

Regulator's reasons for determining to issue its first Financial Support Direction

3 July 2007

This *In Focus* summarises in some detail both the background to the Sea Containers case and the Determinations Panel's hearing to provide an insight into the Regulator's thinking.

Our [News](#) item of 18 June reported that the Pensions Regulator had announced earlier that day its intention to issue its first Financial Support Direction (FSD). The Determinations Panel's reasons for deciding to issue FSDs against Sea Containers Limited (SCL) in relation to the two defined-benefit (DB) pension schemes of its subsidiary, Sea Containers Services Limited (SCSL), were released on 27 June.

Once issued, the FSDs would require SCL to put a financial support arrangement in place making it jointly and severally liable for SCSL's regular contributions as well as the amount SCSL would be required to pay into the schemes if their winding-up were to be triggered (i.e. the debt payable under s75 of the Pensions Act 1995).

The schemes' combined buyout deficit was most recently calculated to be of the order of £133m. However, as they are multi-employer schemes, the debt attributable to SCSL and/or SCL (and hence subject to the FSDs issued against SCL) is smaller at about £90m.

The situation

SCL is a company based in Bermuda. Its core business (and that of the Sea Containers Group) is the leasing of containers.

SCSL is a wholly-owned subsidiary of SCL and is based in the UK. It was set up as a service company for SCL (and the rest of the Group) and effectively operated the container leasing business. It employs many of the Group's key central management and its officers are based in London.

SCL had entered into a "Services Agreement" with SCSL in 1989. This formally documented the existing relationship between SCL and SCSL. It also set out that SCSL would supply management, administration, financial, accounting and other services to SCL on a "cost plus" basis (with a 10% mark-up). "Costs" included the cost of the remuneration and employee benefits of SCSL's employees.

Although SCSL charged out its services to SCL (and other Group companies), no actual payments were (normally) made and inter-company balances were set up; nearly £18m was owing to SCSL at the end of 2004. Instead, cash was provided to SCSL to enable SCSL to meet its liabilities as they became due, but SCSL did not hold surplus cash.

SCL was a participating employer of the Sea Containers 1983 Pension Scheme (the 1983 Scheme) from 1989 until relatively recently (the exact date being disputed). SCL did not participate in the Sea Containers 1990 Pension Scheme (the 1990 Scheme), but senior officers have served as its trustees for much of its life.

In 1991, the trustees of the 1990 Scheme had reported to scheme members that: *“Sea Containers is committed to the future of the Scheme and believes strongly in the value of Occupational Pension Schemes in preference to Personal Pensions.”*

SCL gave the trustees of the 1983 Scheme a notice dated 8 June 2006 that purported to terminate SCL’s participation and liability to contribute as a participating employer. In its reasons for determining to issue FSDs against SCL the Determinations Panel observed that this notice *“was taken by the 1983 trustees as signalling a sea change in [SCL’s] attitude”* towards standing by SCSL’s pension liabilities. (Pun intended?)

On 7 June 2006 (a day before the date of the notice given by SCL!), the trustees of the 1983 Scheme contacted the Regulator to express concern about the ability of the Group to support that scheme. It is not clear, but, if not prompted by the notice given by SCL, the Trustees’ concern might have been triggered by trading statements made by SCL and the announcement made on 1 May 2006 that the filing of its annual report for 2005 would be delayed. (What prompted the trustees of the 1990 Scheme to contact the Regulator is also unclear.)

On 13 July 2006, the Regulator asked SCL to provide financial information. This was followed on 24 July 2006 by a meeting in which SCL outlined proposals for the financial restructuring of the Group, but it did not provide much detail.

The Regulator wrote to SCL on 29 September 2006, expressing *“considerable concern”* that no detailed proposals had been made to the schemes’ trustees regarding the restructuring of the Group and that the schemes’ combined outstanding debt was approximately £138m (based on recent estimates). The Regulator added he was of the view that SCSL was a “service company” as defined in the Pensions Act 2004 and that SCL may be subject to an FSD. The letter concluded: *“You may wish therefore to consider your position very carefully and take due note of the Regulator’s powers”*.

SCL acknowledged the Regulator’s letter in a conference call held on 2 October 2006.

On 15 October 2006, SCL and SCSL (plus another SCL subsidiary) filed for Chapter 11 protection in the US Bankruptcy Court because they had defaulted on a repayment of \$115m. (Chapter 11 of Title 11 of the US Bankruptcy Code allows a company to seek the protection of the courts in order to continue normal day-to-day operations, while it addresses its financial challenges and develops a plan to restructure.)

The Regulator sent Warning Notices to SCL on 19 October 2006. It subsequently issued Amended Warning Notices to SCL on 26 April 2007 to incorporate representations made by both schemes’ trustees, although the Regulator’s case for issuing FSDs against SCL remained unchanged.

SCL requested an oral hearing with the Regulator’s Determinations Panel and this was held on 12 and 13 June 2007.

The determination process

In most cases, a determination is carried out by the Determinations Panel (the Panel). Members of the panel are people with legal, business or pensions knowledge. They are independent of the Regulator and are not involved in investigating cases.

After sending a Warning Notice to any parties who would be directly affected by a determination, the Regulator allows time (usually 14 days) for those parties to make representations. The Panel will consider the Warning Notice and any representations and then make its determination.

The Panel must issue a determination notice to the directly-affected parties within 5 days of making a determination. The directly-affected parties may appeal to the Pensions Regulator Tribunal within 28 days of such notification.

