Webcast: The Joys of Parenting - How Not To Get Hurt By Your UK Pension Plan
Thursday, September 21, 2006 at 12:00 PM ET
Presented by ACC's International Legal Affairs Committee and Eversheds LLP
Moderator: Richard Mosher, Director and Legal Counsel, Absolute Business, Inc.

ASSOCIATION OF CORPORATE COUNSEL

Moderator: Richard Mosher
September 21, 2006
11:00 a.m. CT

Operator: Just a reminder, today's conference is being recorded. Please go ahead, (Dick).

(Dick Mosher): Well good morning, good afternoon or good evening, and welcome to a Webcast on the joys of parenting, how not to get hurt by your U.K. pension scheme. This Webcast is courtesy of the Association of Corporate Counsel, and is sponsored by the International Legal Affairs Committee, and our sponsor Eversheds LLP in the U.K. My name is (Dick Mosher), I'm Chief Legal Officer of (Ingenix) in Seattle, and also Chairman of the ACC Counsel of Committees.

A few housekeeping matters before we turn things over to our speaker, Liz Fallon. First of all, you'll note on the left side of your screen there are several links, link one is for the Webcast slides, which also should appear on your main screen. Link two is a link to Eversheds, and link three very important, a Webcast evaluation form, we urge you to complete and fill out that Webcast evaluation form, and give us some valuable feedback.

Also would like to mention that if you have any questions, the question box is in the lower left-hand portion of your screen, you can enter a question at any time. And type in the text in the question box, push the button send, and I will be looking at those questions and at the appropriate point be asking our speaker, Liz Fallon, to respond.

This Webcast of course will be available for replay I believe within two business days after the program ends, and also will be on ACC's Web site for one year.

That said, let me introduce our speaker today, Liz Fallon. Liz is a partner in the Eversheds Birmingham office in the U.K. Her practice areas are pensions law and human resources. And she specializes in all aspects of pension law, including transactional work. In addition to that, she's a director of the Eversheds pensions trustees limited. We had a very interesting topic today of value to U.K. Corporate Counsel and European Counsel. So with my pleasure, I'd like to introduce Liz Fallon.

Liz Fallon: Well thank you very much, (Dick), and good day everybody. From here in the U.K. it's just after five p.m., so I'll say good evening to you all, and welcome. As the title of the presentation suggests, I'm going to be talking about the joys of parenting. But that's not to do with the joys of napping, changing and weaning, ((inaudible)) not going to be talking about the joys of being a U.S. parent of the U.K. subsidiary, and as the title says, how not to get hurt by your U.K. pension plan. And specifically your U.K. defined benefit pension plan.

In fact the parenting analogy goes further really in that just as our teenage children can give us a headache from time to time, so can U.K. pension schemes for American owners, as I've discovered in my career. So what I'm hoping to do today is to help you understand some of

the issues which arise out of recent legislation over here, which have quiet far reaching effects. And some of the practical things that can be done in response to protect both the U.S. parent and the U.K. subsidiaries.

And so that maybe next time your U.K. finance director calls asking to talk about pensions, you won't just immediately reach for the Tylenol to cope with that headache.

So just to set the scene, I'll be talking about some aspects of the Pensions Act 2004, and the impacts which that has on overseas owners of U.K. companies. I'll mention a little too about the new accounting standards for pensions, that's Financial Reporting Standard 17, FRS17, just to show where this fits into the whole piece, because I know that some of you who deal with the U.K. pensions arena will be coming across that appearing in the company accounts over here.

So the Pensions Act 2004. Well it came into effect on 6th April, 2005, and it really represents a very radical legislative overhaul for U.K. company pension schemes. And most of the Act's provisions came into force in April of that year, some a little bit later on. And it affects quite fundamentally U.K. pension schemes for trustees and their employers, whether they're subsidiaries or parents of U.K.-based or incorporated overseas companies, as well as other entities that are associated or connected with those employers. And I'll come back to talk more about what that term actually means, associated or connected, a bit later, but suffice to say here companies ignore this legislation and the pensions regulator who's empowered by it at their peril.

And just to give you an overview, the key features of the Pensions Act are firstly that it establishes a pension protection fund, very like the Pension Benefit Guaranty Corporation that I'm sure you're familiar with, in fact it was based on the PBGC. And the folks from the Department of Work and Pensions over here visited with your people to understand how it works, and what was good and what the problems were before establishing the (PPF) for us. So as a compensation scheme for members, which really steps in and takes over responsibilities for under funded occupational, that's company pension plans, if the sponsoring employer becomes insolvent.

