1. This is a very high level summary, as at 7 March 2015, based on the very limited available information in the Data Room and discussions we have had with Deloitte.

2. Assuming we have the most recent and correct governing documentation and what we have been told is correct (we have not had direct access to involved parties to verify anything):

2.1 A preliminary review of the Trust Deed and Rules of the Bhs Pension Scheme and the Bhs Senior Management Scheme (the DB Schemes) shows that the Trustees do not have a power to increase contributions, but because the employer also has powers to suspend or reduce contributions, the power to increase is in our view not unilateral (we do not know what the trustees view on that is but it appears to be the correct legal position), they cannot unilaterally trigger a winding up of the DB Schemes and there are no change of control provisions. In order to increase employer contributions, the Trustees would have to use the normal process to change the Schedule of Contributions and if there was a failure to agree with Bhs Limited, involve the Pensions Regulator (tPR). The DB Schemes’ powers of amendment do however contain certain restrictions around what changes can be introduced into the DB Schemes – these would need to be considered and reviewed as regards any proposed changes to be introduced as part of Project Thor (see below); and

2.2 We have been told that Bhs Limited is and has been the only employer in the DB Schemes – amongst other things, this means that in the absence of some form of guarantee (such as the guarantee provided by Davenbush and whether direct or indirect), historical reason or perhaps through moral hazard reasons, as to why any other acquired company may have to provide support in respect of the DB Schemes, the Trustees only have a direct legal claim against Bhs Limited. This is important as regards the effect of corporate actions on covenant strength going forwards – by way of example, dealing with a property owned by Bhs Properties Limited may not necessarily, in the absence of a guarantee or something similar, directly affect the funding covenant, but, a property owned by, say, Lowland Homes Limited might indirectly affect covenant strength (indirect because it would only be available to the DB Schemes by way of any dividend in insolvency after all creditors at the level of Lowland had been paid). A more detailed summary of the issues around the strength of the employer covenant is set out in the attached notes.

2.3 At a high level, flowing from this, there is no immediate power that we are aware of that the Trustees could use to stop any of the corporate actions proposed. We understand though that:

2.3.1 The Trustees consider the proposed acquisition as materially detrimental and are seeking mitigation with the involvement of tPR (the model proposed is, we understand, a £15 million cash contribution from each of the Seller and the Buyer, payable over 3 years, plus a floating charge worth £25 million in favour of the Trustees – there was initially some discussion about whether this could be called within the first 36 months). This is in addition to the £10m per annum that the employer must currently pay to the DB Schemes and which may increase this year, and
2.3.2 There have apparently been discussions about the tPR and Pension Protection Fund potentially seeking an equity stake to agree to Project Thor.

2.4 To implement Project Thor will be expensive and time consuming and there are structural problems that may arise (e.g. trying to show insolvency in a re-financed group and, based on the current structure outlined to us, it is likely that the Pension Protection Fund will seek an equity stake going forward). There is currently uncertainty about exactly what stage of agreement the parties have reached with Project Thor although it appears that currently, the Trustees and tPR recognise it is an option. Post-Completion, all of the implementation risk and cost will be the Buyer’s – it will be difficult for the Buyer to step into negotiations and we were told that the advice that has been given to Taveta (or Arcadia), but not Bhs, regarding Project Thor, will not be made available. There is no doubt that the advice would have been comprehensive and all of the difficult issues would have been extensively traversed so it will be expensive to replicate and there is no guarantee that it will find Project Thor to be legally possible. SPG said himself that this would be breaking new ground.

3. There are 3 summary notes explaining some of the matters referred to in the Matrix, Appendix 1 "High level summary of Project Thor risks", Appendix 2 "High level summary of the powers of the Pensions Regulator" and Appendix 3 "High level summary of insolvency positions and effect on covenant strength".

| TRANSACTION AND PRE-SIGNING AND COMPLETION RISKS |
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| Due Diligence (DD) - general. | The lack of information generally limits the risks that can be identified to very high level general risks which we would expect to arise on a sale of this nature. | We would ordinarily expect full disclosure of all pension information, including historical information, all advice in respect of Project Thor and direct access to the Trustees. | We are instructed that it is not possible in the time available and that the transaction will nevertheless proceed. |
| Lack of actuarial information. | This could result in the liabilities in respect of the DB Schemes being higher than indirectly disclosed in the Project Thor documents. | The Buyer would normally take actuarial advice on the DB Schemes generally and specifically the range of possible deficits prior to inheriting the DB Schemes. | We are instructed that it is not possible in the time available and that the transaction will nevertheless proceed. In addition, the only actuarial information received has been indirect through Project Thor – no valuations have been placed in the Data Room. |
## TRANSACTION AND PRE-SIGNING AND COMPLETION RISKS

