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7 February 2007

Mr Stephen Leinster
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Dear Mr Leinster,

FMLC ISSUE 104: PENSIONS ACT 2004 – ASSOCIATED AND CONNECTED PERSONS

On behalf of the Financial Markets Law Committee ("FMLC"), I write to raise a number of points in reply to your letter of 7 March 2006, itself a response to the FMLC's December 2005 paper on section 38 of the Pensions Act 2004 ("the Act"). Both the paper and your letter are attached.[1]

The extent of the power under section 121(9)(b) of the Pensions Act 2004

The FMLC paper put forward the following solution to address the concerns identified therein: that the Secretary of State should prescribe by regulations, pursuant to the power in section 121(9)(b) of the Act, that receivers be included in the definition of "insolvency practitioner" for the purposes of the Act. The paper argued that the automatic result of such prescription would be to bring receivers within the meaning of "insolvency practitioner" for the purposes of section 38 of the Act.

In your letter you responded by saying that section 121(9)(b) only applies to Part 2 of the Act and therefore would not be of any assistance in expanding the meaning of "insolvency practitioner" for the purposes of section 38 of the Act, which is within Part 1 of the Act.

The FMLC does not agree with this analysis. Section 38(11) of the Act sets out the relevant definition, for the purposes of section 38 as a whole, as follows:

> *(a) a person acting as an insolvency practitioner, in relation to that person, in accordance with section 388 of the Insolvency Act 1986;*

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1 The FMLC paper is also available at www.fmlc.org.

(b) an insolvency practitioner within the meaning of section 121(9)(b) (persons of a prescribed description).

From these provisions, it appears to the Committee that section 38(11) of the Act incorporates persons prescribed under section 121(9)(b) of the Act for the purposes of section 38 itself. It follows that, where section 121(9)(b) of the Act is relied upon to extend the scope of "insolvency practitioner", this must take effect for the purposes of section 38 of the Act. That is so, the FMLC believes, even though section 121(9)(b) of the Act expressly provides a definition of "insolvency practitioner" for the purposes of Part 2 of the Act.

The FMLC recommendation: concerns and objections

In your letter you draw attention to the following difference between an administrative receiver and a receiver: that, whereas, an administrative receiver must be a licensed insolvency practitioner, a receiver may not be (although he may be licensed and often will be). In so far as this may be an objection to the prescribing of receivers, the FMLC believes it can be adequately addressed by limiting the kinds of receivers prescribed. That is, the proposed regulations should make it clear, if it is thought desirable, that only receivers who are also licensed insolvency practitioners are included.

One concern that is not raised in your letter is the possibility of an undesirable consequential effect or impact on the other provisions of the Act that rely on the definition of "insolvency practitioner" if receivers were to be prescribed under section 121(9)(b). If such a possibility is of concern, a promising solution might be to limit expressly the interpretative purposes for which the receivers are prescribed under section 121(9)(b). That is, the proposed regulations should make it clear that receivers are only prescribed for the purposes of section 38.

The market impact of the existing lacuna

Your letter refers to the consultation carried out by the Department of Work and Pensions during the passage of the Pensions Bill through Parliament and notes that the issue of the liability of receivers, and any comparison with the liability of insolvency practitioners, was not raised during that consultation. Although this issue may not have been raised at the time, the FMLC notes that R3 has subsequently taken up this point with you in their letter dated 23 June 2006.

