

# Defined Benefit (DB) Pension Schemes and Loan Documentation

## KEY POINTS

- **Criminal offences and civil penalties** under the Pensions Acts could catch banks and banking lawyers e.g. where lending prejudices the DB pension scheme (e.g. if any security has priority over the DB pension scheme).
- **Pensions Regulator Guidance** provides some comfort that these powers will not be exercised in relation to “ordinary course” lending, but there is no statutory safe harbour for lenders.
- **What should lenders do** – document as part of their loan decision making process the factors which demonstrate it was reasonable to act as they did and include further representations in the loan documentation.

## A refresher: How do a DB Pension Scheme and Defined Contribution Scheme differ?

A **DB pension scheme** guarantees a lifetime pension based on a specific formula when a member retires. The employer bears the downside funding risk of the investments being insufficient to fund the promised benefits.

A **defined contribution (DC) pension scheme**, also known as a *money purchase scheme*, provides members with a fund on retirement made up of their own and their employer’s contributions, plus any investment returns. As there is no benefit guarantee, the employer’s liability is essentially just to make the promised contributions.

Although DC schemes are more common, it’s still crucial to have your legal counsel confirm the type of pension scheme involved at the beginning of any transaction and this can then be factored into any loan documentation.

## The things lenders have always worried about

DB pension schemes have always been an issue for lenders as:

1. They are expensive for employers. DB pension schemes can be a drain on a borrower’s resources which can devalue the business and impact the ability of a borrower to repay its bank debt.
2. The Pensions Regulator has powers to force other parts of the business to contribute to the scheme under its contribution notice and financial support direction powers.
3. Banks can, if they are not careful, become connected/associated with a scheme (bringing them within scope of the Pensions Regulator’s contribution notice and financial support direction powers) when they take a charge over a sponsoring employer’s shares if that charge is enforced. This is an important consideration and will impact on the drafting and controls included in the charge documentation.

## The Pensions Act issues

The Pension Schemes Act 2021 introduced the criminal offence of conduct risking accrued scheme benefits, which can result in a prison sentence of up to seven years or an unlimited fine (or both). Alternatively, a financial penalty of up to £1 million can be imposed. The criminal offence must be proved beyond reasonable doubt, whereas the civil penalty can be imposed on the balance of probabilities.

The issue from a Bank’s perspective is that “conduct risking accrued scheme benefits” is very widely drawn as:

- an act or failure to act that detrimentally and materially affected the likelihood of the DB pension scheme benefits being received; if
- the person knew or ought to have known that act (or failure to act) would have that effect; and
- it was not “reasonable” for the person to act or fail to act as they did.

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The simple act of enforcing security could be *prima facie* in scope of the offence/penalty. This is because (without more) pension scheme trustees are unsecured creditors – so if the Bank enforces security in priority to the DB pension scheme that act could be within scope. The same could apply where a lender chooses not to lend further to a sponsoring employer because of the risk of the lender being exposed to losses.

The Pensions Regulator has issued guidance to the effect that “ordinary course” lending is unlikely to be prosecuted, and that it will adopt a risk-based and proportionate approach. But the real issue is that the Pensions Act does not provide a statutory “safe harbour” for lending activities – the Pensions Regulator has the power to prosecute, or impose a financial penalty on any person, including Banks and their officers and employees.

## How are DB Pension Schemes currently dealt with in loan documentation?

Within the current Leveraged LMA standard loan agreement, there are specific clauses relating to the Pensions Act 2004 including (but not limited to):

- a representation confirming that no Group member is linked to a DB pension scheme; and
- an undertaking to prevent any future Group member from having such a connection.

These are included with the aim of avoiding undisclosed liabilities for pension deficits. The agreement does not, however, seek to mitigate the lender’s Pensions Act risk.

## How can lenders mitigate the Pensions Act risk?

It is sensible for lenders to take active steps to document why the course they took in relation to the lending decision was “reasonable”, even if that decision (e.g. to take security in priority to the DB pension scheme) did *prima facie* detrimentally effect the position of the DB pension scheme. Any “reasonable excuse” defence will be stronger if it is evidenced by contemporaneous records.

This can generally be dealt with relatively simply by asking additional due diligence questions at the start of the financing process and including further representations from the borrower in the loan documentation.

If you’d like to discuss this further with our specialists, please do reach out to any of the contacts.



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