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<td>No direct Buyer access to Trustees.</td>
<td>The Trustees are unlikely to have information on the Buyer's plans (debt/capital/gearing etc.) and appear to have reacted negatively to the sale of Bhs and have sought mitigation. They may also try to increase contributions, and have already involved tPR. tPR's involvement creates concerns insofar as we do not know exactly what its position is regarding the sale of Project Thor, particularly as tPR's approval will be needed to reach a settled position on Project Thor (see below). Some of the planned activities for the business may be &quot;notifiable events&quot; that are reportable to tPR.</td>
<td>Discussions with the Buyer and Trustees should take place as soon as practicable after Completion. Also, we can provide a list of notifiable events to be compared with the current draft Business Plan.</td>
<td>Discussions are clearly taking place with the Trustees, tPR and SPG and some form of agreement has been reached as conveyed to us by SPG - we do not know anything other than high level issues and clearly, whilst we have no reason to doubt in any way, SPG's good faith, Buyer runs a risk of something being said that binds the acquired companies/Buyer (or creates an impression in the Trustees' mind) and which at worst might prejudice the Buyer's position. Given the proximity of the next valuation, the Trustees are probably unlikely to call the valuation forward to try and increase contributions but they may do so at that valuation. A preliminary review of the Rules also indicates that they could not, in our view, increase contributions unilaterally (but we don't know their views) - they would need to seek the employer's agreement to the contribution rate agreed as part of any future recovery plan. They may nevertheless try to do this soon and/or with tPR assistance.</td>
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<td>No visibility on Trustees' view of funding covenant.</td>
<td>The acquisition appears to be viewed negatively by the Trustees (hence them seeking mitigation) and we do not yet know their views on the planned post-Completion restructuring - the Trustees may react as above.</td>
<td>Buyer should plan ahead the post-transaction corporate steps which may impact the funding covenant (e.g., which properties will be sold in what order, any future gearing, the granting of any new security over assets of the group), and what direct effect that will have on the strength of the funding covenant - that way, the Trustees will</td>
<td>Aside from the Davenbush guarantees, we are told that there are no other similar undertakings (one point to mention here as regards the Davenbush guarantees is that although the guarantees are fixed at the level of 105% of PPF benefits the underlying value is based on the maximum value of the properties held in Davenbush and as such the value of the guarantee may fluctuate in the future).</td>
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<td>No detailed information regarding acquired entities' histories or any other pension arrangements.</td>
<td>have sight of the details as it may affect them.</td>
<td>Accordingly, the Trustees only have a direct claim on Bhs Limited - so properties that are held elsewhere may not directly affect the strength of the funding covenant - there might be an indirect effect however, e.g. a value flow from those properties to Bhs Limited on an ongoing basis, or payment of a dividend in insolvency. A very high level insolvency analysis is attached to assist with this thought process and one of the ways Trustees look at covenant.</td>
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<td>There could be unknown historical liabilities that we are not aware of, including in respect of previous pension arrangements and/or current arrangements that have not been disclosed, have perhaps been administered or amended etc. incorrectly, discrimination issues, or miscalculation of benefits and even forgotten beneficiaries. We know that there were previous DB schemes for example and it looks as if they might have been merged into the 2 DB Schemes but in a discussion with Paul Budge, Adam Goldman and Nabarro, there appears to be limited knowledge beyond when they acquired the entities 5 years ago.</td>
<td>Aside from better DD information, we will seek warranty cover in the SPA for the more obvious risks. Initial mark-ups indicate a very low level of warranty cover will be given.</td>
<td>Warranty claims, unless insured, are only as good as the party giving the warranty, they are capped and they can be difficult and expensive to make and it is often difficult to show loss, e.g. because the loss often arises in a different entity from the one directly acquired. Any successful claims brought by claimants arising out of historical problems would also become the liability of the relevant acquired company.</td>
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## Transaction and Pre-Signing and Completion Risks