The Panel can only determine to issue an FSD against a “Target Person” (SCL in this case) if it considers so doing to be reasonable after taking into account:

1. the relationship the Target Person has or had with the scheme’s employer (SCSL in this case) – e.g. is the Target Person the parent company of the employer?
2. the benefits the Target Person has received directly or indirectly from the employer – e.g. has the Target Person received assets or dividends, shared common security or cash-flow arrangements, or gained tax advantages?
3. any connection or involvement the Target Person has or had with the scheme – e.g. as a trustee or employer
4. and the Target Person’s financial circumstances.

The Panel may also consider other factors (in particular, the interests of the scheme members).

The hearing

Arguments in favour of issuing FSDs were made on behalf of the Regulator and the trustees of both schemes.

Although arguments against issuing FSDs were made on behalf of SCL, those arguments did not challenge the Regulator’s case in relation to criteria 1, 3 and 4. One of the main points of contention was criterion 2, i.e. whether SCL had derived “benefit” from SCSL.

In the Panel’s opinion:

1. SCSL was wholly owned and controlled by SCL.
2. SCL derived the benefit of services provided by SCSL and did not (usually) actually pay for them. Also, SCL benefited from Bermuda’s favourable tax regime while retaining an important European trading base.
3. SCL was closely connected to both schemes. It adhered to the 1983 Scheme from 1989 until 2006 (as a participating employer). Senior executives of SCL were also trustees of the 1990 Scheme for much of its life. Scheme members worked for SCL and were connected to SCL through their service.
4. SCL has substantial assets [despite having sought Chapter 11 protection].

The Panel also considered a significant number of other arguments raised on behalf of SCL. These included SCL’s Chapter 11 bankruptcy, “prematurity”, “super priority” and “consistency” – see below.

SCL’s Chapter 11 bankruptcy

It was argued on behalf of SCL that it might be put in an impossible position, given it is in Chapter 11 bankruptcy, if FSDs were issued against it and that, if FSDs had to be issued, they should be made conditional on their approval by the US Bankruptcy Court.

The Panel considered these points very carefully and took extensive evidence from two US attorneys, called on behalf of the trustees of the 1983 Scheme and SCL. The Panel noted it was significant the extent to which the two attorneys agreed with each other on the material points.

The Panel's conclusions included:

- issuing FSDs would not infringe the protection provided to companies in Chapter 11 proceedings
- it would be preferable for the trustees of both schemes to rely upon an FSD as well as the Services Agreement from the point of view of looking to prove a claim in the Chapter 11 proceedings
- a claim based on an FSD would be likely to be approved (although this is by no means certain)
- an FSD would give the trustees a direct claim against SCL.

As a result, the Panel felt that SCL's case was no more than SCL may be prevented from complying with the FSD by the US Bankruptcy Court. However, the Panel noted that, although failure to comply with an FSD would normally result in a Contribution Notice (i.e. a demand for an immediate contribution) being issued, the provisions of the Pensions Act 2004 would allow the Panel to consider the reasons for non-compliance, so SCL's position would not be impossible after all.

Prematurity

It was contended that the Regulator had acted prematurely in issuing Warning Notices and that it would be premature to issue FSDs now.

The Panel considered that the evidence that led up to the issuing of the Warning Notices did not suggest the Regulator had acted with inappropriate haste. SCL had been given substantial time in which to formulate proposals and to explain its position to the Regulator, but no proposal of any detail had been made and nor had any application for clearance.

Super priority

It was observed on behalf of SCL (and the Panel agreed) that it is not part of the Regulator's function to put scheme trustees in a position of "super priority" compared with other creditors.

The Panel's view is that issuing FSDs would not put the trustees of either scheme in a position of super priority or preference and they would rank equally with SCL's other unsecured creditors.

Consistency

It was contended that it was important for the Regulator to act consistently and that the Regulator was not doing so in this case. By reference to the reported facts of other cases, in particular cases that culminated in clearance applications, it was suggested that the Regulator should have stood back and waited for SCL to put up proposals that might themselves be the subject of a clearance application.

The Panel rejected this argument on the grounds that:

- it was not satisfied that the details of the other cases referred to were necessarily accurate or fully accurate; the aspects referred to were selective and did not emanate from any official source
- it was concerned with SCL's apparent assumption that the Regulator's approach in relation to clearance applications and that in relation to its "anti avoidance" powers were one and the same; they are not and such issues are dealt with separately within the Regulator
- the Regulator had not acted with undue haste.

Next steps

The FSDs will be issued on 16 July (i.e. 28 days after the date of the determination) unless SCL makes an appeal before then.

A press release issued by SCL on 18 June says it will consider whether to appeal (and give its full comments) once it has received the Panel's reasons for determining to issue FSDs.

Comment

The trustees of many other schemes that have a "service company" as their legal sponsor may have much in common with the trustees of SCSL's two schemes. Although the decision to issue an FSD in the Sea Containers case will have hinged on certain specific aspects of the situation, in broad terms, the SCSL trustees are not in a unique position.

Employers and trustees should take heed of the Determinations Panel's comments regarding the danger of relying on what has been reported about other cases when trying to predict how the Regulator will behave. Those comments also highlight the importance of being seen to make progress to resolve issues that may be of concern to the Regulator.

As a consequence, we may find:

- trustees use this development to strengthen their position in funding negotiations where the sponsor is a service company
- more employers play it safe and seek clearance whenever they undertake a corporate restructuring.

It is interesting to note SCL does not appear to have challenged the Regulator's jurisdiction over a Bermudan-based company. The resistance put up by SCL would also appear to suggest it accepts the Regulator has jurisdiction (or at least cannot be certain that the Regulator does not have jurisdiction).

It is also interesting that the Determinations Panel observed that different parts of the Regulator deal with clearance and "anti avoidance" issues. The point of seeking clearance is to obtain confirmation that the Regulator will not exercise its "anti avoidance" powers, so one might have thought both issues would be dealt with in the same place.