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ARTICLE

Virgin Territory: What are the Implications of Restructuring Plans for Defined Benefit Pension Schemes?

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Synopsis

The judgment in *Re Virgin Active Holdings Limited* [2021] EWHC 1246 has empowered the use of restructuring plans under Part 26A to the Companies Act 2006 ('RPs') to compromise the rights of unsecured creditors based on evidence that they would receive little or no return on an insolvency – i.e. that they are 'out of the money'.

This is potentially significant for defined benefit pension schemes ('DB Schemes'). Whilst RPs may weaken the whip hand of DB Scheme trustees and the Pension Protection Fund in restructurings, there remain significant hurdles and potential risks to companies seeking to compromise pension liabilities without trustee consent.

The background to RPs

RPs were introduced as part of the package of emergency measures introduced at the outset of the pandemic in the Corporate Insolvency and Governance Act 2020 ('CIGA'). The main feature of an RP is that it enables a company to bind dissenting classes of creditors under an RP, provided at least one class approves the RP by at least 75% by value of those present and voting. This is known as 'cross-class cram down'.

This is in stark contrast to a scheme of arrangement under Part 26 of the Companies Act 2006 which must be approved by each class of creditors.

In the *Virgin Active* decision, the Court for the first time addressed how it will approach sanctioning an RP when a substantial number of classes of creditors have voted overwhelmingly against the proposal.

The terms of the RPs in the *Virgin Active* case

The RPs offered different compromises to different groups of creditors: between secured lenders, landlords (further sub-divided into classes A to E), and general property creditors.

Borrowing from approaches to leasehold company voluntary arrangements under Part I of the Insolvency Act 1986 ('CVAs'), landlords were offered different commercial terms relating to arrears built up during the pandemic and rent going forward based on the companies' assessment of the profitability of the sites.

Importantly, depending on the class to which the relevant lease was assigned, certain landlords were offered only a reduced rent going forward, de minimis payment of accrued arrears calculated to be 20% higher than the (very low) anticipated distribution in an administration, or the ability to exercise a break clause introduced by the RPs.

The remainder of Virgin Active's creditors, including employees, HMRC and trade creditors, were excluded from the RPs on the basis that the plan companies considered that those creditors are essential to their day-to-day business.

The RP also imposed a compromise on the secured lenders. This was required because the Judge accepted that the company was unlikely to obtain the required support of all lenders to impose that compromise under the terms of the finance documents. There was no reduction in the principal owed to the secured lenders. There were however compromises relating to the extension of the maturity date by three years, deferral of certain interest payments, relaxation of financial covenants and introduction of a more permissive disposals regime.

Importantly, the plan companies' evidence was that the value of the business was insufficient to repay the secured debt – i.e. value 'broke' in the secured debt and any unsecured creditors were 'out of the money' in the sense that, were the companies to enter administration, the unsecured creditors would not obtain a recovery beyond a very small recovery from the prescribed part.

Cross-class cram down: the statutory test

Two conditions must be satisfied to enable the Court to exercise cram down:

Condition A: the Court must be satisfied that if the plan is sanctioned, none of the members of the

dissenting class would be any worse off than they would be in the 'relevant alternative'. The 'relevant alternative' is 'whatever the Court considers would be most likely to occur in relation to the company if the compromise of arrangement were not sanctioned…'; and

Condition B: that the plan has been approved by at least one class who would receive a payment or have a genuine economic interest in the company in the event of the 'relevant alternative'.

Provided these two gateway conditions are satisfied, the Court then has discretion as to whether to impose cram down.

When a number of the classes of landlord or general property creditors overwhelmingly voted against the RPs, at the sanction hearing Mr Justice Snowden was faced with the question of whether to cram down dissenting classes.