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<td>tPR</td>
<td>We know nothing about the previous conduct of the companies to be acquired and whether previous conduct in respect of them might make them vulnerable in respect of tPR for either contribution notices (CN's) or financial support directions (FSD's). The Seller could also remain exposed to these measures for a look back period of 6 years (CN's) and 2 years (FSD's) respectively. We do know that the tPR is seeking mitigation and that an equity stake is being discussed.</td>
<td>Aside from better DD information, we will seek warranty cover in the SPA for the more obvious risks but the Seller is likely to refuse or reduce these materially. CN's can be issued in particular circumstances where a corporate step is taken which has the effect of being materially detrimental to the pension scheme. FSD's can only be issued in limited circumstances (broadly, where the employer's net asset value is less than 50% of the buy-out deficit, and there is another or other companies in the group, whose net asset value when added to the employer's would be equal to or greater than 50% of the buy-out deficit). In both cases, it must be reasonable for tPR to take action.</td>
<td>For the reasons above, warranty claims are difficult. In this case, the warranties are also very general in nature and limited to known circumstances, potentially complicating any claim. Also, there may be no immediate loss (e.g. FSD) and where there is it may be difficult to quantify. Initial mark-ups show that the Seller will not give these warranties. A defence to any tPR action will be complicated by the fact that the Buyer may have little or no historical knowledge and will be reliant on the Seller and others for the information which they might not want to assist with if it might lead tPR to look elsewhere.</td>
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<td>Project Thor</td>
<td>The proposal has changed in that the £50 to £80 million lump sum is no longer proposed meaning that it will potentially be more difficult to implement than before. Whilst the current mitigation proposed may be accelerated, it will only create a £15m lump sum initially, reducing over 3 years to zero, which is funded from an external source – all</td>
<td>The more cash that can be secured from the Seller, the less the Buyer will have to fund. Any lump sum commitment of sufficient magnitude would be helpful towards Project Thor.</td>
<td>This is a possible partial solution to DB problem – much detailed work has been done on it. There are difficulties executing it (significantly time and cost) and it will require cash but we are told that the Trustees are broadly in agreement with it. As business improves, it will potentially become more difficult to implement a project which involves members taking a reduction in their benefits - steps should be taken as soon as</td>
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|              | other money will be for the Buyer to fund. In particular, we believe that a
|              | immediate cash contribution to the DB Schemes may be problematic given the lack of
|              | finance available to the Buyer (this may create an insolvency risk on completion
|              | which should be considered). We have also identified a number of legal obstacles to the
|              | successful implementation of Project Thor as regards the ability to reduce / pay out / transfer member benefits without member consent. Even if successful, the new scheme is DB and will have ordinary DB scheme risks associated with it. We do not know what the Trustees' or IPR's view is in respect of the amended proposal other than high level comments we have received. |
| Auto-enrolment | The Bhs group is using a master trust arrangement with Legal and General as its vehicle for pensions auto-enrolment. Importantly, at present, the group has only chosen to make the minimum level of employer contributions in respect of some members - 1% of an employees' "band earnings". This will therefore need to rise to 2% of earnings from October 2017 - September 2018 and 3% from October 2018. In addition, we understand that certain employees are entitled to have their contributions |
|              | The contributions will need to increase in line with statutory requirements - however, some analysis should be done to confirm how the increases will have an impact from a cashflow perspective. |
|              | possible to identify the Trustees' views on the immediate post-transaction covenant and its impact on their ability to agree to Project Thor. In addition, the Pension Protection Fund may seek an equity stake moving forward. |
|              | In due course, we would recommend a very high level legal review of the vehicle used for pensions auto-enrolment to confirm that it meets the criteria set out in the Pensions Act. |
### Transaction and Pre-Signing and Completion Risks

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<td>matched double by their employer if they pay between 3% - 6% of salary themselves.</td>
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### Immediate Post-Signing and Completion Risks