Notwithstanding the responses to the consultation at the time, the FMLC considers that the existing lacuna has a real market impact. This arises from the fact that receivers are subjected to the Act's contribution notice regime as a result of their not being included within the definition of "insolvency practitioner" in section 38. Two particular issues that market participants have raised with the FMLC are set out below.[2]

> First, in the context of acquisition finance transactions, share charges are an important element of the security provided for the transaction. Funds lent to a company that is set up as the vehicle for making an acquisition can often only be secured by the shares of the acquired company, as this is frequently the only asset the acquisition vehicle has available to provide to its lenders. Although current

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2 It should be noted that market concerns could also be addressed by simply excluding receivers from the contribution notice regime. Under section 38(4), the Secretary of State has the power to prescribe persons and circumstances in which the Regulator may not issue a contribution notice. This section could be used to implement regulations providing that contribution notices may not be issued to receivers in certain circumstances (including where the receiver in question is a licensed insolvency practitioner). However, from the FMLC's perspective, which is concerned with legal certainty, greater transparency would be achieved by bringing receivers within the definition of "insolvency practitioner".

practice is to provide additional security from the acquired company in due course, either by way of guarantee or additional security, subject to financial assistance restrictions, the lender will place much reliance on the share charge to secure the borrowing for the acquisition. In many cases, the enforcement of the share charge by the appointment of a receiver will be the most efficient and effective way to realise this security. However, this use of a receiver will be impacted by the absence of the protection afforded to other insolvency practitioners under the Act.

Second, in the context of structured finance transactions, there are certain circumstances where an insolvency-remote special purpose vehicle ("SPV") is used but for a range of reasons (such as a negative pledge in relation to floating charges for the corporate group of which the SPV forms a part, because partnerships form part of the structure or because the group is unwilling to grant a floating charge) it is not possible to appoint an administrative receiver and therefore a receiver will be appointed instead. Rating agencies accept these structures on the basis that a receiver will be appointed (recognising that, in effect, a receiver will have the same powers as an administrative receiver in these situations). However, the analysis of these structures would be affected by potential liability for the receiver under the Act.

Conclusion

The FMLC continues to believe that there are sound arguments for extending the definition of "insolvency practitioner" in the Act to include receivers and does not consider that there are any technical barriers to taking such a course. The FMLC also considers that such an extension would provide significant benefits to the financial markets.

Yours sincerely

Lord Woolf

Attachments: 98736, 110428

December 2005

FINANCIAL MARKETS LAW COMMITTEE

ISSUE 104 – PENSIONS ACT: ASSOCIATED AND CONNECTED PERSONS

Insolvency Practitioners – Receivers and the Pensions Act 2004

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Insolvency Practitioners – Receivers and the Pensions Act 2004

Introduction

1. The role of the Financial Markets Law Committee ("FMLC") is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks, and to consider how such issues should be addressed.

2. In the course of 2005, the FMLC raised a number of legal certainty issues arising out of the moral hazard provisions of the Pensions Act 2004 with the Pensions Regulator. Several of the issues raised by the FMLC were addressed in the responses from the Pensions Regulator. However, some issues remained outstanding and it became clear that they would need to be resolved, if at all, by legislation. This purpose of this paper is to examine one such issue and to address the possibility of a solution.

3. The particular issue under consideration is whether receivers should be included in the definition of "insolvency practitioner" for the purposes of the Pensions Act 2004 and why this would be of benefit to, and promote certainty in, the wholesale financial markets.

Background

4. The moral hazard provisions of the Pensions Act 2004[1] came into force on 6 April 2005. The stated aim of the moral hazard provisions is to mitigate against the risk of employers deliberately shifting the responsibility for the deficits in their pension schemes onto the newly formed Pension Protection Fund.

5. In particular, section 38 of the Pensions Act 2004 empowers the Pensions Regulator to require any person (which includes an individual) who is "connected" with or an "associate"[2] of the sponsoring employer of a defined benefit pension scheme which is in deficit to make a contribution equal to the whole or a specified part of the shortfall sum if:

   (a) the person was a party to an act or failure to act which took place after 27 April 2004 (being the date the moral hazard provisions were first published) and ultimately within a six year period and which had as a main purpose the avoidance of pension liabilities; and

   (b) it would be reasonable to impose liability on that person. In deciding whether it is reasonable to impose liability, the Pensions Regulator is required to consider various matters, including the degree of involvement

1 Sections 38-51

2 These terms are defined by sections 435 and 249 of the Insolvency Act 1986.

of the person in the act or failure to act, whether the person had 'control' of the employer and the purpose of the act or failure to act.

