

PENSIONS ACT 2004, PART 2 CHAPTER 6**DETERMINATION BY THE PENSION PROTECTION FUND
OMBUDSMAN**

Applicant Trustees of the Danfoss Holdings (UK) Pension Scheme

Scheme Danfoss Holdings (UK) Pension Scheme

The Pension Protection Fund (**PPF**) Ombudsman has received a reference of a reviewable matter, following a decision by the Reconsideration Committee of the PPF dated 16 October 2013. The referral concerns the Scheme's risk-based levy for the period 1 April 2012 to 31 March 2013, which is a reviewable matter under paragraph 19 of Schedule 9 to the Pensions Act 2004.

Grounds for Referral

1. Danfoss Randall Limited (**the Guarantor**) and Danfoss Limited were the participating employers in the Scheme. They were subsidiaries of Danfoss Holdings (UK) Limited and part of the Danfoss group of companies, whose parent was a Danish company, Danfoss AS. (The participating employers and company names have since changed).
2. In March 2012 the trustees certified a Type A contingent asset to the PPF, consisting of a guarantee given by the Guarantor. The contingent asset had been accepted by the PPF in previous years, but the PPF refused to do so for the 2012/2013 levy year, as it decided that the contingent asset did not meet the guarantor strength requirement specified in Rule G2.3 of the 2012/2013 Levy Determination (**the Determination**).
3. The definitions section of the Determination said that "contingent asset" was "defined in Rule G2.2" and "contingent asset certificate" was "a certificate which complies with Rule G2.4." Rule G2 said, so far as is relevant to this referral:

"G2 Current Contingent Assets.

G2.1 When does this Rule G2 apply?

This Rule G2 applies where the Board is satisfied that there has been submitted by or on behalf of the Scheme trustees, before the relevant Measurement Time:

- (1) a Contingent Asset Certificate; and
- (2) satisfactory hard copy supporting documents, as required by the Contingent Asset Appendix.

G2.2 What is a Contingent Asset?:

A “Contingent Asset” must be one of either:

- (1) a Type A Contingent Asset, which is a guarantee from a parent company or any relevant associated undertaking in Acceptable Form and which complies with paragraphs 6 and 7 of the Contingent Asset Appendix;

...

and in all cases it must comply with Rule G2.3.

G2.3 Further provisions about Contingent Assets.

- (1) The Contingent Asset must comprise or result from an arrangement which becomes or became effective no later than 1 April 2012 except in the case of a New Scheme where it may take effect on the date on which the New Scheme becomes a Scheme if that is later.

- (2) It must appear to the Board that:

- (1) the Contingent Asset reduces the risk of compensation being payable from the Board in the event of an insolvency event occurring in respect of an Employer in relation to the Scheme; and

- (2) the reduction, if any, in a Scheme’s levy that may result from the recognition of a Contingent Asset for levy purposes is reasonably consistent when compared with the level of that reduction in risk.

- (3) Where Rule G2.3(2)(2) is not satisfied but the Board’s requirements for a Contingent Asset are otherwise met, and it appears to the Board that Rule G2.3(2) would be satisfied if the Contingent Asset were to be recognised in part, the Board may recognise the Contingent Asset to the extent that the Board deems consistent with the reduction in risk. The Board is under no obligation to take into account any Contingent Asset under this Rule G2.3(3).

G2.4 The Contingent Asset Certificate

In order to be a Contingent Asset Certificate, a certificate must:

(1) contain the information set out in paragraphs 30 to 48 inclusive of the Contingent Asset Appendix which is relevant to the type of Contingent Asset;

(2) certify that the Scheme benefits from a Contingent Asset as specified in Rule G2.2; and

(3) provide all the information and certifications required by Exchange in relation to the relevant Contingent Asset;

provided that if the certificate required on Exchange requests less or different information or certifications than those set out in the Contingent Asset Appendix, then the correct and full completion and submission of the relevant certificate in Exchange shall be treated as sufficient compliance with sub-Rules (1) and (2) above and this sub-Rule (3). The Board reserves the right to request the further or different information required in accordance with the Contingent Asset Appendix and to reject the certificate if such information is not supplied.”

