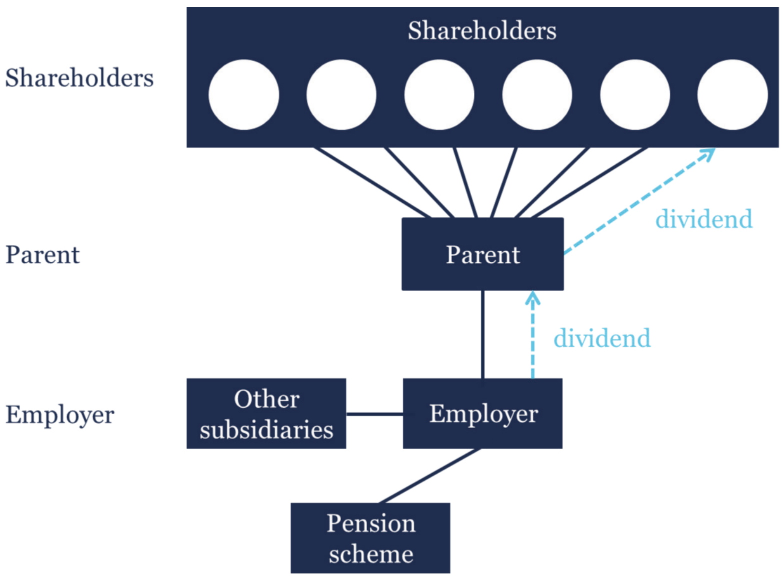
Pensions Issues on Paying Dividends

Key points

- Recent high profile insolvencies have highlighted the need for both companies and trustees of UK pension schemes to consider the implications of dividend payments on the security of the pension scheme.
- Dividends can affect the strength of the employer support (covenant) available to a pension scheme.
- Any change in the strength of the covenant as a result of a dividend payment could impact on ongoing funding arrangements. If there is a material adverse change, trustees may look at their options to agree new ongoing funding arrangements with scheme employers. Dividends will also be relevant when trustees look at the affordability of deficit contributions.
- A dividend payment could also raise potential risks of the Pensions Regulator exercising its moral hazard powers to issue a contribution notice or a financial support direction.
- This briefing outlines:
  - the UK pension implications for a scheme employer (Employer) and its parent company (Parent) of:
    - (i) a dividend to shareholders by the Parent, and
    - (ii) an intra-group dividend by the Employer to its Parent (eg to fund the Parent to pay its own dividend); and
  - the actions that the Parent and the Employer should undertake to limit any trustee concerns and the risk of Pensions Regulator actions regarding the impact of the proposed dividend on the scheme.



Introduction

Companies will often want to pay dividends to shareholders – whether:

- by a Parent out of the group (to ultimate shareholders); or
- within a group, (from the Employer to the non-employer Parent).

Pension schemes are direct creditors of the relevant Employer (by reason of the statutory funding obligations under the Pensions Act 2004 and the debt on employer provisions in section 75 of the Pensions Act 1995). Schemes are not automatically direct creditors of other companies in the group (absent a direct guarantee or the Pensions Regulator exercising its moral hazard powers). For further details see our briefing, Pension debts – priority of claims.

Dividends can affect the strength of the support (covenant) available to a pension scheme. Recent high profile insolvencies have highlighted the need for both companies and trustees of UK pension schemes to consider the implications of dividend payments on the security for the pension scheme as such payments are likely to be scrutinised where there is a significant deficit in the scheme. In its funding statement published in May 2017, the Pensions Regulator made it clear it would expect to intervene in schemes where the employer covenant is constrained and payments to shareholders are prioritised, impacting on the affordability of contributions to the pension scheme. Some companies are already taking action and halting dividend payments and in light of recent cases, the government give further thought to the issue in its forthcoming White Paper on the regulation of defined benefit pension schemes, which is expected to be published in Spring 2018.

In this briefing, we discuss the main pensions issues that need to be considered in relation to a proposed dividend payment, including:

- the impact on ongoing funding arrangements;
- the potential risks of the Pensions Regulator exercising its moral hazard powers; and
- the disclosure and notification obligations and how to deal with any conflict of interest.

We also set out the actions that the Parent and the Employer could undertake to limit any trustee concerns regarding the proposed dividend on the scheme.