The judgment

The Judge made the following key findings:

- The Judge accepted that, for the purposes of Condition A, he needed only to consider the relevant alternative as at the date of the sanction hearing.
- It was not relevant to Condition A if the plan companies (or their directors) might have acted differently or if the plans were negotiated in a way that was unfair to certain creditors or inappropriately elevated shareholders' interests at the expense of landlords.
- The conduct of the directors of the negotiations was only relevant to the discretionary part of the cram down test and cannot be used to argue that the relevant alternative should have been more favourable to creditors had the directors approached matters differently. If, for example, the directors had improperly closed down more attractive alternatives for stakeholders, that does result in a different 'relevant alternative' but is instead only relevant to the Court's discretion to sanction the RP.
- It did not matter if the 'most likely' alternative was not itself probable (i.e. more than 50% likely) to occur. The Judge simply has to assess which of the alternatives is most likely to occur absent sanction of the RP.
- The Judge did not agree that there is a rebuttable presumption that an RP will be sanctioned where Conditions A and B are satisfied (picking up the suggestion of Mr Justice Trower in *Re DeepOcean* [2021] EWHC 138 (Ch) that there would be a 'fair wind' behind sanction for such an RP).
- Whilst the Judge noted that the explanatory notes to CIGA refer to the discretion to cram down only being exercised where 'just and equitable', these words should not be read into Part 26A of the Companies Act 2006 and there is no justification for the Court to impose its own views of what is (or is not) fair or just and equitable.
- The Judge found that, as a matter of fact, value broke in the secured debt. He concluded that the business and assets of the plan companies therefore in essence belong to those secured creditors. It is for those creditors to determine how to divide up any value created by the restructuring (often referred to as the 'restructuring surplus').
- The Judge concluded that, on the facts, the secured lenders had acted commercially rationally in seeking to obtain the best terms from the shareholders. Those terms (£45m of secured funding and an undertaking to subscribe for £6m of equity) were, the Judge concluded, better than any terms available in the market.
- The Judge therefore concluded that whilst there may be cases in which incentives offered to shareholders (but not unsecured creditors) could be a disproportionate financial advantage or 'bounty' for that stakeholder, this was not such a case. If value were to break in the unsecured debt, there would have been a need to look closely at whether stakeholders' share in the restructuring surplus was proportionate or comparable to the compromise each is asked to make.
- Finally, the Judge found that a creditor who is 'out of the money' has no 'genuine economic interest' in the company. Provided a plan company could satisfy the Court that this is correct on the evidence, a plan company could apply at the first of the two court hearings (the convening hearing) for an order that meetings of those out of the money creditors are not required to be summoned at all.

What does this mean for DB Schemes and the restructuring of pension liabilities?

Using an RP to compromise pension liabilities

Although the point has not been decided by a Court yet, it seems likely that pension liabilities (both the requirement to make ongoing contributions and the contingent section 75 debt) are capable of being restructured/compromised by way of an RP. This would seem logical because: (i) it is possible to compromise contingent liabilities via a scheme of arrangement or a CVA; (ii) a section 75 debt ranks as an unsecured claim; and (iii) most fundamentally, there is no reason why a

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pension creditor should be treated more specially than any other creditor as a matter of insolvency law.

This means that a Court should be able to impose an RP on a DB Scheme even against the wishes of the trustees of a DB Scheme (and the Pension Protection Fund ('PPF')) by exercising cross-class cram down.

Before the *Virgin Active* judgment, it was widely anticipated that the Court would take a more involved assessment in determining whether or not it would be 'just and equitable' for an RP to be sanctioned even if the conditions for cross-class cram down had been satisfied.

Further, in the course of CIGA's passage through Parliament, the Parliamentary Under-Secretary of State for Business, Energy and Industrial Strategy also observed that it would be expected that the Court should be mindful of the interests of employees in any pension scheme that would be impacted by the RP.

However, following the Judge's comments in *Virgin Active* about there being no justification for the Court to impose its own views of what is (or is not) fair or just and equitable, this has, to some extent, thrown into question how far the particular interests of pension creditors can be expected to be taken into account by the Court in determining whether it will sanction an RP. If a similar valuation-focussed analysis as in *Virgin Active* is applied to pension creditors as to other unsecured creditors, then it seems likely that an RP could be sanctioned which compromises pension liabilities in a way that could never have been achieved under the usual CVA or scheme of arrangement mechanisms.

If a present or contingent liability to a DB Scheme can indeed be compromised, then this would seem likely to raise a number of interesting issues, particularly in the context of assessing the 'relevant alternative': for example, how far should the Court look through the DB Scheme to the DB Scheme's members who would benefit from PPF protection in an administration, but not if an RP is approved? In addition, if a DB Scheme's contingent section 75 debt is compromised under an RP this may impede the entry of the DB Scheme into the PPF, leaving a zombie scheme which may have no prospect of ever reaching full funding and which may never enter the PPF if the restructured business survives.