4. The trustees asked the PPF to reconsider its rejection of the contingent asset, emphasising the strength of the employer covenant and that Danfoss AS was fully committed to supporting the Scheme. Danfoss AS confirmed that it would provide sufficient financial support to the Guarantor to meet its liabilities in relation to the Scheme. The trustees said that Danfoss Holdings (UK) Limited had also provided a guarantee, and Danfoss AS was prepared to do so if required. The trustees said that the Danfoss group was in a very strong financial position.
5. The trustees said that the two participating employers had distinctly different roles and operated independently of each other. The Guarantor manufactured heating controls in the UK. Danfoss Limited was a sales company, dealing with products manufactured by Danfoss outside the UK.
6. The trustees referred the PPF to paragraph 5.3.4 of its contingent asset guidance, which said:

“[where] net assets are limited, a business may still have real value if it is cash generative, so profitability or like information could also be considered, as the business could either generate the sum required for the guarantee or be sold.”

The trustees said that the Guarantor’s sale value was considerably more than the amount of the guarantee. They pointed out that the Guarantor’s overdraft limit was more than three times the amount of the guarantee, and paragraph 5.2.10(b)

of the contingent asset guidance said that trustees could take the ability of a guarantor to borrow money into account. The trustees also said that the Guarantor's net assets were sufficient to cover the guarantee, and paragraph 5.2.10(a) of the contingent asset guidance permitted trustees to take account of a guarantor's net asset value.

7. The trustees concluded that the guarantee satisfied the terms of the Determination, and all the formal requirements for certification.

Reconsideration Committee's decision

8. The PPF's Board noted that it had no discretion to depart from the requirements set out in the Determination. The PPF said that the contingent asset was rejected under Rule G2.3, which required the PPF to ask itself whether the guarantee reduced the risk of the PPF having to pay compensation, and whether the reduction in the levy resulting from the guarantee was reasonably consistent with the reduction in risk attributable to the guarantee.
9. The PPF agreed that the first requirement was clearly met. So far as the second requirement was concerned, the PPF said that paragraph 5 of the Contingent Asset Appendix provided that the guarantee should be sufficient to cover the Scheme's underfunding, which was £27,790,829.83. The PPF took into account that the Guarantor was also a participating employer, and so a significant part of the underfunding related to the Guarantor's obligations as employer rather than its obligations under the guarantee. As the Scheme Rules provided for the trustees to segregate assets on cessation of an employer's participation, the PPF assessed the Guarantor's strength in accordance with its "Observations on the PPF's assessment of guarantor strength for selected Type A contingent assets certified/re-certified in 2012/2013" which was published on 15 March 2013.
10. The PPF's "observations" said that in relation to a partial segregation scheme:
 - "6 Where an employer is guaranteeing the obligations of fellow employers, for the risk reduction to be consistent with the levy benefit that would arise, the guarantor would need to be able to meet the deficit of the other employers (which therefore must be assumed insolvent) whilst still continuing to trade so that it can meet its own obligations over time.
 7. However, if the guarantor was unable to meet the deficit of the other employers and continue to trade (that is, if it were to become insolvent itself), we do not envisage a scenario where the

guarantor would then be able to meet the guarantee in full where all of the employers (including the guarantor) were insolvent.”