6. The FMLC has raised a number of issues arising out of the moral hazard provisions of the Pensions Act 2004 with the Pensions Regulator. The first of these concerned whether a lender who took security over shares in a company was subject to those moral hazard provisions. Such a lender would normally have a right under the security instrument to exercise voting rights in relation to the shares on an event of default in relation to the loan. The FMLC sought clarification from the Pensions Regulator as to whether it considered that the lender could be subject to a contribution notice or financial support direction in the following situations:

   (a) where an event of default has not occurred and so no right to vote the shares has accrued, but a contingent right to exercise voting rights exists under the terms of the security instrument; or

   (b) where the right to vote the shares had accrued following a default, but no control over the shares or direction to vote had been exercised by the lender.

7. The Pensions Regulator provided clarification on this issue. The correspondence has been published on the FMLC's website at www.fmlc.org.

8. The second issue the FMLC raised with the Pensions Regulator related to whether receivers should be included in the definition of insolvency practitioner for the purposes of the Pensions Act 2004. Insolvency practitioners are not subject to the moral hazard provisions of the Pensions Act 2004 if they act in accordance with their functions as an insolvency practitioner. The FMLC has been given to understand the Pensions Regulator regards this as an issue that would be better raised with the Insolvency Service.

The position of insolvency practitioners

9. In the context of insolvency practitioners, section 38(3)(c) of the Pensions Act 2004 provides that the Pensions Regulator may issue a contribution notice to a person only if,

> the Regulator is of the opinion that the person in being a party to the act or failure, was not acting in accordance with his functions as an insolvency practitioner in relation to another person ...

For the purposes of section 38 of the Pensions Act 2004, insolvency practitioner is defined as a person acting as an insolvency practitioner in accordance with section 388 of the Insolvency Act 1986 or within the meaning of section 121(9)(b) of the Pensions Act 2004.

10. Section 388 of the Insolvency Act 1986 provides that a person acts as an insolvency practitioner in relation to a company by acting as its liquidator, provisional liquidator, administrator, administrative receiver or in relation to a scheme of arrangement, a nominee or supervisor. In addition, section 121(9)(b) of the Pensions Act 2004 provides that an insolvency practitioner, in relation to a person, means in such circumstances as may be prescribed, a person of a prescribed description.[3]

11. It is clear from the Report for Grand Committee dated October 2004 entitled "Consultation on the Moral Hazard Clauses in the Pensions Bill" that the inclusion of a statutory exemption from the contribution notice regime for insolvency practitioners came about as a result of the consultation process and is an acknowledgement that it would not be fair and reasonable to impose liability for pension scheme deficits on insolvency practitioners to the extent they are acting in accordance with their functions.

The current position in relation to receivers

12. It is not evident from either the consultation documentation referred to in paragraph 11 above or from Hansard as to how the definition of "insolvency practitioner" was arrived at in the context of the Pensions Act 2004.

13. It is, however, clear from the definition of "insolvency practitioners" that a receiver, other than an administrative receiver, would not be able to benefit from the statutory exemption for insolvency practitioners contained in section 38(3)(c) of the Pensions Act 2004. This is the case even if such receiver is an insolvency practitioner regulated by the Insolvency Service.

