Pensions: **Corporate Agenda**

SUMMER | 2019

Directors' duties, *Sequana* and the Government's pensions White Paper

Earlier this year, the Government published its long-awaited consultation response setting out its proposed changes on protecting DB pension schemes in the UK. Shortly before the response was published, the Court of Appeal considered the case of *Sequana*. This looked at when directors must have regard to creditors as opposed to shareholders in taking decisions which affect their company.

The Government's consultation has important ramifications for directors and other creditors. Directors will need to notify the Pensions Regulator and pension trustees in certain circumstances where other creditors will not be informed. The Pensions Regulator is also to be given new powers. How do these changes sit alongside a director's duties to other creditors as set out in *Sequana* and how else might creditors be affected?

Sequana: directors' duties clarified

In the case of *Sequana*, the Court considered whether the directors should have considered creditors when paying dividends. The Court decided that, even with a real risk of insolvency, this did not mean that the directors had to act in the interests of creditors in carrying out their duties. It went so far as to say that this would have a "chilling effect" on business activity.

Instead, the "creditors' interests duty" was triggered when the directors know or should know that the company is:

> actually cash flow or balance sheet insolvent – this has never been in doubt; or

> likely (as in probable) to become insolvent – that something less than actual insolvency would trigger the duty has long been assumed, but the "what" has been unclear.

Previous cases had not been clear on this second limb, focussing on vague statements such as the company being in a "parlous financial state". In *Sequana*, the Court dismissed these as unhelpful – even if they were correct descriptions of a particular company's situation.

The Court said that, once the duty is triggered, then creditors' interests should become paramount (rather than simply being considered without being decisive). In most cases this will be a sliding scale as companies move closer to insolvency. Much to the disappointment of creditors who could be detrimentally affected by the payment of dividends, the Court said that the duty had not arisen in the case of *Sequana* as the company was not insolvent or likely to become insolvent at the time of the payment of dividends.

The Government's pension proposals

The Pensions Regulator has always been clear that it expects directors to share information regarding an employer's financial health with pension trustees, in a way that the employer might not otherwise do for other unsecured creditors. This may be through attendance at trustee meetings, informal information sharing, or more detailed information sharing protocols.

Indeed, there are fundamental differences between pension creditors and other creditors:

> any credit that has been "extended" to an employer by reason of a deficit in a pension scheme has arisen not as a result of a decision by trustees, but instead as a result of external factors such as increased life expectancy or poorer than expected investment returns;

> secondly, in many cases trustees will not have negotiated consent requirements for certain corporate actions or early triggers for information, as are common in secured bank facilities.

Given these fundamental differences and recent corporate failures resulting in pension scheme members losing out, the Government is proposing changes to better protect pension schemes so that by law they are considered by directors earlier in the process, and far in advance of the timing to act in creditors' interests in *Sequana*. The Government has sought to do this in two key ways: through the introduction of the requirement for a declaration of intent; and by introducing new notifiable events.

Declaration of intent

One of the Government's landmark proposals is a requirement for "corporate transaction planners" to prepare a "declaration of intent" on the sale of a controlling interest in an employer, the sale of the business or assets of an employer, and the granting of security in priority to the pension scheme.

The detailed content of the declaration has yet to be finalised, but the Government has suggested it will include an explanation of the transaction, confirmation that the trustees have been consulted, whether the trustees agree with the proposals and how any detriment is to be mitigated. It will be addressed to the trustees and shared with the Pensions Regulator.

Currently, in such circumstances, directors will usually engage with the trustees of pension schemes – for example to gain certainty as to how trustees will view the changes and approach scheme funding – and if necessary will agree mitigation as part of the transaction or the next valuation. However, there is flexibility for directors not to do so in advance of the transaction, or to conclude that the scheme will not be detrimentally affected and so engagement with the trustees is not required. If the directors get that decision wrong, or if trustees do not feel that the employer is giving sufficient attention to their concerns, trustees are already able to call upon the Pensions Regulator for support and the Regulator has power to intervene and require mitigation for the scheme through use of its moral hazard powers.

Although engagement with trustees is to be welcomed, there are two elements to the proposals which might give rise to issues for creditors, especially in light of the clarity in the *Sequana* case about when directors must flip to prioritising creditors' interests.

First, the Government has said that the directors must seek to agree the declaration of interest with trustees. If they cannot do so, this must be stated in the declaration. While secured creditors may include certain information and consultation requirements in their agreements with borrowers, unsecured creditors (such as pension trustees) will not generally have such rights. In requiring agreement to be sought, companies may be required to act in a fundamentally different way towards pension scheme creditors than they do with other unsecured creditors. Given the nature of pension deficits, this is not necessarily unwelcome, but other creditors will need to be aware of trustees' further enhanced rights when considering their own position.

Secondly, the requirements introduce additional administrative complexity at a time when speed may be essential. Where time is critical, requiring further discussions and preparation could be detrimental to all parties, including pension trustees.

More notifications to the Pensions Regulator

In addition to the declaration of intent, the Government has suggested changes to the "notifiable events" regime. It is proposed that there will be two new events which must be notified to the Pensions Regulator:

> the sale of a material proportion of the business or assets of an employer which has funding responsibility for at least 20% of the scheme's liabilities; and

> where the employer grants security on a debt to give it priority over a debt to the scheme.

Interestingly, the Government considered whether payment of dividend (as was the case in *Sequana*) should be added as a notifiable event, but decided against this because of concerns over how this might affect business growth.

The Government recognises that there is significant lack of clarity in the proposals at this stage. For example, what is a material proportion? On what basis are the scheme's liabilities to be assessed? What is security – will it be limited to charges registered at Companies House or will it extend to the creation of quasi security, such as placing cash in a bank account with rights of set-off? Irrespective of these uncertainties, the changes will require earlier consideration of pension scheme creditors than is the case for other creditors following *Sequana*.

In addition, it is not clear why the second event is required at all. The Government does not explain why the existing requirement to act in the interests of creditors as a whole (as considered in *Sequana*) and the protections against "preferences" in the Insolvency Act are not sufficient.

Pensions: moving away from Sequana?

The *Sequana* case provided guidance on when directors must turn from shareholders to creditors. But, pension scheme creditors are often seen in some way as "different" from other unsecured creditors. The Government has sought to further formalise the time at which information needs to be provided to trustees, putting them on a different footing from other unsecured creditors.

The early notification proposals and the requirement for directors to actively set out their intention on certain corporate activity to pension trustees may be seen as giving the Regulator and trustees the opportunity to enter into a dialogue with the employer before other creditors have been made aware of the existence of a potential issue and even influence the next steps in the process. This may cause the employer to alter proposals that they believed were in the best interests of the employer's creditors as a whole.

In finalising its proposals, the Government will need to be careful to balance the interests of the Regulator and pension trustees with the legitimate interests and expectations of other stakeholders especially in light of the guidance provided by *Sequana* on when creditors' interests trump those of shareholders.

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