11. The PPF said that it would therefore need to be satisfied of the Guarantor’s ability to meet the part of the Scheme’s underfunding attributable to the other participating employer, which the PPF assessed at £13,950,000. It would also need to be satisfied that the Guarantor would have sufficient assets to meet the full amount of the Scheme’s underfunding (£27,790,829.83).
12. The PPF said the overdraft facility was not an asset owned or controlled by the Guarantor, and it was not clear that the Guarantor could be compelled to call on the overdraft, or that there was any recourse for a creditor in the event of the Guarantor electing not to make a call. The PPF was satisfied that in current conditions the overdraft facility would cover the Guarantor’s obligations, but it considered that if the other participating employer became insolvent, the full overdraft facility (£50,000,000) might not be available, due to keeping the other employer going, or the lender reducing the amount of the overdraft.
13. The PPF noted that Danfoss Limited, the other participating employer, derived its income from other companies in the Danfoss Group. The PPF felt that if Danfoss Limited became insolvent, it would be as a result of wider problems within the Danfoss Group, which might affect the Guarantor’s ability to call on the overdraft facility. The PPF said that the overdraft facility was too uncertain a source of funding for it to conclude that the Guarantor would be able to meet its obligations in the event of Danfoss Limited’s insolvency.
14. The PPF said that the Guarantor’s net asset value was £10,300,000 at 31 December 2011 and £11,625,000 at 31 December 2012. Neither was sufficient to meet the £13,950,000 attributable to Danfoss Limited for contingent asset purposes. In March 2012 £2,000,000 was paid into the Scheme to reduce the deficit, but the PPF said that the underfunding amount took account of that. The Guarantor owned freehold land and buildings, with the total valuation varying from £500,000 to £4,000,000. The PPF said that it had not seen evidence supporting the various valuations, but even if they were taken into account, the Guarantor would have to dispose of all its assets to meet its obligations under the guarantee. If this happened, the Guarantor would not be able to continue trading, and therefore would not be in a position to meet its own obligations to the Scheme of approximately £13,840,000.

15. The PPF concluded that Danfoss Limited's insolvency could place the Guarantor in a position where it could meet Danfoss Limited's obligations, but not its own liabilities to the Scheme. The PPF said that in those circumstances, there would be a clear risk of a call on the PPF.
16. The PPF considered the possibility of the Guarantor's business being sold to fulfil the guarantee. The trustees said this would raise £38,000,000, which would cover the full amount of the Scheme's underfunding. However, the PPF said that the valuation, which was provided by the Guarantor, had not been independently verified and the methodology was unclear.
17. The PPF said that the only discretion available to it was provided in Rule G2.3(3) of the Determination. The PPF did not find anything sufficiently exceptional to justify part recognition of the contingent asset.

The PPF's response to the referral

18. The PPF says that it is under no obligation to take any contingent asset into account. It was not satisfied of the Guarantor's ability to pay £13,950,000 if Danfoss Limited became insolvent, or for it to be able to meet the Scheme's underfunding of £27,790,829.83. The overdraft facility was not a sufficiently certain source of funding, given the likelihood of Danfoss Limited's insolvency being part of wider problems in the Danfoss Group, which would affect the availability of the overdraft. The PPF noted that Danfoss AS' letter of confirmation to the Guarantor stated that nothing in the letter was intended to constitute any legal commitment. The PPF felt that this supported its view that the Guarantor did not own or control the overdraft facility, and could not be compelled to call upon it, nor was Danfoss AS obliged to honour the facility.
19. The PPF also says that an independent valuation submitted by the trustees was not provided until after the reconsideration decision had been issued, and the trustees had used the top end of the valuation (£25 per square foot), rather than adopting a cautious approach. The PPF says that the valuation contains unsupported assertions about an offer of between £5,000,000 and £6,000,000 for a property owned by the Guarantor.
20. The PPF says that the benefit of the doubt is given to guarantors in marginal cases. It has considered what the outcome would be, taking the independent valuation into account, but using £20 per square foot, which was the lower

estimate in the valuation. This increased the Guarantor's net assets to £12,201,000, which fell short of £13,950,000 which was needed to cover the guarantee in respect of Danfoss Limited. The PPF says the difference could be regarded as marginal, but it feels that the Guarantor could not meet a call for £13,950,000 whilst continuing to trade, which it would need to do to cover its own liability to the Scheme.

21. The PPF refers to paragraph 5.4 of its Guidance for the 2012/2013 levy year. This said:

"It is intended that Type A guarantees with guarantors unable to meet the value of their guarantee will, in general, be wholly rejected even where the contingent asset may be considered to have some value. Partial recognition could encourage the use of under resourced guarantors (for example, listing a series of guarantors, of varying substance and levy rate) on the assumption that they would get at least partial credit.