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<td>tPR</td>
<td>In addition to the Risks identified above, there is a risk of tPR considering whether the transaction meets the materially detrimental test explained in the attached notes, (particularly if there is an insolvency type event) and either issuing anti-avoidance measures, or, using the threat of its anti-avoidance powers to secure further concessions to the DB Schemes. Also, any steps immediately taken following the transaction (e.g. securing the properties for cash to use in the business) would potentially weaken the covenant further, again inviting interest from tPR. We have also been informed that as part of Project Thor, tPR, acting on behalf of the PPF, may look to take an equity stake by way of an “anti-embarrassment” provision and to secure</td>
<td>Although potentially a risk for the Directors of the Buyer, this type of transaction does not fall comfortably into any of the examples in tPR’s guidance. It is a factual test though – whether the act in question was materially detrimental – although this risk is mitigated somewhat by tPR having to be reasonable. It is further mitigated in our view by what we understand to be the mitigation package proposed as described above.</td>
<td>The risk can be reduced by keeping notes of the pension-related issues that are considered and given that our instructions are that the plan is a turn-around of the business, there is probably an argument that it would be unreasonable for tPR to use its powers at this stage. The lack of DD information that would enable an assessment of the effect of the business plan on the DB Schemes’ likely recovery is not helpful, but it can to an extent be counteracted by keeping board minutes etc. which clearly show (as may be appropriate):</td>
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<td></td>
<td>The reasons for the purchase</td>
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<td>The fact that pensions were considered</td>
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<td>The decision saved 12,500 jobs</td>
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### Immediate Post-Signing and Completion Risks

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<td>some future upside for the DB Schemes.</td>
<td>The DB Schemes are post-Completion not in the Seller group and there is no direct legal obligation for the Seller group to do anything in respect of them (though there may be residual Regulatory concerns but these will diminish over time as the statutory look back periods expire). The Seller does want to be involved in any clearance application made regarding Project Thor or similar.</td>
<td>• The fact that mitigation is not possible because there is no available money&lt;br&gt;• Even if mitigation was given, it might of itself amount to a preference etc.</td>
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<td>Project Thor</td>
<td>The Buyer, now the owner of Bhs Limited, will carry the execution risks of the proposed future restructuring project in addition to those risks listed above. In particular, in order to agree to Project Thor, the Trustees will need to be sure (as will tPR), that insolvency is inevitable - we would need to look at this in more detail, but to give one example, would this still be the case if the money owing to Arcadia by Bhs Limited is written off? Could it be on the brink of insolvency immediately after purchase and following re-financing? These are the sorts of questions tPR will investigate. If that debt is securitised or additional or increased interest becomes payable in respect of it, tPR will probably have difficulty with it, and there may also be difficulties with implementation under the DB Schemes governing documentation and the statutory rules on preservation of member benefits - all of these points would need to be looked at in more detail.</td>
<td>We would need to engage with the Trustees at the earliest possible opportunity. We will not be able to review copies of the legal advice taken on this proposal or, see copies of any correspondence with the Pensions Regulator on this matter - we will have to form our own view of the likelihood that this could be successfully implemented with input from Grant Thornton.</td>
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APPENDIX 1

HIGH LEVEL SUMMARY OF PROJECT THOR RISKS

PROJECT HARVEY

1. General

1.1 We have now seen summary documents from Deloitte in respect of Project Thor and have had a further discussion with Deloitte. Consequently, we are unable to give a detailed analysis of the legal framework within which Project Thor would be implemented nor the likelihood of its successful implementation but we are able to set out a few high level summary points:

1.1.1 The documents do not contain any legal analysis of the issues for the Company in respect of Thor (we have asked for these but they have been refused).

1.1.2 Although we have been told that a draft clearance application was submitted to the Pensions Regulator ("Regulator"), supported by the Trustees and with no particular concerns raised by the Regulator, we have also been told that the underlying proposition of the project has been changed and we believe it to be material — consequently, there are risks associated with Project Thor, including:

- Whether Thor is an option that the Regulator/PPF would consider in its revised form — they might if it was clearly better than the alternative entry into the PPF and there was not too much risk to the PPF. We also have no supporting evidence, beyond the Seller's word, that Project Thor was acceptable in its original form to the Regulator or the Trustee either;

- Given that the amount estimated under the proposal (as now revised) will potentially be paid over time, there are several factors which could substantially increase the actual amount necessary — it could be well in excess of the £80 million estimate; and

- Execution risks and costs associated with implementation (e.g. we assume it is possible under the rules of the respective schemes but have no details of the legal advice given, there is considerable more work to be done and it will be expensive — we understand that advisers' fees are expected to be in the order of £1 million or more for implementation.).