The Act also, as I said, establishes – creates a new pensions regulator who main (remit) is to minimize calls by pension schemes on the (PPF). It's a government body, it's staffed by civil servants, by accountants, and by a few lawyers too, I have to say. And the regulator works to protect members' interests by firstly insuring that schemes are more robustly funded than previously, and also that some to the ongoing contribution rate, it can be done through special contributions, and also through special powers of the regulator to impose additional obligations on companies called contribution notices and financial support directions, and you'll know more bits about those and why they might be relevant to you by the end of today's session.

And finally, a key thing that the Pensions Act does is establish a notifiable event framework, which is there really so the regulator can get advanced warning as soon as possible of events affecting the pension plan sponsoring company, or indeed the trustees.

So all this added member protection really comes at the price, and the Act has widened the net as to who might pick up what could amount to a hefty bill, and unfortunately for U.S.

parents, they could well be included in that. And I'll come back to that, and what companies can do in response to these new responsibilities and these new obligations.

I'll also before I close today, as I said, have a word about the new FRS17 standard, which come – forces companies really to account for pensions assets and liabilities on their balance sheet in a way which was rather different from the old SSAP 24 standard. And there's obviously an impact there on shareholder protection about company finances, and company solvency, and so those analyzing company accounts following the introduction of this new standard will be really scrutinizing the accounts to assess pension risk and deciding when and whether to buy shares in that particular company.

So that's an accounting standard that's of direct interest to companies, it's not the accounting standard by which the trustees measure the scheme. And I'm going to say a bit more about the different ways in which you look at funding of pension schemes, because one of the things I find my U.S. clients say to me very often is they just don't understand where these big ((inaudible)) for debt come from, they don't understand, you know, how the contribution rate has worked out, and why you get quite a number of different bases that all look very different.

So why should a U.S. corporation be concerned about the Pensions Act and U.K. pensions law? Well as I said, the government's really widened the responsibility boundaries here for pensions, so that now any type of corporate transaction in the U.K., whether it's a sale of a company, or a restructuring downsizing exercise, or the purchase of a business, well that has to be undertaken with a number of the Act's provisions in mind, and pensions has really become a key issue for both buyers and sellers. And the parties need to consider those issues

as early on in the proceedings, and as early on in the negotiations as possible, so that it's properly taken account of, and no party actually gets stung at the end of the day.

And the Pensions Act introduces the concept of moral hazard, it's also referred to over here as anti-avoidance. And the moral hazard provisions of the Act are aimed at preventing employers from using corporate structures to avoid pension liabilities. And this did happen in the past. And then just to link in with that funding issue that I mentioned earlier, to add further legislative icing on the cake, if you like, the U.K. has also introduced relatively recently new secondary legislation which creates more onerous funding levels and funding obligations. And in essence, that law dictates that on the winding up of a defined benefit pension plan, the employers will be liable for full buyout costs of that scheme, and that in broad terms means securing every member's benefits in full by purchasing annuities with an insurance company, which is of course potentially very costly given, as I'm sure you've experienced in the states, increased longevity, and just generally worsening annuity rates. So we now have a much more onerous liability than was previously the case for companies funding their pension plans.

And just to make sure that we've got a good, clear picture of those funding bases, the first one to mention is the old minimum funding requirement basis. That was introduced in 1997, it's been around for almost 10 years, but was abandoned at the end of 2005. Up until that point, the majority of defined benefit schemes were valued using the (MSR) basis, and it was basically the statutory minimum level for scheme funding, but it was very much criticized because it just wasn't realistic, there was no way that schemes which were able to refer to themselves as fully funded on that (NFR) basis could have gone out and paid in full for the member's benefits they were promising if that scheme were to wind up.

So unfortunately having been set as a sort of a minimum benchmark, it became the benchmark by which schemes were generally funded. And as a result, shortfalls in the true cost of pension provision were getting worse and worse.

So the (NFRs) gone out of the window, I just wanted to give you that background, but you can forget about it, although some of you who do get to deal with U.K. pension plans will see that funding basis referred to. What you're going to have now going forward is the new basis, the scheme-specific funding requirements. And that says that, as I've got on the screen there, the scheme must have sufficient and appropriate assets to cover its technical provisions, and technical provisions means the actual is assumptions actually about investment returns, salary inflation, and investment return too. And it's a much more realistic higher level of funding.

The trustees and the employer are required to agree that rate in a dialog between them, at least every three years, but it's looked at annually now. And if they can't agree, then the regulator can step in and impose a contribution level, so it's in the interest of all parties to agree what that rate is going to be. And as I say, it is materially higher than the old (NFR) rate.

The final basis which I had on my list, which is also relatively new in the last couple of years, this requirement to – I'm winding up fund buyout, and that is the third basis to bear in mind, and the third basis that you will hear U.K. pension trustees and actuaries talking about. That's so to say the cost of going to an insurance company to purchase the benefits. And that could be up to 30 to 40 percent more than that scheme's specific funding

requirement. So it's no surprise that a very significant number of U.K. pension schemes find themselves way less than 60 percent funded on a buyout basis.

