Pensions Aspects of Takeovers and Mergers in the U.K.

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The purpose of this paper is to provide a brief outline of how pensions are typically dealt with when larger companies are taken over in the UK, and to highlight some of the main issues arising, in particular:

- what happens to employees' rights and, more importantly, expectations?
- what should employers watch out for?

A typical transaction

1. A typical transaction would be where the share capital of a company is sold by one corporate group to another by private treaty. Many corporate groups operate group pension arrangements, in which case there is an apportionment of the group scheme in which the company being sold participates, and a bulk transfer to the group scheme of the purchaser. Other groups maintain separate schemes for separate subsidiaries; if the vendor is selling a company with its own pension scheme the purchaser might decide to maintain it as a separate entity. Many companies have a level of benefit provision which applies across all subsidiaries, in which case there would be an attempt to bring the acquired employees onto the same basis. Other companies might agree to maintain existing rights without seeking to make them conform to a uniform group basis.

2. In the common case of an apportionment followed by a bulk transfer, there is unlikely to be time to make detailed calculations in advance of the sale agreement being signed. Usually there is only limited time to investigate and negotiate the pension aspects and it is common for the actuarial principles to be specified in the sale agreement, leaving the detailed calculations to be dealt with subsequently. Where there is reason to suppose that the transfer payment might prove "inadequate", the sale agreement might specify that the vendor will if necessary top up the scheme transfer payment to a specified level on an agreed basis or that there will be an adjustment to the purchase price. Indeed, the trustees of the vendor's scheme are not normally a party to the sale agreement, and the purchaser needs to be protected from the transfer payment being calculated on a less favourable basis than expected. Often the transferring members would remain in the existing scheme for a few months until suitable new arrangements have been made for them.

Interested parties

3. The various parties who are interested in the transaction include:

(a) **The employees**

Who have certain benefit rights often based on current pay levels, and usually rather higher benefit expectations, based on pay at retirement.

(b) **The trustees of the vendor's and of the purchaser's schemes**

Who have to act in accordance with the Trust Deed and Rules of their schemes and who have duty of care in respect of all current and prospective beneficiaries, including those not directly involved in the transfer.

(c) **The employing subsidiary**

Which may participate in a group scheme or maintain a separate scheme for its employees.

(d) **The parent companies**

Whose shareholders have an interest in the size of transfer payment since it affects the level of pension expense of the subsidiary; the purchaser should expect the price agreed for the business transaction to reflect the adequacy or otherwise of the transfer payment to finance the pension obligations taken on; the vendor will wish credit for any surplus transferred to be reflected in the price.

Provisions of trust deeds and rules

4. A good deal hinges on the specific provisions of the particular scheme. Most trust deeds and/or rules of UK pension schemes include "partial dissolution" clauses enabling transfer of pension rights to other schemes. Such provisions can cover any or all of the following circumstances:

   (a) voluntary early leaver;

   (b) group transfer on sale of part of the business;

   (c) group transfer on sale of a participating company;

   (d) winding up of the whole scheme.

   Surprisingly many schemes make no special provision for members on the sale of part of a business and treat such members no differently from ordinary early leavers even though the individual members are not changing scheme of their own volition.

5. There are many different types of partial dissolution clause. The benefits provided, by way of either deferred pension or transfer value, might be one of the following:

   (a) Basic early leaver benefits, augmented only at the discretion of the principal employer (assuming the assets are sufficient).

   (b) Basic early leaver benefits augmented at the discretion of the trustees.

   (c) A proportionate share of the whole fund, subject to a maximum representing the value of the member's accrued pension rights as if he were not leaving the fund.

   (d) A proportionate share of the whole fund without maximum except to comply with Inland Revenue requirements.

   (e) A part of the fund decided by the trustees on the advice of the actuary as appropriate in the circumstances.

   (f) A part of the fund decided by the actuary as appropriate in the circumstances.

6. The resulting transfer payments could differ very significantly, and purchasers need to establish what basis of calculation applies. Conflicts of interest can arise between trustees

and principal employer, for example when the partial dissolution clause is vague, or does not cover the particular circumstances, and the sale agreement calls for an effective reduction in the sale price if the transfer amount falls below a specified level. However the trustees have to act in accordance with the trust deed and rules of their scheme, and with trust law, and they should not regard themselves as bound by the agreement made between vendor and purchaser, to which they will not have been a party.

A review of practice

7. In a paper which Adrian Garner, Andrew Wise and the author presented to the UK Institute of Actuaries in November 1985 we reviewed practice in the area of pension takeovers by analysing nine hypothetical cases. There is not space to discuss these in detail here but it will be interesting to consider a few of them briefly.

   – One of the cases concerned a fund which was in surplus (which we defined as an excess of assets over what was needed to cover the liabilities in respect of past service, but allowing for future pay and pension increases) and where year-for-year rights were transferred; a share of surplus was also transferred. Following the transfer there were a number of redundancies and the upshot was that the next valuation of the purchaser's scheme revealed a substantial surplus. This was a windfall to the purchaser as neither he nor the vendor had taken account of this in the sale negotiations.

