Report under s89 of the Pensions Act 2004

Issued by The Pensions Regulator ('the regulator') in relation to the Kodak Pension Plan

Background

Kodak Limited (Kodak UK) was the sole sponsoring employer of the Kodak Pension Plan (KPP). The KPP had approximately 15,000 members.

As part of the 2007 and 2010 valuations the trustees secured a guarantee from Eastman Kodak Company (EKC), the US parent company of the multi-national Kodak group which included Kodak UK. The purpose of the guarantee was to provide support to the KPP should it be required.

In January 2012, EKC filed for Chapter 11 bankruptcy protection in the Southern District of New York along with various other entities in the Kodak group, not including Kodak UK. The trustees of the KPP filed a claim in the Chapter 11 proceedings for $2.837 billion (being the scheme's buy-out deficit) on the basis of the guarantee.

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The Pensions Regulator

Impact of Chapter 11 on the scheme

EKC's entry into Chapter 11 proceedings had a direct effect on the KPP. The value of the guarantee from EKC to the scheme would be subject to the Chapter 11 settlement and could, potentially, be worthless.

There was also an indirect effect due to the impact of the Chapter 11 proceedings on group entities which were not insolvent. The Kodak group was structured so that there was a high degree of interaction between group entities. This meant that if EKC (and the other group entities subject to Chapter 11) failed to emerge from bankruptcy proceedings and were instead put into liquidation, the solvent group entities might also fail. Therefore although the sponsor of the KPP, Kodak UK, was not subject to any insolvency proceedings itself, the trustees considered that it was likely to become insolvent if EKC entered liquidation.

Therefore any failure of EKC to exit Chapter 11 would risk leaving the scheme without a solvent sponsoring employer and without any material support from the wider group. This would prevent the scheme from receiving any further deficit repair contributions and would be likely to result in a low return for the scheme from an insolvency of Kodak UK, leaving the scheme with a substantial shortfall.

Despite actions being undertaken whilst EKC was under Chapter 11 bankruptcy protection (including the sale of intellectual property), the company was not expected to have sufficient liquidity to emerge from the proceedings. Even if EKC was able to generate sufficient liquidity to exit Chapter 11, it would not be able to settle the KPP claim for cash. Therefore this would have required alternative approaches for the KPP's claim to be settled, which might have taken the form of an equity stake in EKC of uncertain value.

Settlement between EKC and the trustees

The trustees of the KPP spent several months in detailed negotiations with EKC. Many options were explored but none were attractive. The trustees were in frequent discussions with the regulator during this period.

The trustees turned their attention to Kodak's 'document imaging' and 'personal imaging' businesses (now known as Alaris). EKC had marketed the Alaris businesses to third parties during the Chapter 11 process but, due to the weak bargaining position of EKC, the offers which had been received had been lower than expected.

The trustees noted that the Alaris businesses were profitable and cash generative, with combined revenues of $1.4 billion a year and profits of $110 million a year. As the KPP was a mature scheme it had significant benefit payment obligations both in the short term and the long term, so the trustees considered that the cashflows available from Alaris would be a good match to meet a substantial part of these benefit payments each year.

Following extensive due diligence and negotiation with EKC, a deal was agreed under which the KPP would acquire the Alaris businesses. The trustees would pay up to $325 million in cash (substantially lower than the third party bids which had previously been rejected), release their claim against EKC in Chapter 11 and, subject to the regulator's approval and the non-objection of the Pension Protection Fund (PPF), release Kodak UK's liability to the scheme by way of a regulated apportionment arrangement (RAA).

The regulator's consideration of the proposal

The regulator considered whether to approve the proposed RAA in relation to Kodak UK. The regulator reviewed the independent financial, actuarial and legal advice received by the trustees, including the detailed financial and legal due diligence on the Alaris businesses.

As part of its assessment of the proposed RAA, the regulator considered various factors, including:

- whether the insolvency of the scheme's sponsoring employer, Kodak UK, was otherwise inevitable
- whether the scheme might receive more from an insolvency; and
- whether a better outcome might otherwise be attained for the scheme by other means including the use of the regulator's moral hazard powers.

The regulator noted that Kodak UK's business was integrated into the wider Kodak group, meaning that its fortunes were bound up in the ability of EKC to emerge from Chapter 11. The regulator also noted that Kodak UK was unable to properly support the scheme without support from the wider group (which had prompted EKC to provide the guarantee). As such, the regulator was of the view that an insolvency of Kodak UK was inevitable if the proposal was not effected and would have led to the KPP entering the PPF.

The regulator also considered what the KPP might receive in the event of a global insolvency of the Kodak Group, which was considered to be the likely outcome if EKC did not exit Chapter 11. The regulator's view was that this would have resulted in a minimal return for the KPP and PPF levy payers would have taken on responsibility for the significant funding shortfall.

The proposed mitigation for the RAA was unusual, in that it required part-payment by the trustees. However, the analysis carried out by the trustees' advisers demonstrated that the value of the Alaris businesses to the scheme far exceeded the $325 million cash contribution required from them and the equity they might have otherwise received in EKC (assuming that EKC was able to exit Chapter 11 in those circumstances).