1.2 Project Thor, even if it is absolutely successful, still leaves a defined benefit pension scheme in the acquired group, albeit possibly more manageable, with the attendant risks of operating such schemes, including dealing with Trustees, ongoing contributions (under the revised proposal), future funding volatility and the ongoing risk of moral hazard action from the Regulator.
1.3 Rather importantly, legal advice regarding Project Thor has been given to Taveta Investments Limited (or perhaps Arcadia?) as we understand it and not the employer company, Bhs Limited. This means that the advice will need to be re-done. Fortunately, a similar issue does not arise in respect of the Trustees although of course they will need to take advice on the revised structure and will also want comfort on the Buyer's future plans for Bhs Limited.

2. Key issues

2.1 The key issues therefore to keep in mind thus far include the following:

2.1.1 If Thor or a similar project is an option post-Completion, it will require a significant amount of time and ideally, a large amount of available cash (or something similarly secure) to facilitate its implementation, assuming Regulator "buy-in";

2.1.2 The Trustees can only look at this type of option if there is a real and imminent risk of corporate failure - the Regulator will also only look at this type of arrangement in those circumstances; and

2.1.3 the Pension Protection Fund may seek an equity stake going forward to agree to Project Thor. Although Deloitte have recently mentioned a possible different approach than by using a regulated apportionment arrangement (thus possibly avoiding the equity stake), we have no details in that regard and it will require considerable work post-Completion to establish whether the suggestion is legally and financially possible.

2.2 Flowing from that, in order to proceed with Project Thor, the post-Completion covenant will need to meet the above requirement (i.e. the Trustees will need to be of the view it is materially weakened) and that test will need to be considered in the light of, amongst other things, the current debt owing from Bhs Limited to Arcadia. By way of explanation:

2.2.1 If the debt is assigned to the Buyer in its current form, the Trustees are likely to view that as covenant neutral - all that has changed is the identity of the creditor (though the Regulator might try to attack the assignment, there may be other good commercial reasons for it);

2.2.2 If the debt is assigned and then secured (assuming it could be), to the extent that the security weakens the covenant strength, the Regulator would be likely to challenge the position on an insolvency or if it was looking into the transaction generally. Similarly, interest payments (assuming they could be made) would be open to challenge - the argument here would be that securing the debt and de-prioritising the pension scheme might constitute a preference - see Appendix 3 for further details; and

2.2.3 How the business is in that precarious financial position immediately post-Completion.
2.3 If Thor is a real option, at this stage, our view is that it should be done as soon after Completion as possible, particularly if Bhs Limited does start to do well because that would alter the dynamic of whether the Trustees could even consider it.

Ron Burgess / Andy Campbell
Olswang LLP
7 March 2015
APPENDIX 2

HIGH LEVEL SUMMARY OF THE POWERS OF THE PENSIONS REGULATOR

PROJECT THOR

1. Executive summary

1.1 This Appendix contains a high level summary of the two principal powers of the Pensions Regulator (the Regulator) and some of matters it takes into consideration in respect of exercising those powers. It is intended as a general guide to assist the Buyer team to understand the risks and explain the terms used in the risk matrix.

1.2 To date, the Regulator has formally exercised its anti-avoidance powers on approximately six occasions but there are many unreported instances, where the involvement of the Regulator or the threat of the exercise of the powers, have led to appropriate settlements.

2. Anti-avoidance powers

2.1 The Pensions Regulator (the Regulator) has wide-ranging powers to intervene in the running of occupational pension schemes and these include the so-called "anti-avoidance" powers (also referred to as the "moral hazard" powers).

2.2 Broadly, the Regulator may:

2.2.1 Issue a contribution notice (CN) to an employer, or a person associated or connected to the employer, who was party to an act or deliberate failure to act where either:

   2.2.1.1 The act or failure had a material detrimental effect on the likelihood of accrued scheme benefits being received; or

   2.2.1.2 The main purpose, or one of the main purposes, of the act or failure was to prevent the recovery of all or part of an employer debt, to prevent the debt becoming due or to compromise, settle or reduce that debt. This may relate to a series of events which can be regarded as an "act", and is not limited to a single event or step.

A CN is effectively a demand for a specified sum of money to be paid to the relevant scheme within a specified period of time.