Impact on funding arrangements

As part of the scheme specific funding arrangements, trustees will need to consider the strength of the employer covenant supporting the plans when assessing scheme specific funding. Trustees are increasingly looking for a formal covenant review and the proposed dividend will be relevant to this assessment.

The Employer may need to agree new ongoing funding arrangements with the trustees of the scheme. Trustees are likely to take the prospect of a dividend into account when assessing the strength of the Employer as the principal employer of the scheme, and any additional support that could be expected from the Parent. Depending on size and materiality, the dividend can affect the level of contributions which trustees seek from an Employer.

(i) Dividend from the Employer

An intra-group dividend from the Employer to the Parent would have the effect of reducing the net assets of the Employer and therefore would weaken the strength of the Employer. The scheme would be (if an insolvency occurred) an unsecured creditor of the Employer. Depending on the financial impact, the trustees may consider a dividend to be a material change when looking at covenant issues. This will have an effect on the negotiation of future funding.

The impact of this may in some cases be counterbalanced (to a degree) by the extra strength given to the Parent (depending on what the Parent plans to with the proceeds of the dividend) given that the Parent is part of the Employer's 'wider group'. In some circumstances, the Parent may be an entity that the trustees look to for support in any event.

(ii) Dividend from the Parent

As noted above, schemes are not automatically direct creditors of other companies in the group (absent a direct guarantee or the Pensions Regulator exercising its moral hazard powers). For further details, see our briefing, Pension debts – priority of claims. The effect of a dividend from the Parent to its shareholders, is to weaken the strength of the Parent. The materiality of that to the scheme will depend on the size of the dividend. But schemes may have an interest in the strength of the

Parent for various reasons:

- the Employer may be a creditor of the Parent (eg if it has lent funds to the Parent), so that the strength of the Employer depends (in part) on the ability of the Parent to repay that debt;
- the Parent may have given security or support direct to the Scheme;
- the Scheme may consider that the Pensions Regulator could exercise its moral hazard powers (see below) and force the Parent to contribute or give security to the Scheme; or
- the Parent will form part of the 'wider group'[1] (as opposed to the shareholders who may not be) on which the Employer or the Scheme may be able to rely (to a degree) in practice even absent a formal legal obligation.

(iii) What can the trustees do?

Trustees' powers, when faced with a dividend (or notice of a potential dividend), to raise employer contributions, depend on the terms of the scheme and the funding arrangements already agreed.

- Some schemes give trustees a unilateral power to fix contributions – in such cases, where the dividend has a potentially material impact, the trustees may consider exercising that power and raising contributions.
- In other schemes, the rules provide for contributions to be fixed by the Employer or by agreement – here the trustees do not have a unilateral power to increase contributions, but they may be able to seek agreement with the Employer on a revision to the funding arrangements in light of the dividend. The scheme specific funding provisions under the Pensions Act 2004 include provision for a scheme's recovery plan to be reviewed 'and if necessary revised' where the trustees 'consider that there are reasons that may justify a variation to it'[2]. If the trustee and the Employer do not agree, then the Pensions Regulator may have power to impose a new schedule of contributions (s231 of the Pensions Act 2004).

Moral hazard powers

The Pensions Regulator's statutory moral hazard powers include powers to make third parties liable for pension deficits/ funding etc in certain circumstances. The Pensions Regulator could use its moral hazard powers to issue a contribution notice (CN) or a financial support direction (FSD) in connection with (or as a result of) the proposed dividend. For further details see our briefing, The Pensions Regulator: Moral Hazard Powers.

In order to issue a CN or an FSD against someone that is not a participating employer of the scheme:

- that third party must be connected or associated with a participating employer;
- the relevant conditions for issuing a CN or an FSD must be met; and
- the Pensions Regulator must consider it reasonable to issue such a notice.

The following entities/persons, in particular, would be potential targets of the Pensions Regulator's moral hazard powers:

- the Parent and other entities in the Parent group; and
- the directors of the Employer.

A dividend has three potential impacts on the risk of a CN or FSD:

- the dividend could be a trigger for the Pensions Regulator to consider using its moral hazard powers; or
- the dividend could itself satisfy the condition for a CN - eg as being an act that has a material adverse effect on support for the scheme; or
- in the case of a dividend payable to the Parent, the fact of the dividend having been paid could reinforce the connection of the Parent with the Employer. It is an example of the Parent having drawn a benefit from the Employer and so could make it more reasonable to make a CN or FSD against the Parent. See for example the reasons given by the determinations panel of the Pensions Regulator in the Box Clever determination in 2011[3].

