The Trustee toolkit downloadable

How a DB scheme works

Scenario three

In this scenario you will consider the possibility of the employer selling the company premises. Later another possibility emerges.

As you work through this scenario you will be tested on your knowledge at decision points. Here you will have the option to work through a related technical tutorial before returning to the scenario or you can skip the tutorial. You can always work through the tutorial separately later if you would prefer. This scenario includes two tutorials:

- Implications of winding up a DB scheme
- Corporate transactions

Glossary

A detailed glossary of technical terms can be downloaded from the Resources tab when you log in at **www.trusteetoolkit.com**

The Pensions Regulator

Sale and leaseback

The last few weeks have been anxious ones, with a lot of emails and phone calls flying to and fro between the trustees. One in particular, from Charlotte, catches your eye.

Email from Charlotte

'I am attaching a letter I've received from Mr Davis. As you can see, he is planning to sell the company's freehold property to a third party, and the third party would then lease it back to the company. There are serious implications of this proposal for the scheme. I therefore think we should meet as soon as possible.'

A serious proposal

The meeting is quickly arranged and Charlotte briskly sums up the situation. Charlotte says: "You've all read the letter. Mr Davis is looking to retire due to his health problems and he wants to sell the company's premises to fund it. The property would be sold to a third party and then leased back to the company. Mr Davis says he wishes to draw dividends against this sale. We need to consider whether this loss of value from the company affects the employer's ability to support the scheme long term."

Adrian says: "In my opinion there are two things to think about: the ability of the company to meet its ongoing funding obligations to the scheme and the position on insolvency. If the freehold property is sold and its entire value is paid out to Mr Davis in the form of dividends when he retires, the company will have rental expenses that may affect its ability to meet its funding obligations to the scheme. Also, it looks likely that without the freehold property (which is a very significant company asset), the return to unsecured creditors, which includes the pension scheme, would be minimal if the company became insolvent."

Charlotte says: "I agree, and I think that if the situation with the business deteriorates further, we may have to consider triggering a scheme wind-up. So I've asked Beatrice, our scheme lawyer, to join us and talk us through those implications before we make any decisions."

Beatrice joins you and your fellow trustees to discuss the implications of winding up the scheme. Charlotte says: "Just to summarise where we are…If Mr Davis sells the freehold property asset, dividends out the proceeds and then arranges for the company to leaseback the property with rental expenses, this reduces the cash available in the company on a day-to-day basis to fund the scheme."

"It also means that if the company subsequently becomes insolvent, and considering the recent financial performance this is a real possibility, the return to unsecured creditors would be minimal. Our primary duty is to the beneficiaries of the scheme so we need to consider the implications of triggering a scheme wind-up. To clarify, we have received previous legal advice that we as trustees have the right to wind up the scheme."

Rodney says: "If the scheme is wound up, what happens to the pensions that are already being paid?"

Alicia says: "What happens to the future benefits of the active members?"

Adrian interjects: "Can I just pull the conversation back a bit? Could you explain to me what winding up the scheme means? Does it just stop?"

Charlotte says: "Beatrice, perhaps you could give an explanation of wind-up?"

Beatrice says: "Sure. If the scheme is wound up, active members cease to accrue benefits. In order to wind-up the scheme, the trustees need to ensure that members' benefits are secured by buying insurance policies to cover all the pension benefits for members and their dependants. This is extremely expensive and might actually push the employer into insolvency. At the very least it would seriously reduce the sale value of the company as all the insurance policies would have to be bought with company assets before any future sale of the business is completed."

Decision point: Crunch time for the trustees

After you've listened to Beatrice you're all a lot clearer about the situation and feel able to consider the options. Which one of the options do you think would result in the best outcome? The trustees should...

1. ...ask the scheme actuary to certify the scheme as insolvent
2. ...decide to trigger a scheme wind-up now
3. ...instruct their covenant advisers to advise on the impact of the sale and dividend on the strength of the employer covenant
4. ...move the scheme assets into high risk/high reward assets to reduce pressure on the employer

Answers at the back

Need help with this question? Read the **Tutorial 'Implications of winding up a DB scheme'**

A change of heart

The next scheduled board meeting isn't for a few weeks yet so you're surprised to get a message from Charlotte. "Hi, I don't know whether you've heard the news but Mr Davis decided not to sell the company premises, but the company itself is now up for sale and there's a potential offer on the table. We're scheduling a meeting for two days time, I hope you can make it."

A new offer

You walk into the meeting room, and the first person you see is Edmund! Charlotte quickly calls the meeting to order.

Rodney says: "Edmund! Nice to see you. Are you back on the board?"

Edmund says: "Well, strictly speaking I never actually left the board. But I've not been at your recent discussions because I was conflicted."

Charlotte says: "We discussed this in detail a few weeks ago when Adrian wasn't here. Edmund recognised that he was conflicted as a trustee because he was also FD of the company. Edmund agreed to absent himself from discussions where he would also have a specific interest as financial director. That's why he hasn't been here recently for most of our discussions."