As a result of the mitigation on offer, the regulator determined that it should approve the RAA and grant the clearances sought by various Kodak entities.

Position of KPP after settlement

The effect of the RAA (and the release of the guarantee from EKC) was to leave the KPP with no sponsoring employer covenant. The scheme would be wholly reliant on its assets, including the Alaris businesses, to fund benefits.

In the majority of cases where an RAA has been entered into, a scheme will immediately enter into a PPF assessment period and subsequently transfer to the PPF. However in this case, whilst the trustees of the KPP considered that the assets of the scheme (including Alaris) could not support the KPP's existing liabilities, in their view a substantial proportion of the scheme's liabilities could be properly supported by those assets.

After discussion with the regulator and the PPF, the trustees made a proposal to members: either members could remain in the KPP which would transfer to the PPF (the default option), or members could elect to transfer to a new scheme (KPP2), which would offer benefits better than the PPF, but lower than in the KPP.

Following an extensive communication exercise by the trustees, including very detailed information about the risks and potential outcomes of the choices on offer, members representing in excess of 94% of the total liabilities in the KPP voted in favour of a transfer of their accrued benefits to the new plan.

In March 2014, the liabilities of those members who elected to join the KPP2 transferred to the new plan, along with a proportionate share of the KPP's assets (including Alaris), and the KPP entered a PPF assessment period on the same day.

The regulator's consideration of continuation of the KPP2

It is unusual for a scheme to continue following an RAA. In most cases, continuation would require a scheme to run an inappropriate level of risk resulting in an unfair balance between the interests of the members and the PPF (and its levy payers).

In this case, there were two key factors supporting continuation. Firstly, members chose to transfer to a scheme offering lower benefits. This meant that the liabilities in the KPP2 were lower than in the original scheme, so the PPF's future exposure was reduced. Secondly, the trustees obtained detailed analysis of the expected performance of the Alaris businesses which suggested that there was a good prospect of the businesses generating sufficient cashflows to fully fund the scheme.

However, as the KPP2 would be eligible for PPF compensation, all parties recognised that the transfer of members to the new scheme would leave the PPF exposed to risks. These risks included the risk of scheme investments not performing in line with expectations or performance of the Alaris businesses being worse than forecast, which could leave the PPF to take on an increased deficit in future.

Given these issues, the trustees of KPP2 and the regulator agreed that a mechanism needed to be put in place to mitigate the risks. The trustees of KPP2 and the regulator therefore agreed a governance framework in relation to the scheme. This involves:

- regular, scheduled monitoring of the performance of the Alaris businesses and the scheme's funding position
- restrictions on the augmentation of benefits
- restrictions on investments
- triggers for the winding up of the scheme, based on the position of the scheme.

The regulator considers that the governance framework provides a level of protection for the PPF and members by limiting the potential deterioration of the scheme's position.

Key messages

The best outcome for members and the PPF is generally a strong ongoing employer alongside an appropriate funding and investment strategy including, where necessary, a suitable recovery plan.

In some circumstances this will not be possible. Where appropriate, the regulator will work constructively with all parties to obtain the greatest value for the scheme. This optimal outcome may (but will not always) be achieved where the employer is able to avoid insolvency. On occasion, an RAA may be appropriate.

Where a restructuring (including via an RAA) leaves a scheme without any material sponsoring employer covenant, continuation of a scheme would not be appropriate in most cases because members and/or PPF levy payers would be exposed to unacceptable levels of risk. In that default situation, a controlled entry of the scheme into the PPF (or a winding up outside the PPF where the scheme is sufficiently funded) will be the correct next step.

However in some exceptional cases, the regulator may accept that it would be reasonable for a scheme to continue, considering the interests of members and the PPF. This assessment is likely to require considerable independent analysis to be obtained by the trustees. In the rare event that continuation is acceptable, the regulator will expect trustees to agree to manage the residual risk to the PPF to ensure that a fair balance between members and PPF levy payers is maintained. This may require restrictions over future behaviour.

The reduction of accrued benefits, as occurred in this case via the voluntary transfer of rights to the KPP2, is a step which trustees should approach with the utmost caution. The regulator should be consulted before any such exercise is begun and will expect trustees to conduct a thorough and balanced communication exercise with members prior to a decision or vote of the membership. The regulator would not expect any proposal for the reduction of benefits to be made unless all other creditors and shareholders have similarly agreed to compromise their rights, and in some cases those rights should be entirely sacrificed.

The regulator's consideration and approach to individual cases is informed by the specific circumstances presented by a case, not all of which are referred to or set out in this summary report.

This summary report must be read in conjunction with the relevant legislation. It does not provide a definitive interpretation of the law. The exercise of the regulator's powers in any particular case will depend upon the relevant facts and the outcome set out in this report may not be appropriate in other cases. This statement should not be read as limiting the regulator's discretion in any particular case to take such action as is appropriate. Trustees and other parties should, where appropriate, seek legal advice on the facts of their particular case.

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