14. Receivers who would not therefore benefit from the exception include receivers appointed to fixed charges only (so called "LPA Receivers") and receivers or managers appointed to companies not incorporated under the Companies Act 1985 or under former Companies Acts, e.g. foreign incorporated companies and statutory companies.[4]

15. In the context of the Pensions Act 2004, it is unclear why receivers are treated differently from administrative receivers, liquidators, provisional liquidators and administrators. We are not aware of any reason why receivers should be treated

3 Prescribed by the Secretary of State by way of regulation (section 318).

4 Section 251 of the Insolvency Act 1986 requires the term "company" to be construed in accordance with Section 735 of the Companies Act 1985 which defines a company as a "company" formed and registered under the Companies Act 1985, or an existing company (i.e. a company registered under former Companies Acts). This definition is stated to apply "unless the contrary intention appears". Although the first instance case of *Re International Bulk Commodities Ltd* [1992] BCC 463 held that administrative receivership of a foreign company was possible, the reasoning in this case has been criticised in the case of *Devon & Somerset Farmers Ltd* [1994] Ch. 57. Indeed, the widely held view is that *Re International Bulk Commodities Ltd* was wrongly decided.

differently, given their function. Receivers fulfil the same function as administrative receivers and are appointed in the same way. This distinction has potential negative consequences for insolvency practitioners and for secured financing arrangements generally.

The impact of receivers not being included in the definition of insolvency practitioner

16. The potential negative consequences can be demonstrated by looking at the typical secured financing arrangement. When security is taken in the context of a financing arrangement, the security documentation will generally allow the beneficiaries of the security to appoint a receiver upon the occurrence of any breach of the underlying financing arrangements. A receiver appointed over the whole or substantially the whole of a company's property pursuant to a debenture containing a floating charge is an administrative receiver.[5] Any such administrative receiver would be entitled to the statutory exemption in the Pensions Act for insolvency practitioners referred to above if, as a result of the appointment, the administrative receiver becomes "connected" with or an "associate" of the employer company or any holding or intermediate holding company of the employer.

17. In all other cases, the receiver appointed pursuant to the security instrument will not be an "administrative receiver" and will instead be a receiver or a receiver and manager. Therefore, the receiver would not be able to benefit from the statutory exemption in the Pensions Act, even though such receiver could also find himself "connected" or "associated" with the employer company (or its holding company or intermediate holding company) through the powers conferred on him by the security instrument. This places receivers at risk of being made responsible for pension scheme shortfalls through the Contribution Notice regime.

18. A receiver could become "connected" through a security arrangement where the security instrument contains a fixed charge over more than one third of the shares of the employer company (or its holding company or intermediate holding company). On enforcement, the receiver would take on all the rights of a legal owner of the shares including, for example, the right to vote the shares at a general meeting. Similarly, a receiver appointed pursuant to a security agreement could become "connected" if, as a result of his actions he is deemed to be a "shadow director".[6] A receiver could also become an "associate" of the employer (or its holding company or intermediate holding company) in his capacity as officer/employee of any of those companies.[7] Once connected in this way, the

5 The ability to appoint an administrative receiver is of course dependent upon the transaction being one that falls within one of the exemptions in the Enterprise Act 2002.

6 Section 435(10)(a) Insolvency Act 1986

7 Section 435(4) Insolvency Act 1986

receiver is then exposed to the risk of being made responsible for pension scheme shortfalls.[8]

19. The risk that receivers may be caught by the provisions of the Pensions Act, when they are simply acting in accordance with their appointment under a security instrument, creates a disincentive for receivers to take appointments, unless they are adequately indemnified for possible pension scheme deficits. There appears to be no underlying reason for receivers (who are commonly regulated insolvency practitioners) to be put in this position. The situation created may seriously impede the ability of creditors to enforce security and therefore undermines the ability of a company to obtain finance.

Conclusion

20. As stated in paragraph 10 above, section 121(9)(b) of the Pensions Act 2004 empowers the secretary of state to prescribe by regulation other persons who may benefit from the exemption. The FMLC considers that there is a strong argument in favour of the Secretary of State exercising those powers to expand the category of insolvency practitioners to include receivers for the purposes of the Pensions Act 2004.

[8] These examples could become more acute where the receiver acts as principal, e.g. after the company to which he has been appointed has gone into liquidation, terminating his agency.