Given the issues in the *Virgin Active* case regarding expert valuation evidence, pensions valuation issues could also potentially introduce further complexity (and, indeed, expense). It may be difficult for pensions issues to be aired in a timely fashion before the Court, particularly with the involvement of other dissenting creditors. This may also give rise to confidentiality issues.

Compromising pension liabilities without trustee consent

Compromising pension liabilities without trustee consent seems to raise three key hurdles: (i) circumventing the broad powers available to the trustee; (ii) ensuring that pension creditors are recovering adequately in the 'relevant alternative' scenario; and (iii) the threat of the Pensions Regulator's ('tPR') moral hazard powers and the new pension criminal offences.

The scope of the trustee's available powers

In practice, the ability of an RP to compromise liabilities associated with DB Schemes has not yet been tested. That being said, there is no reason why a DB Scheme should be considered to be a more 'deserving' creditor from an insolvency law perspective than any other creditor, although there may be other practical and regulatory reasons which might make compromising pension liabilities a more complicated prospect. An RP seeking to compromise such liabilities would need to solve a number of issues given the absence of the trustees' (or the PPF's) consent, including but not limited to:

- Where the RP would have the effect of amending the DB Scheme in a way which would require trustee consent;
- Where the trustees have the power under the Trust Deed to trigger the section 75 debt and/or wind up the DB Scheme following the implementation of the RP;
- Where the DB Scheme has additional powers such as a unilateral contribution power; or
- Where the DB Scheme is also a secured creditor.

A number of established mechanics from schemes of arrangement may be deployed to seek to solve some or all of the above (for example, a power of attorney being granted under an RP on behalf of the trustees). These would however need to be considered on the facts of each RP.

A cleaner way to approach the above hurdles could be simply to limit the recourse of the DB Scheme to a specific pot of assets (as is done, for example, in asbestosis-related schemes of arrangement) or to limit the payment obligation such that the company's obligation to fund the Scheme does not exceed a certain amount while the company remains solvent. This way the specific provisions of the Trust Deed would not need to be amended as one would seek to do in a landlord restructuring to amend rent provisions of a lease. Provided that the pot of assets or the funding amount is calculated to be larger than it would be on insolvency, then logically such arrangement could be sanctioned by the Court (see below regarding the 'relevant alternative').

Although it seems possible for an RP to be used to redraw a DB Scheme's recovery plan it is unclear what effect this would have on subsequent statutory valuations or on the ability of tPR to impose its own recovery plan on a DB Scheme's sponsoring employer(s).

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However, if an RP were to cap the company's obligation to fund the Scheme (as described above) or to subordinate any future increased contributions, that could potentially bind the trustees and tPR in subsequent statutory valuations.

The PPF and the 'relevant alternative'

TPR and PPF are entitled to the notices which are received by creditors and members in relation to RPs. The purpose of this was to make sure that a DB Scheme's interests (and those of the PPF) were taken into account in the restructuring of a sponsor company. The PPF also has a statutory right to step into the shoes of the trustees and vote on the proposed RP as if it were a creditor. However, an RP does not trigger a PPF assessment period or the payment of a section 75 debt.

Guidance published by the PPF indicates that: (i) it is unlikely to agree to RPs that potentially compromise the DB Scheme's eligibility for PPF protection; (ii) it expects substantial and early engagement from directors and advisers; and (iii) it considers its vote for creditor approval of the RP should be valued at the estimated section 75 'buy-out' debt level. However, based on the *Virgin Active* judgment, it is not clear that the PPF's views will be any more persuasive than the views of other unsecured creditors like landlords.