So what is the significance of that buyout basis? Because if you get your scheme going forever and ever until the last member retires, or dies, you would never actually have to face that. Your scheme specific funding level would have you targeting funding to that point in time, so that the books would balance at the end of the day, if you like. Well this buyout figure comes relevant in two very specific circumstances, and that's referred to under section 75 of the Pensions Act.

When that section is triggered, a debt equal to the shortfall in the buyout cost for the scheme is triggered. And section 75 comes into play firstly when a final salary plan goes into wind up. And that shortfall liability is shared among the employers who participate in the scheme at that time. So we call it a wind up debt.

The second situation is when one of the employers in a group wide plan with a number of companies participating ceases to participate in the scheme. And on cessation, that subsidiary becomes liable for its share of any under funding in that scheme as an exit debt due to the scheme trustees.

Now this can arise on the obvious situation as a sale of that company, but there are some other situations which can unwittingly trigger an exit debt too. For example, if you've got a dwindling membership, I've got one scheme at the moment where one of the companies has only one active employee member participating, forget about deferreds, the people who've

left the company, forget about pensioners who've already retired, we're talking about the active employees still working for the company who are in the scheme.

And my last active member has just asked for a transfer value quotation, because he's thinking of moving his benefits elsewhere. That would trigger an exit debt for that company. If you are perhaps closing down a site for perfectly good business reasons, don't forget about the pension scheme. If you're going to end up with no more active employees with the company on that site, then that will trigger an exit debt.

You may be looking at benefit redesign to perhaps moderate pension costs, or just rationalize the whole benefit package. Bear in mind that if you are terminating the active membership of pension scheme members, you could end up with an immediate debt. Even if you're just disposing of the business and assets of a company, and keeping the company within the group perhaps dormant, if it's got no employees left after the transaction, you've possibly got an exit debt there too.

So it's important when thinking about any broad corporate strategy, any commercial plans, just check on what it does to your U.K. pension scheme, because it could be extremely expensive, especially now that we're no longer working from that weak (NFR) basis and it's a buyout debt that you're talking about.

So really for many companies, this is (neeming) at the moment that they can no longer wind up their plans or cease to participate, because it's simply too expensive to walk away. Well what can you do about it? If you are wanting to do a reorganization, a restructuring, a disposal of some sort here in the U.K., you can actually make arrangements for withdrawal

of that company, you can approach the pensions regulator for what's known as an approved withdrawal arrangement. You've got to be prepared to put in place some suitable financial support from elsewhere in the group, maybe such as a guarantee, a charge over assets, or simply another company taking on that liability. And you may get approval from the regulator for that company to leave without paying the debt directly up front.

There is a test that needs to be passed, it was initially described as test meaning that it was more likely that the moneys would be paid to the scheme eventually through the proposed withdrawal arrangement than if the exiting employer were required to pay, and that was really there to address a situation where the exiting employee simply did not have the assets to meet the forecast. I think the regulator's taking a broader look at this now, and is more receptive to circumstances where well, you know, the exiting company could pay most if not all of it, but commercially there are good reasons why it might be taken on by other parts of the group, it's certainly worth thinking. So that's withdrawal arrangements.

When we've got other alternatives too apart from a withdrawal arrangement, we've got, you know, this concept of the buyout debt here clearly printed on our brains, and I mentioned too these moral hazard provisions. Well how do they actually work? Apart from the exit debt that we have possibly got there, which is dealt with by a withdrawal arrangement, there are two other key powers that the pensions regulator has in terms of finding financial support from elsewhere. And those other two key powers are contribution notices and financial support directions.

Now in the first case, the regulator has power to issue a contribution notice on certain parties if he thinks that an act or omission on their part has as one of its main purposes the

prevention of recovery of section 75 debt, either the whole or part of it. Or there's an intention to prevent that debt arising, or that company's trying to get a compromise of the amount that that company will pay.

Now note the requirement for intent there, there is a test of good faith here. As I said, the regulator's got to be satisfied that at least one of the main purposes of what's going on is getting out of pension liability. And so just some practical examples of where you should think about this. I mean a situation for example where an employer has all its assets (hived) across to another company, so that it's actually got nothing with which to meet a section 75 claim if subsequently that company's wound up and the demand is made by the trustees. Well that's going to get the regulator interested.

Maybe another example is where a corporate group is restructured, and there's just one active member left behind in this scheme. I mentioned a scheme just now that I'm dealing with where quite legitimately that one employee remains behind, and that's because in fact there have been a number of closures, and he's been managing the whole process.

But here, if you had a restructuring that looked somewhat artificial, and that the scheme rules state that where the scheme has no active members left, it automatically goes into winding up, then that could get the interest of the regulator too. If you got two schemes merging, when you know, perhaps more naturally you might think well why wasn't one scheme wound up, why tip it into another? That could cause interest, as could choosing to run a scheme on as a closed scheme rather than winding it up.