2.2.2 Issue a financial support direction (FSD) where the employer is a service company or is "insufficiently resourced". FSDs can be imposed on the employer and/or persons associated or connected to the employer. The recipient of an FSD is required to put in place financial support for the scheme, which must remain in place while the scheme is in existence. An FSD does not generally require an immediate cash payment to the scheme.
3. Clearance

3.1 To provide certainty, and reduce the adverse effect of the anti-avoidance provisions on corporate activity, the Regulator has the power to provide advance clearance in relation to specific activities. Applying for clearance is voluntary but recommended in some instances where the effect of the corporate event would be "materially detrimental" – the Regulator is particularly concerned with what it calls "Type A" corporate activity and lists out a number of Type A events where clearance may need to be sought (e.g. change of control events, increase in gearing, sale of assets out of a group, sale and leaseback transactions, dividend payments, changes in priority and so called "phoenix" events). By giving clearance, the Regulator confirms that it will not seek to issue a contribution notice or an FSD in relation to a particular transaction, but, clearance is only effective provided that all material information was made known to the Regulator at the time of the application.

4. Contribution notices

4.1 In order to issue a CN under either of the two grounds, the Regulator must also be satisfied that:

- The target was a party to, or knowingly assisted in, the act or deliberate failure to act (within the last 6 years).

- The target was the employer, or connected or associated with the employer, at any time in the period between the act or failure occurring and the Regulator issuing a warning notice in relation to a contribution notice and it is reasonable to require the target to pay the sum specified in the contribution notice.

4.2 CN's: material detriment test

4.2.1 The material detriment test is effects based - will be met in relation to an act or deliberate failure to act if the Regulator is of the opinion that the act or failure has "detrimentally affected in a material way the likelihood of accrued scheme benefits being received". The circumstances in which the Regulator expects to issue a CN as a result of the material detriment test being met include a substantial reduction in the strength of the employer company's support (there are several others as well). By way of examples:

- A situation which would not normally be considered materially detrimental to the likelihood of members receiving their accrued benefits might be where an employer grants security in the form of a first charge over some of its assets when renegotiating its borrowings with the bank, provided that the employer engages with the trustees and provides appropriate mitigation to the scheme for the reduction in covenant; and

- A situation where a CN might be expected would be broadly where there is a significant weakening of the covenant with no mitigation.
4.2.2 There is a statutory defence - the Regulator cannot issue a CN on material detriment grounds where a potential target successfully raises the statutory defence. Broadly, in order to rely on the statutory defence the target must show that:

- Before becoming party to the act or failure, he gave "due consideration" to the extent to which the act or failure might detrimentally affect in a material way the likelihood that accrued scheme benefits would be received. "Due consideration" requires the person to have made the enquiries and taken the actions that a reasonably diligent person would have made in the circumstances.

- Where the target concluded that there might be a material detrimental effect, he took all reasonable steps to eliminate or minimise the potential detrimental effect identified.

- Having regard to all the relevant circumstances prevailing at the time of the act or failure, it was reasonable for the target to conclude that the act or failure would not be materially detrimental to the likelihood of members receiving their accrued scheme benefits. These circumstances include those of which the target was aware, or ought reasonably to have been aware, at the time.

The Regulator has stated that: (i) the sorts of due diligence and discussions that responsible employers currently undertake would "in many cases satisfy the Regulator that the person can raise a statutory defence"; and (ii) employers should make a record of decisions and actions, which could be used when raising a statutory defence.

4.3 CN’s: main purpose of an act or failure to act

4.3.1 The alternative ground on which the Regulator may issue a contribution notice is where it is of the opinion that the main purpose, or one of the main purposes, of an act or failure was either:

- To prevent the recovery of the whole or part of the debt, including a contingent debt, that was, or might become, due from the employer in relation to the scheme under section 75 of the Pensions Act 1995 (PA 1995).

- To prevent such a debt becoming due, to compromise or otherwise settle the debt, or to reduce the amount of the debt which would otherwise become due.

4.3.2 Main purpose

4.3.2.1 The Regulator must determine whether the main purpose test is met. There is no statutory definition of the term or guidance on how
the main purpose of an act is determined, but the test has been considered by the Determinations Panel recently and in practice, it will be determined in light of the available evidence including minutes of meetings, resolutions of trustees and directors, any announcements and correspondence. Consequently, employers should keep a record of the purpose of a transaction in order to provide evidence that the main purpose of an act was not to avoid an employer debt. In a recent case, it was accepted to be a two-fold main purpose test:

- First, an act should be considered objectively to decide on its purpose, since the purpose was not the same as motive.
- Second, a subjective test should be applied: on the facts, what did the target subjectively intend to achieve in acting as it did?