Where PPF involvement could be relevant is if the compromise proposed under the RP would leave the DB Scheme's members in a worse position than they would be if the scheme entered the PPF (for example, following the administration of the company proposing the RP). This may lead to a debate as to whether it is appropriate: (i) for the Court to look solely at the position of the DB Scheme against the employer (where the employer may argue that the RP puts the DB Scheme in a better position as against the employer) – this should be the default position as it is the DB Scheme not the underlying DB Scheme members who are creditors of the company; or (ii) that the Court should consider the position of underlying DB Scheme members who may be better off if the DB Scheme were to go into the PPF. As noted above, if an outcome for the Scheme can be shown which is better than the relevant alternative of insolvency then, on its face, the restructuring of the DB Scheme should be sanctioned, following the logic of the *Virgin Active* judgment. Such an outcome would seem likely, though, to trigger a strenuous challenge from the trustee/PPF on the basis that the position of underlying DB Scheme members should be taken into account.

A further alternative route around the PPF issue above could be the promulgation of a simultaneous CVA alongside the RP to deal with pension liabilities, given that the promulgation of the CVA is a trigger for entry into the PPF. Although the CVA would likely require trustee/PPF support as the DB Scheme would be the main creditor, any opposition of the trustee/PPF to the CVA could presumably inform the approach taken by the Court in relation to pension liabilities in sanctioning the RP.

The Pensions Regulator's powers

Most fundamentally, there would seem to be a risk that tPR could look to exercise (or at least threaten to exercise) its moral hazard powers (which will shortly include new criminal and civil penalties) against relevant stakeholders, whether they be the employer, other group companies, lenders, investors and, even advisers, if there were the prospect of an RP compromising a DB Scheme. The Pension Schemes Act 2021 ('PSA') has introduced broad new powers (including three new criminal offences for failings in relation to DB Schemes) which could extend to professional advisors and even lenders and investors. Penalties on conviction include an unlimited fine and/or imprisonment for up to 7 years. There are also financial penalties of up to £1 million. These new powers are due to come into force this Autumn and given their broad scope and force the risk of such liability may, in practice, discourage directors and other stakeholders from proceeding with an RP other than with support from the relevant pensions interests or having carved out the scheme as a non-creditor.

If, however, an employer does seek to compromise its pension liabilities without trustee consent, it would be interesting to see whether the sanction of an RP by the Court – where the Court does not simply act as a rubber stamp but would need to be satisfied that there is no blot on the RP – could be sufficient to act as a defence to liability under the PSA. As a matter of public policy, directors cannot be precluded from placing a company into liquidation. By analogy, there may be an argument that similar policy considerations would apply to the promulgation of an RP. As such, the act itself by the directors of promulgating an RP may not be the failing in relation to the DB Scheme that triggers tPR to exercise its powers; rather, it may instead be the previous conduct of the directors which is more likely to be the hook for tPR action (or threat of action).

The tension between tPR's ongoing moral hazard powers and companies (and their officers) seeking finality under an RP – complicated by the different legal tests associated – may therefore give rise to difficult questions for employers seeking to use an RP to restructure for the benefit of all creditors and for tPR in wanting to ensure its discretion is not fettered in any decision to sanction an RP.

Deferral of pension contributions

An area where there may prove to be more scope for employers to act without trustee consent may be in

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seeking to secure the deferral of pension contributions through an RP. Deficit Reduction Contributions should be capable of being compromised under an RP. Deferral could be a more palatable compromise to both the Court and pension creditors than writing down the pension debt. Where deferral will result in the same long term outcome for the DB Scheme, it would likely be more difficult for a creditor to resist such an RP unless it can be shown that either the company will not be able to avoid insolvency (in which case the RP should fail) or that the DB Scheme would be better off in insolvency – both of these may be difficult for a creditor to show.

Even if an RP is simply used to defer contributions to the DB Scheme, there would still be a risk of tPR exercising its moral hazard powers, which again may discourage any such use. TPR might also be able to use its statutory funding powers to subvert any such attempt to defer as this would not involve any compromise of the business' underlying funding obligations.

Conclusion

The advent of cross-class cram down and the *Virgin Active* judgment has suggested to some that trustees of DB Schemes (and the PPF) may have a weakened hand than they have had historically in restructurings (e.g. through their ability to secure beneficial compromises in CVAs given the strength of their voting rights and tPR's moral hazard powers). However, there remain substantial hurdles to companies compromising pension liabilities without trustee (or PPF) consent. It remains to be seen how the Court will approach any attempt to compromise pension creditors in the future or, indeed, if any company is willing to attempt it in the first place.

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