All those situations are ones where the regulator could look for a degree of intent or fault, if you like, and it may well be that there's perfectly legitimate commercial reasons for doing this, not related to avoiding the triggering of a debt or getting out of debt. But it's important to think through, as I say, any commercial strategy with these possible consequences in mind, and be able to demonstrate that they're done in good faith without the purpose of avoiding debt. Keep an audit trail too both in terms of the company minutes and company records, and of course to the pension scheme trustees as well because they can come under attack if they are found to be complicit in any shenanigans of the company, if you like.

Well what are the consequences of receiving a contribution notice? Well if you receive a contribution notice, it's going to order you to make a payment into the pension scheme of an amount up to the size of that section 75 debt, and at the time of the act or omission in question. And anybody who was a party to that act or avoidance, and who was either a participating employer or associated or connected with that employer can be fixed with a contribution notice. I look at what we mean by associated and connected when I've come on to talk about the regulators other power financial support directions, but suffice to say here it could well cover a U.S. incorporated parent company.

More than one party can be named, and those parties will be jointly and severally liable, and for a contribution notice, it can apply to individuals as well as corporate entities, and that does always get directors of companies pretty worried, I have to say.

So that's all sounding very alarming, but it's important to remember that the regulator can't just hand out contribution notices when he feels like it, there is that intent test, and also the

regulator has to assess whether it's reasonable to issue a contribution notice on a particular person. And he'll look at the level of involvement of that person with particular acts or omissions. He's look at when there was a relationship with the employer, what was the relationship, the financial circumstances, was there involvement with the pension scheme too?

And the regulator will also be considering whether one of the purposes of what we've done was to avoid loss of employment. And that's a very important part of what the regulator is there to do, he does have, as well as minimizing calls on our pension protection fund, our equivalent of the PBGC, they do have a duty to look at whether companies are really trying to save jobs. It's not exactly clear what the regulator will regard as acting otherwise and in good faith, nor exactly what he's going to accept as proof of the purpose behind any act or failure. But there certainly has to be more of a near connection with the company.

He'll certainly be looking at the financial inter-relationship and benefits that's being derived by one corporate entity from the association with another, for example.

The contribution notice can be applied retrospectively to any act or omission after 27th April, 2004, and don't ask me why that date was chosen. It can be issued up to six years after the event, and as I say, the regulator has wide powers to issue against any overseas corporate entities. The comfort here though is as yet the regulator has not issued any contribution notices, I know that they are looking at some, and they're looking at some in relation to foreign entities in Europe at least.

So I mean just recapping before moving onto financial support direction. The contribution notice can be issued by the regulator where there is an act or omission, one of the purposes of which was really to escape a debt being triggered, either by maneuvering assets around a group of companies, or artificially maintaining membership numbers or something like that.

When it comes to the next power of the regulator, the second key power, financial support directions, this doesn't require any element of intent, and you will hear it heard of as the no fault test. So even while there's no deliberate attempt to avoid section 75 liability, and there's maybe no section 75 liability arising, the regulator can still think about putting in place liability for defined benefit funding on parties who don't participate in the scheme by means of a financial support direction. And there was a financial test here, and it might be issued where the participating employer in question is what's known as a service company, it employs staff, but has very little in the way of assets, or it's insufficiently resolved.

And insufficiently resolved tier means that the value of that company's resources is less than 60 percent of the section 75 debt for that scheme at the question – at the time in question. There's again got to be a reasonableness test, and again the regulator can issue a financial support direction to an employer who is connected or associated with the participating company. But unlike contribution notices, you can't get an (SSD), as they're known, issued against individuals unless that individual is themselves an employer. So you can't attack the directors of a company here in the way you can if the regulator decides there has been intent to avoid debt.

So the support directions will require the recipient of the notice to put in place some sort of financial aid, and it might be a schedule of payments, it might be a guarantee, it might be a charge over the assets of that company, something of that (ilk).

And what happens if you fail to comply with the financial support direction, well it could result in a major demand for cash payments, and a contribution notice being issued.

As I said, there's a reasonableness test here, and the sort of things a regulator will look at are going to be the level of involvement with the pension scheme, and the value of any benefit received by that party. And to give you an example here, I've got a German client with a U.K. subsidiary, and over the years in fact the German company had been trying to support its rather unhealthy U.K. subsidiary with this under funded pension scheme. And at one point in time it had taken a transfer of the assets, really to plan the machinery of the U.K. company at value, and it was at the low end of value, admittedly. But the idea was to inject some capital into the U.K. company, so German parent ends up with the assets or a substantial part of the assets of the U.K. corporate entity. That got the regulators very interested, though at the end of the day there was a sufficient audit trail showing valuations and showing acceptable valuations to show that the German parents had actually been giving more support to the U.K. than it had received in benefit from the U.K. But that's the sort of situation that might get looked at.

