due from the employer to the scheme immediately after the relevant time, the act or failure would have materially reduced the amount of the debt likely to be recovered by the scheme.*”
- The ‘relevant time’ is the time of the act or failure: s.38C(5).
- Hypothetical scenario of an employer insolvency triggering a s.75 debt immediately after the act or failure: compares
  - recovery of that hypothetical s.75 debt <u>with</u> the impact of the act or failure; vs.
  - recovery of that hypothetical s.75 debt <u>without</u> the impact the act or failure.

‘Employer Resources’ test: s.38E

Outer Temple Chambers

- Where “*(a) the act or failure reduced the value of the resources of the employer, and*
  (b) that reduction was a material reduction relative to the estimated section 75 debt in relation to the scheme.”
- The Pensions Regulator (Employer Resources Test) Regulations 2021, SI 1047 (15 September):
  - the employer’s ‘resources’ are its profits before tax (stated in its most recent annual accounts before the act or failure), adjusted to exclude the effects of non-recurring or exceptional items
  - compares <u>actual</u> ‘resources’ (so defined) – necessarily without the effect of the act or failure – with a hypothetical assessment of such ‘resources’ adjusted for any effect of the act or failure <u>as if the act or failure had occurred immediately before the beginning of that accounting period</u>.

Statutory Defences

Each of the new ‘triggers’ has a statutory defence similar in form to the ‘material detriment’ statutory defence:

- the target “*gave due consideration*” before the act or failure to its impact on (as applicable) recovery of the hypothetical s.75 debt / the employer’s resources; and
- where the target considered that the act or failure “*might*” have a material impact, took all reasonable steps to eliminate or minimise that potential impact; and
- the target reasonably concluded that there would not be a material reduction in (as applicable) recovery of the hypothetical s.75 debt / the employer’s resources.

Which corporate activities will be caught?

Outer Temple Chambers

- Each of the new triggers will be satisfied by a wide range of ordinary commercial acts: e.g. –
  - the Employer Insolvency test may be satisfied by an employer investing in new IT and software, reducing its immediately realisable assets in order to improve long-term future profitability
  - the Employer Resources test may be satisfied by an employer selling a subsidiary, reducing how its profitability over the prior accounting period would have looked (hypothetically), albeit increasing its cash.

Which corporate activities will be caught? (continued)

Outer Temple Chambers

- Whereas the ‘material detriment’ test looks at “*the likelihood of accrued scheme benefits being received*” over the lifetime of a scheme, the new ‘snapshot’ triggers do not.
- The existing ‘material detriment’ test takes account of the long-term interplay between capital and profitability; i.e. –
  - how an employer may invest capital (potentially reducing its immediately realisable assets) in order to improve future profitability (which may support a scheme); and
  - how an employer may dispose of parts of its business and thereby reduce immediate profitability but increase available capital (which again may support a scheme, if only by re-investment in the business for long-term repositioning and/or growth).

Which corporate activities will be caught? (continued)

Outer Temple Chambers

- Not only will the new 'snapshot' triggers more routinely be satisfied by ordinary commercial transactions …
- But also the statutory defences will be harder to establish.
- Although the statutory defences look similar to the existing defence to the 'material detriment' test, they will be hard to establish because the new defences do not allow for targets reasonably to conclude that the act or failure would not materially impact "*the likelihood of accrued scheme benefits being received*" <u>over the lifetime of a scheme</u>.
- The new defences require the targets reasonably to have concluded that there would be no material impact on recovery in a hypothetical insolvency or on employer profitability <u>immediately</u>.

Do the new triggers constitute a regulatory shift?

Outer Temple Chambers

- The new triggers plainly constitute a shift in how easily and quickly tPR can establish jurisdiction to issue a CN, with the remaining issue then being the ‘reasonableness’ of issuing a CN.
- tPR may hope that the scope of expert evidence will be more confined; and that the regulatory process will be quicker: but ?
- The new triggers represent a further move away from any requirement of ‘fault’ (cf. the ‘main purpose’ test); and a move away even from any necessary long-term detriment to the likelihood of accrued scheme benefits being received.
- The net effect will be to make targets even more reliant on ‘reasonableness’, vulnerable to this assessment being made pursuant to a warning notice issued up to 6 years after the event, normally when the acts or failures relied upon have in fact ultimately proven unsuccessful for the employer.

Do the new triggers constitute a regulatory shift? (continued)

OuterTemple Chambers

- The Employer Resources test raises particular uncertainties as to what is a material reduction of profitability "*relative to the estimated s.75 debt*"
- The immediate s.75 debt is hypothetical and could be paid out of assets, not requiring to be met out of profitability (which is more relevant to the affordability of ongoing contributions).
- Difficult to 'relate' a reduction in profitability to the immediate hypothetical s.75 debt.
- tPR has indicated that this might be showing the impact on the number of <u>future</u> years of 'normalised profit before tax' needed for contributions sufficient to meet the hypothetical s.75 debt.
- Sits uneasily with the fact that the test is not a 'before' and 'after' test, instead comparing profitability over the same <u>historic</u> period.

Draft Code of Practice 12 and Code-related Guidance

Outer Temple Chambers

- Under s.90(2)(aa), tPR has issued a draft new Code 12 setting out "*the circumstances in which we expect to issue a* [CN]" where it believes that the new triggers are met; and also Code-related Guidance.
- the Code is admissible in legal proceedings: if any provision is considered relevant to an issue by the court or tribunal, must be taken into account in determining that issue.
- The Code-related Guidance gives illustrative examples of acts or failures which tPR considers warrant a CN if "*no or inadequate mitigation was provided to the … scheme*".
- Inevitably very generic and gives little insight into what tPR will consider reasonable; e.g. "*leveraged acquisition – weakening of scheme's creditor position*".

Conclusions

- The new triggers are unlikely to change the sorts of cases in which tPR initiates regulatory investigations seeking a CN.
- But the new triggers may increase the number of CN cases which tPR initiates over the next few years.
- The new triggers are likely to be invoked in most CN cases.
- The regulatory process may become faster, with more confined expert evidence; but similar expert evidence may still be deployed by targets claiming their conduct was reasonable.
- tPR will find it substantially easier to establish jurisdiction to issue a CN on the basis of these new triggers.
- Moving the emphasis even more onto ‘reasonableness’ of issuing a CN, with the uncertainties (and potential subjectivity) which that involves, and attendant challenges for advisers.
- ? more advice documenting consideration of pension schemes.