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Date: 7 March 2006

Dear Joanna

FMLC ISSUE 104 PENSIONS ACT 2004 – ASSOCIATED AND CONNECTED PERSONS

Further to my letter of 13 February, I have now received comments on the matter you raise from the Department for Work and Pensions. However, I would first like to make some general comments on the role of receivers.

The paper (paragraph 15) asserts "receivers fulfil substantially the same functions as administrative receivers and are appointed in the same way". With respect, in my view that is not the case. The insolvency legislation recognises a difference in the nature and degree of control exercised respectively by receivers and administrative receivers in the companies in respect of which they are appointed; they are different creatures.

It is true that receivers are appointed by charge holders under the terms of the charge to deal with property covered by that charge. However, insolvency legislation makes a very clear distinction between receivers and administrative receivers. Section 29(2)(a) of the Insolvency Act 1986 defines "administrative receiver" as "a receiver or manager of the whole (or substantially the whole) of a company's property appointed by or on behalf of the holders of any debentures of the company secured by a charge which, as created, was a floating charge, or by such a charge and one or more securities".

As you know, a person appointed as an administrative receiver must be a licensed insolvency practitioner. Also, although a receiver **may** be a licensed insolvency

practitioner, there is no requirement that he must be so.

Therefore, to the extent that any request for an extension of the existing exemptions to cover insolvency practitioners while acting as receivers, as distinct from administrative receivers, relies on the argument that they fulfil substantially the same functions, I would suggest that this is not a sound basis for the request.

I also understand that members of the Society of Turnaround Professionals, if they are not acting as insolvency practitioners in relation to a company, do not benefit from an exemption but that they rely on the clearance procedures, which are already in place, where they consider that necessary. It seems to me that a turnaround professional is more likely than a receiver to be exposed, for example to the extent of becoming a director in some cases.

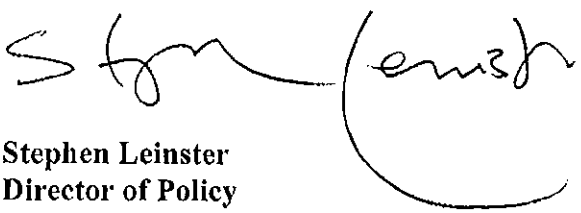
Turning now to the comments I have received from the Department for Work and Pensions, it may be helpful if I explain that during debate, the Government consulted a number of organisations in the pensions industry and more widely about the "anti avoidance" provisions of the Act. This focused on the aims, objectives and practical application of these provisions. Those consulted included the Insolvency Service, the Association of Pensions Lawyers, The Society of Turnaround Professionals and PriceWaterhouseCoopers. The issue of interaction / liability of receivers and insolvency practitioners was not raised (or if it was - not considered a major concern). The definition of "Insolvency Practitioner", for the purpose of section 38, was determined through these discussions.

It is true that a receiver, as distinct from an administrative receiver, would not be able to benefit from the exemption contained in section 38(3)(c) of the Act. However, section 38(3)(d) enables the Regulator to operate the "reasonableness" test to determine whether to impose liability on the person to pay the sum specified in the contribution notice. It will look particularly for evidence of mitigation of risks to the pension scheme. Section 38(7) provides the legislative framework upon which the Regulator is able to base this decision.

The receiver could also seek "clearance" from the regulator. In essence, and in answer to most of the points raised in the paper, the risk of Receivers being made responsible for pension scheme shortfalls through the requirement to comply with contribution notices, is largely eliminated with the provision of the clearance procedure.

Finally, the FMLC have suggested that section 121(9)(b) of the Act empowers the Secretary of State to prescribe, by regulation, other persons who may benefit from the exemption. This is true, but the provision only applies to Part 2 of the Act relating to the Board of the Pension Protection Fund. This would not assist with any possible amendments to section 38.

Yours sincerely



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