I talked about connected and associated, and this is where the net is cast much more widely. And as I said, you can get an (SSD) or a contribution notice against a connected or associated party, and those terms come from U.K. insolvency legislation. And a person's connected with a company if they're a director or a shadow director or an associate of either

of those. And an associate can be an individual's husband or wife, or these days as civil partners we have over here two. And it can actually even include an ex-spouse, it can include relatives of the individual, and a company can be an associate of another company. If one company controls the other, or if the same person controls both companies, or you know, one company controls one and then an associate of that company controls the other. And this in fact has got British venture capital associations and some institutional lenders over here very concerned about these broad requirements, and their degree of involvement in some companies and groups of companies, and really for a while it looked like discouraging investment, there has though since been some assurance in the regulator, there was no intent to just go out routinely to attack the wider group, but with justification they say they would.

So you can see why with that broad definition of connected or associated, why overseas parent companies come within these new provisions. And whilst I can see that it's relatively straightforward to enforce these provisions from the U.K. against other European Union corporate entities, I think probably those based in the U.S., it's a bigger challenge, but I don't think we can rule it out. I don't know if anybody's got any thoughts, and there very well come to ((inaudible)) through our questions box if you've got any thoughts or comments on that particular jurisdictional point.

So having outlined the issues, well is there a way around it? I've spoken about withdrawal arrangements as one possible solution, there is another solution in the form of clearance, and I've listed up on the screen the sorts of situations in which companies will wish to think about going through a clearance process, that is applying to the pensions regulator to say this is what we're planning, this disposal, this restructuring, are you please prepared to agree to this, and confirm there will be no contribution notice or financial support direction issued.

Now it's worth noting that if the scheme in question has a surplus on that accounting standard, that company accounting standard, FRS17, and I'll say a few words about that a little later, then the regulator is likely to be happy with that scheme and not want to impose a contribution notice or financial support direction, because ((inaudible)) feel well on an ongoing basis, that scheme's probably doing OK, and it's got a schedule of contributions in place that will get the job done, unless the regulator has fears that that business might be winding up or closing down in the near future. And then he's going to be much more interested in that buyout cost that I mentioned to you earlier.

Well what sort of events is the regulator interested in? Well the principles which drive the regulator's approach are that pension schemes are essentially unsecured creditors of the sponsoring employer. And in liquidation of the company, they rank there at the bottom of the pecking order alongside trade creditors and a handful of others, because banks, et cetera, who have secured lending get paid out first. So the regulator is therefore going to be interested in events that would reduce the status of a scheme as a creditor, even lower, diluted chances of getting some money. And the regulator ((inaudible)) also thoughts of events – type A events, and I think of them as a trio of Cs really, charges, capital and control, a change in the priority order of the pension creditor. For example, if the company is granting a fixed or floating charge over the assets, means less for the secured or the unsecured creditors.

A return of capital or a special dividend, or a change of control, a disposal of one of the companies in the group, less assets than to support the pension scheme. So if you are

looking at special dividends, refinancing, selling out of the group, think about this particular interest of the regulator.

Clearance is voluntary, it may be given on a conditional basis. And it will be given on the very specific facts presented to the regulator. The trustees need to be involved in that process too, and you really got to get their buy in before actually talking to the regulator.

Well what happens if you choose not to seek clearance? Well if you do, and you go ahead, I suppose effectively it means the sort of (Damocles) hangs over the participants in that transaction for up to six years. So I'm finding that companies are interested in applying for clearance, I'm finding that in terms of practical experience, well the regulator is actually being quite commercial, quite speedy, and it's a government organization, but they are actually very responsive.

Some of the implications, well they haven't been delaying corporate transactions too much at all, provided the parties think about it early.

(Dick Mosher): Liz …

Liz Fallon: Yes.

(Dick Mosher): … excuse me, Liz, let me interrupt you, if I could. Do you have some practical guidance in terms of how long companies should plan to seek clearance before an event takes place, what kind of lead time might be necessary …

Liz Fallon: Yes, I mean …

(Dick Mosher): … to avoid delays?

Liz Fallon: … my advice is plan as early as you possibly can. When you're thinking about the corporate strategy, factor in pensions then. The regulator has been known to respond within say two to three weeks from beginning to end of the process, where in fact jobs are at stake, company is sinking in this risk of insolvency, they treat that with urgency. So more routine, corporate planning, regular, you know, bread and butter disposals, they take longer, and they take a couple of months. And this is why I say, you know, don't ignore it, it's significant numbers, it can affect the value of the company for sale, and the buyer might be inheriting the risk as well, which impacts on their post acquisition plans.