The Board may, however, partially recognise a recertified or new contingent asset if all the circumstances justify it and if there has clearly been no intention to seek to gain an unfair levy advantage. However, schemes should not assume that the Board will exercise its discretion to partially recognise a contingent asset simply because the contingent asset is unchanged from the previous levy year. This will particularly be the case for levy year 2013/2014 onwards, where schemes have had one year to familiarise themselves with the Board's requirement as to guarantor strength."

22. The PPF says that the trustees made no submissions about exercising discretion prior to the issue of the reconsideration decision. The PPF says that part recognition of a contingent asset is intended for exceptional cases, not as a fall back option for schemes whose contingent assets fall short of the required amount.

The trustees' position

23. The trustees say that the PPF should have exercised its discretion and partially recognised the contingent asset. They say that the two participating employers operate in different markets, and Danfoss Limited's insolvency would have no effect on the Guarantor. The Danfoss Group is set up in such a way that Danfoss Limited could not become insolvent unless the entire Group became insolvent.

24. The trustees consider that the independent valuation should be used at the top rate of £25 per square foot and credit given for at least half of the offer for the property of between £5,000,000 and £6,000,000.
25. The trustees say that the Guarantor's finance director, who is also a trustee, carefully and prudently valued the Guarantor's business at £45,000,000. Even in the event of a forced sale, there would be enough to cover the guarantee. The trustees say this is a marginal case, and refer to paragraph 5.3.5 of the PPF's Guidance which says that the PPF would:

“...apply its consideration in a way which gives the benefit of any doubt to schemes and their guarantors...and only to challenge guarantees where the net assets are somewhat below the sum guaranteed rather than applying an exact comparison.”
26. The trustees say that the Guarantor's property was undervalued in its accounts, and based on the independent valuation, the company's net asset value can more accurately be stated as being between £13,625,000 and £14,125,000.
27. The trustees have submitted a presentation showing that the Danfoss Group has a presence in diverse markets across 60 countries. The Group was cash positive overall at March 2012, and the trustees say that the full £50,000,000 overdraft facility would have been available to the Guarantor if required. The presentation says that the Danfoss Group accounts have shown a profit in 78 out of 80 years. The trustees say that this reinforces their view that it is a very remote possibility that the entire Danfoss Group would become insolvent.
28. The trustees say that in the light of the strength of the Danfoss Group and its diversity and breadth, together with the overdraft facility and the independent valuation, they are confident that the Guarantor would be able to make good any claim arising under the guarantee.
29. The trustees say that the guarantee reduced the risk to the PPF, so the levy was not calculated in accordance with the Determination.

Conclusions

30. I do not have power to go behind the Determination. My jurisdiction is limited to deciding whether the PPF complied with the Determination. Matters of fairness and proportionality are outside this narrow scope.

31. Deciding whether I prefer the trustees' or the PPF's view of the contingent asset is not part of my role. I can only interfere with the PPF's decision if it has not been reached correctly. I cannot intervene just because I disagree with the substance of the PPF's decision, or would have decided differently myself.
32. The trustees say that the PPF's refusal to accept all or part of the guarantee amounts to a failure to comply with the Determination. Rule G2.3(3)(3) said that the PPF "may" recognise a contingent asset to the extent that it deemed consistent with the reduction in risk. The Rule also said that the PPF was under no obligation to accept any contingent asset. The PPF's view of the strength of the guarantee differed substantially from that held by the trustees, but it does not necessarily follow that the PPF failed to comply with the Determination.
33. I am satisfied that the PPF's decision was not reached incorrectly. The PPF gave full reasons for its decision, which were not beyond the bounds of reasonableness. The PPF appears to have carefully considered the contingent asset in accordance with the requirements of the Determination. The PPF adopted a more cautious approach than the trustees, but it was entitled to do so in making a decision which to some extent depended on assumptions about the future.
34. It follows that the PPF is not required to take any further action regarding this referral.

Tony King
Pension Protection Fund Ombudsman

23 December 2014