4.4 Potential targets of a CN

4.4.1 The Regulator can issue a CN against a party which was the employer in relation to the scheme or a person connected or associated with the employer at any time in the period between the act or failure occurring and the Regulator issuing a warning notice in relation to the CN. It is a very broad category of potential recipients.

4.5 Reasonableness test: CNs

4.5.1 The Regulator may only issue a contribution notice to a person if it considers that it is reasonable to impose liability on that person to pay the amount specified in the contribution notice. In deciding whether it is reasonable, the Regulator must have regard to the extent to which, in all the circumstances of the case, it was reasonable for the person to act or fail to act in the way that the person did.

4.5.2 In addition, the Regulator must have regard to any other matters it considers relevant, including, where relevant, the following matters:

- The degree of involvement of the person in the act or failure to act. For example, did the person sanction the business deal?

- The person's relationship with the employer or whether the person had control of the employer and any connection or involvement of the person with the scheme (such as being a scheme trustee or an employer in relation to it).

- Whether the act or failure was a notifiable event that the person had a duty to notify to the Regulator but failed to do so.
• All of the purposes of the act or failure to act, including whether a purpose of the act or failure was to prevent or limit the loss of employment.

• The person’s financial circumstances.

5. FSD’s: piercing the corporate veil

5.1 An FSD will require the target or targets named in it to put financial support in place for the scheme by a particular date, and maintain the financial support until the scheme is wound up. For cases in which the Regulator has exercised its power to issue an FSD, see box, Regulator’s use of anti-avoidance powers above.

5.2 The Regulator may issue an FSD if it considers that the employer in relation to the scheme is either of the following:

• A service company – e.g. a company in a group of companies and its turnover contained in the latest available statutory accounts is solely or principally derived from amounts charged for providing the services of its employees to other group companies; or

• Insufficiently resourced – an employer will be insufficiently resourced if the value of its resources is less than 50% of the employer debt due from the employer to the scheme, as estimated by the Regulator and either:

  • The value of resources of a person who is connected or associated with the employer, when added to the resources of the employer is at least equal to 50% of the estimated employer debt; or

  • The aggregate value of the resources of two or more persons who are connected or associated with the employer and with each other when added to the resources of the employer is at least equal to 50% of the estimated employer debt.

However, in order to impose an FSD, the Regulator must be of the opinion that it is reasonable to impose the requirements of the FSD on the target and it will consider:

• The target’s relationship with the employer and the value of any benefits received by the target from the employer (directly or indirectly, dividends, tax etc.).

• Any connection or involvement the target has had with the scheme and the target’s financial circumstances.

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7 March 2015
APPENDIX 3

HIGH LEVEL SUMMARY OF INSOLVENCY POSITIONS AND AFFECT ON COVENANT STRENGTH

PROJECT THOR

1. Executive summary

1.1 Absent any guarantee or any other reason, the Trustees only have a legal claim against the participating employer in the pension schemes – we have been told that Bhs Limited is the only employer and the Trustees of the Bhs Pension Scheme and the Bhs Senior Management Scheme will thus only have a direct legal claim against that employer.

1.2 Because insolvencies (as explained below) are viewed on an individual company basis, when Trustees consider the effect of transactions on their funding covenant from an insolvency perspective (e.g. what their immediate pre- and post-transaction insolvency position will be), it will be affected by where the realisable assets lie. So, by way of examples and at a high level;

- the value of any subsidiary company to Bhs Limited if both were insolvent would be indirect and limited to the dividend payable to Bhs Limited after that subsidiary had paid its creditors and even then, the Trustees claim would be limited insofar as it would only be a concurrent claim with other creditors (absent any guarantee etc.); whereas

- a structural subordination of their position as a creditor by, say, security being granted to another party, is direct in its effect on the covenant.

1.3 The Pensions Regulator (the Regulator) has wider powers, and can look at whether other companies (i.e. non-participating employers) should provide financial support to the pension scheme – e.g. they might have benefitted in the past at the expense of the pension scheme.

1.4 So the insolvency analysis will help the Buyer in considering at a high level the possible effects of actions it proposes to take, subject to the Regulator caveat above, on the employer’s funding covenant and the way in which the Trustees may view that action.