And also you'll find it's being (slapped) up early through warranties, indemnities about, you know, what the company has been doing. So it really just get brought into the frame early on these days, (Dick). And it's – you know, it's one of the first things all the corporate lawyers have been educated by as to (rays).

(Dick Mosher): So a couple of months would be …

Liz Fallon: Yes.

(Dick Mosher): … conservative, or liberal …

Liz Fallon: Well, you know, that's still acting pretty quickly. I say that because most companies, you know, they don't – they don't have that ((inaudible)) issues around confidentiality in relation to transactions which make it difficult. A couple of months longer if you possibly can.

(Dick Mosher): OK, because (Renow's) counsel, that seems to be, you know, the number one issue that we're all faced with, and that is we need to close this transaction immediately, or by the end of …

Liz Fallon: Yes.

(Dick Mosher): … the year, and so we're constantly meeting those deadlines, and you know, we may have to deal with merger authorities, and get other approvals as well. So …

Liz Fallon: Well I've got one as …

(Dick Mosher): … from.

Liz Fallon: … yes. Just to give you a real example here of why we're in a terrific hurry on one at the moment, because it's on the back of chapter 11 proceedings in the U.S., which I mean you'll know better than me have, you know, a very strict procedure, hoops to go through, and rather late in the day the organization in question thought about, OK what about our U.K. group, oh, big liabilities in there for pensions. We need to clean up globally, can you please do this by the end of September? Well sorry, no that isn't possible, it does take longer. It's

those sorts of situations where you might not naturally think about pensions about U.K. where you really do have to these days.

(Dick Mosher): thank you.

Liz Fallon: OK. Just moving on, because I'm a little bit conscious of time. Yes, a word on enforcement against U.S. corporations. You know, the regulator has power in the legislation to enforce, but obviously there's jurisdictional issues, each state having its own – its own legal system in effect. It's not going to be the most appealing prospect for the U.K. regulator to do that. But if a sizable amount were at stake, then I can see them having a go.

You could also see actually situations where there's a contractual obligation on the part of a foreign parent that needs to be looked at. And I think also I wouldn't underestimate the reputational issues for an organization having a contribution notice or financial support direction issued against them. You know, to be seen to try to resist it, the PR implications, the reputational implications, relations with unions, I think they all need to be thought about really, and it seems to me the best way is actually to negotiate with the regulator.

That's all I wanted to just say on the moral hazard procedures itself. But to just mention to you something else to just keep in the back of your mind is the notifiable events rating which has been introduced under the Pensions Act. The regulator has set up what they see as an early warning system to find out about scheme related events from trustees, and employer related events from companies. And in certain circumstances, notification is mandatory, I said to you that clearance is voluntary, notification is mandatory. And on the part of a company, certain events are always notifiable if the scheme is less than 100 percent funded

on that (PPF) level, or if the employer has defaulted in any contribution obligation over the last 12 months.

And the events that we'll need to be notified if those two hoops or boxes are picked, or one – or at least one of each of those boxes is picked is a breach of a banking covenant that's not waived, a decision, not the actual relinquishing of control, but the decision to dispose of a company. Another one that can get missed is changes of CEO and FD, or are those responsible for the affairs of the U.K. company, and therefore responsible for ultimately pension scheme obligations. And again I've had a notification recently where I've had to tell a regulator about that, and they immediately came back on the phone wanting to know more about the circumstances behind those change of office.

Change in the employer's credit rating too, that will need to be notified. Events that are always reportable, so it doesn't matter how well funded you are and that there's been no default in contributions, a decision to compromise or try and take action to compromise any section 75 buyout debt, exiting the U.K., if the directors of this received advice about wrongful trading, or they've had any conviction for dishonesty, then that has to be notified for pretty obvious reasons, as has a change of the employee's credit rating where they're ceasing to have a recognized credit rating.

So it's important really to understand that list of notifiable events, it's being added to all the time, to make sure that you've got internal procedures to trigger a notification to the regulator, allocating responsibility to somebody best here in the U.K. to deal with that, and to track the new additions to that list, because if you fail to notify and you end up on the regulator's radar screen, then they – you know, they have the power to come and do dawn

raids, and what have you, to find out what on earth has been going on in the pension scheme. So it's all common sense stuff, but it's easy to overlook.

(Dick Mosher): Liz, before we get into the accounting provisions …

Liz Fallon: Yes.

(Dick Mosher): … it might be a good time to answer a question that we received. The question is, we are a large outsourcing company, if we assume pension obligations for employees we take over in connection with the outsourcing transaction, and we maintain those obligations for a number of years while we provide the outsourced services, but then if those services are terminated and transferred to a new outsourcing company who takes over the account, if that new company goes – then goes under, or goes under …

Liz Fallon: Yes.