The Pensions Regulator's views on dividends

In its Code of Practice on funding defined benefits issued in July 2014, the Pensions Regulator recognised that paying dividends is a normal business activity which can be consistent with both the employer's sustainable growth plans and the

[1] See TPR's Clearance guidance' (2009) at para 172 and 176, and TPR's guidance on 'Monitoring employer support' (Nov 2010) at para 32.

[2] Reg 8(5) of the Occupational Pension Schemes (Scheme Funding) Regulations 2005. The Pension Regulator's Code of Practice 03 on 'Funding Defined Benefits' suggests it will usually be appropriate to commission an early actuarial valuation and review in the light of that (para 152).

[3] Determination against ITV and others on 21 December 2011 at para 41.

trustees' funding objective to pay benefits as they fall due. However, the Pensions Regulator expects that trustee scrutiny can be limited to those situations where the covenant strength is a concern, where the timing of proposed dividends is unusual or where exceptionally large dividends are proposed. In those circumstances, trustees should consider obtaining additional security or a share of any upside from the success of the employer's growth.

In its annual funding statement published in May 2017, the Pensions Regulator made it clear that it would expect to intervene in schemes where the employer covenant is constrained and total payments to shareholders (including dividends and share buy backs) are being prioritised and therefore are restricting or reducing the level of contributions being paid to the scheme. The Pensions Regulator expects schemes where an employer's total distribution to shareholders is higher than deficit reduction contributions being paid to the pension scheme to have a relatively short recovery plan and that the recovery plan is underpinned by an appropriate investment strategy that does not rely excessively on investment outperformance.

Limiting any trustee concerns

The Parent and the Employer could consider undertaking the following actions to limit any trustee concerns regarding the impact of the proposed dividend on the scheme:

(i) Explain the group's dividend policy to the trustees

This action does not seek trustee consent, but merely clarifies that the trustee board is aware of the position. This may also allow the company to claim that dividends are not material (either for moral hazard purposes or scheme funding). It also reduces the potential for the trustee to seek changes to the current ongoing funding arrangements.

However, it must be remembered that this offers no express clearance or exemption from moral hazard powers.

(ii) Agree the dividend with the trustees

The dividend policy of the Employer/Parent could be agreed with the trustees, at the time or in advance (eg as part of the scheme funding negotiations). This should give support to an argument by the company that dividends within that policy are not material (either for moral hazard purposes or scheme funding).

(iii) Mitigate any reduction in the Employer covenant

In relation to a material dividend from the Employer to the Parent, mitigation could be offered – eg a parent company guarantee may result in no overall covenant reduction (and could improve the scheme's PPF levy situation), but would also formally tie the Parent to the Employer and scheme. Furthermore, a parent company guarantee would not then be available for future negotiations if needed.

(iv) Seek clearance from the Pensions Regulator

Formal clearance from the Pensions Regulator will provide comfort to the parties that the Pensions Regulator won't exercise its moral hazard powers (but only to the extent of the facts as disclosed). The Pensions Regulator or the trustees may also want extra funding in return and the clearance may not cover all future events.

Changes on the horizon?

Dividend payments by companies which sponsor defined benefit pension schemes are likely to be scrutinised where there is a significant deficit in the scheme. There is a risk that the level of a dividend or a return to shareholders could later be compared to pension deficit repair contributions and outstanding deficits (e.g. by the Regulator or the trustees of the scheme). In its funding statement published in May 2017, the Pensions Regulator made it clear it would expect to intervene in schemes where the employer covenant is constrained and payments to shareholders are prioritised, impacting on the affordability of contributions to the pension scheme. The government's Green Paper on the regulation of defined benefit pension schemes (for further details, see our briefing, Green Paper on defined benefit pension schemes: a measured approach), published in February 2017, did not specifically mention restricting dividend payment by scheme employers, but it did raise for consultation the question as to whether it should be necessary for businesses to consult with trustees of any underfunded pension scheme in the group prior to the payment of any dividends. Recent cases may lead the government to consider imposing legislative restrictions on dividend payments by companies with underfunded pension schemes. We expect the government to set out its position on this issue in the forthcoming White Paper, which is expected to be published in Spring 2018.

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