2. General

2.1 Assuming the companies are incorporated in England and Wales and subject to the UK Insolvency Act 1986, each individual company is assessed in respect of any insolvency.

2.2 Each company’s assets will be realised and used to pay, to the extent that it is possible, the liabilities of that company. The table at schedule 1 sets out the general order in which liabilities of the wider group would be settled (assuming there is more than 1 company in insolvency) and only after all liabilities have been settled in full would any surplus be capable of being passed to the shareholders of that company (which is unlikely in the event of administration or insolvent liquidation).
3. **Pension liabilities**

3.1 In the absence of security in favour of the pension schemes, any pension liabilities (which we understand are liabilities of Bhs Ltd only) would be ordinary unsecured liabilities. Therefore a dividend would only be payable once those liabilities ranking ahead of them have been paid in full, and would rank equally with all other ordinary unsecured liabilities.

3.2 Importantly, in the event that the Regulator did issue anti-avoidance measures in insolvency against a member of the group or a party connected or associated to the group, the Courts have held that this ranks as a "provable debt" and therefore equal with the other unsecured creditors of the company.

4. **Securing the debt due from Bhs Group Limited**

4.1 There has been discussion about possibly securing the currently unsecured debt of approximately £240 million (circa. £190 million owing by Bhs Limited, the remainder by Bhs Group Limited) due to Arcadia. We do not deal with whether the Directors of either company could as a matter of law provide the security (or indeed make any interest payments on the indebtedness).

4.2 There is a risk that if the liquidation or administration of Bhs Limited and Bhs Group Limited were to commence within six months of the security being granted (or two years if it could be argued that Bhs Limited and Bhs Group Limited and the recipient of the security were connected parties) an administrator or liquidator may review the granting of the security to see if it could be set aside as a preference. Any interest payments may also be looked at.

4.3 In our view, there is a similar risk that the Regulator may look at the granting of such security or interest payments on the debt in the event of insolvency and may try to use its powers to re-adjust the position to render the security ineffective or claim back any interest paid.

5. **Preference**

5.1 Broadly, a company gives a preference to a person if the recipient is one of the company's creditors (or a surely or guarantor for any of the company's debts or other liabilities) and the company does anything which has the effect of putting that person into a better position in the insolvency process. For a transaction to be a preference, the transaction must:

- Have been entered into within six months (two years if the parties are connected) prior to the date on which the liquidation or administration of the company commenced;
- The company must have been insolvent at the time of the transaction or become insolvent as a result or the transaction; and
- The company which gave the preference must have been influenced in deciding to give it a desire to put the recipient into the better position (where the parties are connected that desire will be presumed).
5.2 If the administrator or liquidator can establish the grounds set out above such that the granting of security is held to be a preference, then the Courts may set aside the security such that the debt would remain unsecured. Furthermore, any payments made in servicing the loan prior to a liquidation or administration of Bhs Limited commencing may also be capable of being challenged as a preference.

5.3 Importantly, where a company enters into an insolvency process (or the directors are of the belief that an insolvency process is inevitable) then the directors are faced with a number of other issues, including the risk that they could be held to be wrongfully or fraudulently trading. These issues are outside the scope of this note, but the group directors would need to take detailed advice on each of these areas should they believe that an insolvency event may occur.

**Priority order of creditors on insolvency**

1. Fixed charge security* (subject to the costs of realisation, and only up to the amount of the secured debt).

2. Floating charge security,* settled in the following order:
   - The remuneration and expenses of the liquidator or administrator;
   - Payment of preferential claims (primarily certain claims of employees);
   - Prescribed part – this is a prescribed amount of floating charge realisations which is to be set aside to meet in whole or in part the claims of unsecured creditors. It is calculated on a sliding scale up to a maximum amount of £600,000 but only applies to floating charges created after 15 September 2003;
   - Floating charge holder (up to the amount of the secured debt).

3. The remuneration expense of the administrator or liquidator (to the extent not already satisfied from floating charge realisations).

4. Preferential creditors (to the extent not already satisfied from the proceeds of realisation of floating charge realisation).

5. Unsecured creditors on a “pari passu” basis – this would include the BHS pension schemes.

6. Any surplus to be returned to shareholders in accordance with their rights

*Our current understanding is that none of the BHS companies within the Group has security registered against them. To the extent correct, 1 and 2 above would be irrelevant.

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7 March 2015