(Dick Mosher): … in a bankruptcy sense …

Liz Fallon: Yes.

(Dick Mosher): … couldn't we have ongoing liability for those pension obligations? And in particular, a concern about the ability of the government to send us a contribution notice or financial support direction.

Liz Fallon: Yes. Where you do transfer on, it's important to get appropriate indemnities and a release from the obligations that could stay with you, because those obligations your – our delegate is right, it could stay with you. Now obviously an indemnity is only as good as the party giving it. And if that party then goes into insolvency and can't meet its obligations, there is a chance that in fact the obligations could come back. However, if it's all been dealt with properly under the sale agreement, and there has been a transfer on in full, you ought to be reasonably comfortable about that.

The government – I don't know if this is an outsourcing organization that actually does take on government contracts, or they're just thinking about the government powers generally in relation to contribution notice or financial support direction. In general terms, there will be no degree of association or connection so that the regulator would come back at that outsourcing party with a financial support direction or a contribution notice, where you'd simply – you'd want a contract to provide services for five years, at the end you haven't managed to – you haven't managed to re-win, if you like. So, you know, that wouldn't be the case.

But I've just seen up on the screen this individual has said yes, they do take on government contracts. I think you've got to look very, very carefully at the small print of what you're taking on, and what you're offering. It's actually quite a detailed area, and it's rather different from the topic that we're talking about today, which is really about contribution notices and financial support directions, which as I say you wouldn't really get in the context of the ending of an outsourcing arrangement. But there are a whole host of thorny issues coming out of taking on board government contracts where the employees do participate in what can be very generous defined benefit schemes, you might be asked to mirror that

arrangement, put them into your own passport approved, as they're called, pension schemes for a period of time. And when your contract comes to an end, you want to make sure that you transfer them on lock stock and barrel, and get a release at that stage.

(Dick Mosher): Liz, is that something you can negotiate with the – with the agency here, or is – do you deal with that strictly in terms of your contract liability?

Liz Fallon: Well you've got parameters within which you can negotiate, it always boils down at the end of the day as to how keen the contracting party is to win the work, take on the work, and that's obviously down to how much profit there is in it. You've really got to factor in pension costs when putting in your bid for these government contracts, and it is all part of the – it's part of the pricing, it's a big part of the negotiation, although sometimes the scope for negotiation is closed down by the government who take a quite intransigent approach at times.

Everyone varies though, it depends on the sector, and it depends on the nature of the contract, et cetera.

So, (Dick), should I move on and just …

(Dick Mosher): Yes.

Liz Fallon: … tie up what I was saying? What I wanted to do was mention FRS17 accounting, because I've talked about the different funding bases, I've talked about MFR, I've talked about scheme specific, I've talked about buyout. And the other thing I can hear you asking

is, oh, I saw a company account for the U.K. the other week, and that gave a completely different slant on funding. And for company accounts, there's been a new accounting standard effective well since 2005, accounts being produced after then that really does magnify the importance that defined benefit pension schemes assume within a company's accounts. And it's very different to what it replaced, the (SAT24) previous accounting standard.

And FRS17 reflects the trend towards balance sheet driven accounting, whereas (SAT24) was on the profit and loss. And under the (SAT24) regime, you based your estimate of pension costs on the investment strategy underlying the scheme, which for most schemes included at least, you know, 60, 70 percent equities. And so actually could anticipate higher expected returns from equities to be taken into account.

FRS17 measures liabilities by reference to (AA) rated bond yields on a particular day. And so the difference in the market value of the assets and liabilities based on that assessment gives rise to a lot more fluctuation, and there's no spreading. Under (SAT24), you would spread your deficit or surplus, if you were lucky enough to have it, over the future working lifetime of your employees. And so without this spreading under FRS17, it's much more of an instant snapshot on a particular day, by reference to market conditions on that day. So I was going to say, it leads to a lot more volatility, there's also a lot more noted in the accounts now, a lot more detail, for example, about what the directors pension costs are. And all of that really does attract quite a lot of shareholder interest, you've got volatility, you've got your assets and liabilities being measured against a yardstick that's different really from what your assets under the scheme are likely to be invested in. And so the two don't move in tandem.

It's had a number of impacts already in fact, I mean investors are looking, it's impacted on share price, and certainly on payment of dividends in some cases, where companies have not felt able to pay dividends they were otherwise planning to do. It's a disincentive to offer any benefit improvements to start us as well to directors particularly, and it also causes a rather narrow view at times of investment strategy. And it's really caused one or two companies to look much more closely about closing their final salary schemes, and thinking about how they can actually get out of making final salary provisions, and going much more in the direction that you have in the U.S. with really many, many more defined contribution arrangements.