Edmund says: "You also need to know that I undertook to give the trustee board any important company information they needed to protect members' interests. I stayed on the board on that basis, and today, I have some very important information for you.

You've already heard that Mr Davis has decided not to sell and leaseback the premises, but instead to put the company up for sale. The other directors and I have been considering a management buy-out which would be structured to use a newly incorporated (newco) holding company wholly owned by the management buyers to buy the company's shares. We think that we can do it.

We're looking to set up financing for the purchase, and so we're arranging for our newco to receive a large loan from the bank that would be secured against company premises and other assets. The newco would use the loaned funds, together with the money we will invest in the newco, to fund the purchase of the company's shares from Mr Davis.

So we're all set to go ahead – but we haven't clinched the deal yet. We need to convince the bank that our holding company would be able to generate enough cash to meet the loan repayments and turn around the business now that it has lost its most important customer."

What a relief!

Edmund has told you all he can for now, and he's left the meeting. You are all feeling relieved and quite excited but you need to discuss the implications this would have for the scheme.

Adrian says: "That sounds really great, and an employer we know is much better than one we don't. All our worries are over!"

Charlotte says: "Well, I agree that its excellent news, but we still have some thinking to do. The new holding company would have a large debt to service, and its only asset would be the company."

Alicia says: "And Edmund did make it very clear that the deal isn't clinched yet."

Rodney observes: "That must be a sizeable loan they've taken on."

Charlotte says: "Yes, and I don't want to be a wet blanket, but that is a concern. If the holding company were unable to service the debt the bank would call on the company to do so under the guarantee. This may threaten the company's ongoing funding obligations to the scheme and would result in the employer's covenant weakening as it would have less cash to meet its commitments to the pension scheme.

Moreover, if the company failed to pay the outstanding sums owed to the bank by the holding company, the bank would look to enforce the security over the company's premises and other assets. As a consequence, those assets would be unavailable for paying the deficit in the scheme."

There follows a long and protracted discussion. It is quite difficult to know what to do. On the one hand, you know and trust Edmund and his fellow directors, and it would be great if they bought the company. On the other hand, there's certainly a risk to future benefits, and you have to put members' interests first.

Decision point: What do we do?

The following options are discussed at length before a decision is made. Which one of the following possibilities do you think might be a sensible solution?

1. Apply to The Pensions Regulator (TPR) for clearance
2. Insist that the management buyers provide a guarantee from their newco to pay the deficit in full
3. Instruct a covenant review of the impact of the sale and the secured debt on the employer's covenant to the scheme
4. Push Mr Davis to make up some of the deficit or to fund the buy-in of insurance policies to cover some pension benefits prior to the sale

Answers at the back

Need help with this question? Read the **Tutorial 'Corporate transactions'**

Rounding up

In the end you agreed to instruct a covenant review expert to assess the impact of the sale and the introduction of the secured debt on the company's covenant to the scheme. When the results of that review are received, the trustees would consider whether mitigation should be sought if the covenant would be weakened.

Now that you have completed this scenario we would recommend that you begin to work through the 'Check your scheme' worksheet for this module.

Answers

Decision point: Crunch time for the trustees

The third answer is correct. The trustees should first seek advice on the change to the company's covenant and the level of mitigation which may be appropriate as a consequence of the proposed sale and dividend. If negotiations with Mr Davis do not result in appropriate mitigation for the scheme then the trustees could approach The Pensions Regulator (TPR) to make it aware of the situation.

Triggering a scheme wind-up now is not right. It is not clear that wind-up is necessary at this stage and it is extremely expensive which might actually push the employer into insolvency.

Moving the scheme assets into high risk, high reward assets is seeking to deal with the potential detriment without first seeking advice, considering how much investment loss the company could make good or discussing the position with the company. Changing the investment profile of the scheme's assets is a very risky approach because if the assets in which the scheme is invested in diminish in value, the scheme will be poorly-funded with a poor employer.

Finally asking the scheme actuary to certify the scheme as insolvent is also incorrect as this does not assess the impact of the sale of the property or the dividend on the scheme.

Decision point: What do we do?

The third answer is correct. The trustees should carefully consider the results of the covenant review setting out the degree to which the scheme is prejudiced by the proposals. Then they should consider what mitigation would be appropriate to compensate for that detriment. They may also need to consider whether their scheme investment strategy or the assumptions underlying their latest scheme valuation remain appropriate given any material change to the employer's covenant.

If they insist that the new owners make up the deficit in full, it may prevent them from being able to buy the company. They could ask the current owner to make up some of the deficit prior to the sale for example, but Mr Davis has no interest in doing so given that the company is then to be sold and it would likely increase the price of the sale for the management buyers.

If mitigation is paid to compensate for the deficit to the scheme, the employer may wish to seek clearance from TPR, not the trustees. The trustees would need to consider whether they support any clearance application. The trustees should only support it if they consider the mitigation sufficient in light of the detriment suffered.

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