So that's FRS17. It links in with the international accounting standards too, just to mention briefly, because U.K. listed companies also have to prepare their consolidated accounts in accordance with that international standard, and that applies in fact to all E.U. listed companies. I think though that the international accounting standard is really very similar to FRS17 in terms of the way it deals with pensions. And they're not particularly more onerous for companies who were already accounting on the FRS17 basis, I think the international accounting standard is really just an opportunity for multi-nationals to try and more consistently understand and measure their plans across the world really.

So that was just a quick mention of FRS17, because you do have to think of it separately, but alongside those other bases for measuring pension liabilities.

And I guess well, you know, what was the message today? Well I hope I've helped you understand a bit more about pension accounting, pension costs, and why in fact your finance

director might be on the phone at regular intervals wanting to talk to you about pensions, and nervously telling you about the latest estimate and the cost of the pension scheme going up, and why the contribution rate needs to go up.

I think I also wanted to make clear, and I hope I have, that if you're thinking about broad corporate strategy, somewhere along the line your U.K. pension scheme could impact on that, and impact quite adversely. But there is a way around it, you know, reshaping companies, restructuring, it can be done, it just takes a bit of consideration, it probably takes the involvement of the pensions regulator, and these days it will have to involve the pension scheme trustees too. There's been reticence to do that in the past, and they need to be involved, they do sign confidentiality agreements, but in the words of one of our major telecom companies, as they say in their ad campaign, it is good to talk, it's good to talk to the trustees, and where necessary the regulator to get clearance.

So maybe next time your (RSTKFD) rings out and nervously asks to talk about pensions, you won't feel you just want to reach straight for the Tylenol, because this is that big headache coming back again.

(Dick Mosher): Liz, thank you. Let me just add a couple of follow-up questions here that we can cover in the remaining couple of minutes. Like most U.S. corporate counsel, we like to get checklists of items that we absolutely have to look at first thing. Can you give us oh two or three essential matters that you've covered here that we really ought to take a look at right away in terms of this liability?

Liz Fallon: Yes, I think firstly, go back if you've got defined benefit plans in the U.K., take a look at the last figures that they actually produced, here we're giving you ongoing, here they've given you buyout figures. Have a How to think about that. Have a look at the profile of the pension scheme, how many active employees have you got? Are you at risk of a buyout debt being triggered because for either corporate disposal reasons, or some of the others I touched upon, you're not going to have any active participating members very soon.

I think it's important to also one other kind of leave behind is to keep up a dialog with the trustees. They're going to be asking you for reports on how the company's doing, that's one of their requirements these days. Well I think you need to be asking them how the pension scheme's doing too, get a dialog going on investment strategy, on funding, and really I think probably plan ahead and don't wait for events to take a hold of you.

(Dick Mosher): And I think a Webcast wouldn't be complete, Liz, unless we mentioned the fact that if you're subject to U.S. securities laws, you might take a look at your liabilities and responsibilities toward reporting potential pension liability, and your Sarbanes-Oxley liability in terms of what you have to communicate to your shareholders.

Finally, Liz, where do you see this headed? Do you – do you think this legislation is a success? And what effect do you see it having on U.K. pensions going forward?

Liz Fallon: Well I think whether you view it as a success depends upon where you're sitting. The regulator thinks it's a success, because the regulator has noticed that companies are funding their pension scheme deficits over a much shorter period of time. So the regulator sees that that will mean less call on the pension protection fund, better protection for members. I

think sitting on the corporate side of the fence, I see it going towards a shift to defined contribution away from what are hugely attractive to the member defined benefit plans, but risky, volatile liabilities for companies. And when I'm not dealing with the pensions regulator on clearance, another big part of my job is actually talking to companies about how they can get out of their defined benefit provision, which having been in pensions for 25 years makes me a bit sad really, but that's where we're at.

(Dick Mosher): Liz, thank you very much, that was outstanding, and not only a good review of the new law and the liabilities, but some very good practical advice for all of us. So on behalf of the Association of Corporate Counsel, and our listeners and myself, I want to thank you and Eversheds very much.

Liz Fallon: My pleasure.

(Dick Mosher): Thank you. Just a final reminder before we close off her, the links on the left-hand side of your page, make certain that you fill out the Webcast evaluation form, we'd very much appreciate the feedback, contact information for Liz is on the last page. There's a link to Eversheds, and also of course the link to the Web slides that we've been looking at. Again thank you very much, and have a terrific day.

Liz Fallon: I should just chip in there, (Dick), and also if you go onto our Web site, you will find that there is a navigation tool around the moral hazard procedures. So if you're facing those issues, and you're wanting to recall some of what's been said, it's there.

(Dick Mosher): And thank you very much, appreciate that.

Liz Fallon: OK.

(Dick Mosher): OK, we'll sign off now.

Liz Fallon: Thank you.

(Dick Mosher): Goodbye.

END