   – Another case was similar except that the scheme was in deficiency. In the haste to settle the sale agreement it was simply provided that the actuaries would agree on the appropriate transfer payment later on. Given the deficiency however this proved very difficult and a compromise was eventually reached which was not regarded as satisfactory by either party.

   – In a third case a year-for-year transfer was arranged. The fund was in surplus. However it was established before the sale was completed that the company's intention was to reduce contributions to absorb the surplus and that there was no intention to make benefit improvements. In view of this no part of the surplus was transferred. An interesting feature was that the trustees of the vendor's scheme required a commitment from the purchaser to pay special attention to the pension increases for the transferring members bearing in mind that the assets transferred included a substantial amount in respect of advance funded but discretionary increases.

   – A fourth case was rather similar to the previous case. The vendor originally sought for the purchaser to "earmark" a part of the receiving scheme corresponding to the assets transferred, to be used only for the benefit of the employees who transferred. This course however held a number of difficulties for the purchaser who preferred not to maintain a distinction between the transferring employees and other employees. Eventually the vendor's requirement was dropped on the basis that there was to be a strong commitment from the purchaser regarding pension increases. Another commitment which the vendor required concerned generous early retirement conditions to be applied to employees who were made redundant after the sale. This was accepted by the purchaser at the time although subsequently it was discovered that in practice the undertaking had not been carried out in every case following the company being sold on to a new owner at a later date.

8. A number of morals can be extracted from these cases. In the first case both vendor and purchaser should have taken into account the share of surplus to be transferred and the possible effect on redundancies, as this had a significant bearing on the commercial value of the sale transaction. In the second case the pension aspects should have been properly looked into before the sale agreement was completed so that the basis of transfer would not be the subject of argument later. The third case was an example of how much better it is when matters are properly looked into, whilst the fourth case illustrates the difficulty of protecting the position of transferring employees however strong the undertakings are which are secured at the time of the sale.

9. The **ideal** procedure for a pension takeover would be for as full as possible an exchange of information on the benefits and asset transfer to be made, for decision to be taken on the benefits to be offered, and then for the adequacy of the assets to meet the benefits to be offered to be taken into account by both sides in settling the sale agreement. The commercial reality however is that pensions are only part of many aspects of a transaction. There is usually a great shortage of time and a need for confidentiality which means that consultation on the pension aspects is sometimes left very late. Furthermore in the case of a public bid, particularly a contested one, the purchaser may have difficulty in obtaining the information he needs.

A recent court case

10. It is unusual in the UK for pension takeovers to be the subject of a court case but there has been a case recently concerning the transfer of assets from one pension fund to another after the sale of certain subsidiary companies. The employees involved joined a new pension scheme of the purchaser and their past service benefits were transferred. The scheme from which the members were transferring provided benefits linked to final pay and a recent actuarial valuation showed that there was a significant excess of assets over what was required to meet the past service benefits of the members based on completed pensionable service but allowing for expected future pay and pension increases. The sale agreement provided for the purchaser to establish an identical scheme of benefits and for pension benefits to be transferred on a year-for-year basis.

11. The transfer payment was to be calculated in accordance with the trust deed of the vendor's scheme but was underwritten by the vendor if the amount fell short of the "past service reserve", i.e. the amount needed to cover the cost of transferred benefits on an agreed basis. The trust deed and rules of the vendor's scheme did not specify the method of calculation to be adopted and left the amount to be determined

by the actuary to the scheme at his sole discretion having regard to all the circumstances that appeared to him to be appropriate. The vendor's actuary calculated the transfer payment as the past service reserve but the purchaser challenged this principle of calculation claiming that the pension fund should have been split on a proportionate basis, i.e. so that a share of past service surplus would have been transferred to the new scheme.

12. A considerable amount of written and oral evidence was provided for the court case but the case was decided against the claim of the purchaser simply on the basis that the method of calculation adopted was a recognised method of calculation, which the purchaser's actuary accepted in court was not unreasonable; no grounds were provided for suggesting that the calculation had not been made correctly. However, the judge went on to give his view that the method of calculation adopted was preferable to a share of fund calculation as the surplus in the fund at the time of transfer effectively represented temporary surplus funding by the employing company. This observation was made in the context of the particular case and cannot necessarily be relied upon in other circumstances but would no doubt be taken into account nevertheless in any other cases which arise.

13. The main professional significance of the case was the confirmation of the principle established in previous case law that the courts will not impeach the valuation certificate given by an expert unless there is proof of mistake, negligence or reliance on a wholly erroneous principle. The judge said "Where there is a choice of methods that choice is left to the actuary. It is only where he has made a cardinal error that any successful challenge can be mounted."

Issues arising

14. We next consider what can go wrong in pension takeovers, and how can this be avoided. From a company's point of view, if the financial implications are not investigated too much may be paid for a purchase or a sale may be made too cheap. From the employees' point of view their benefit expectations could be inadequately protected if the vendor does not take any steps to protect them. An unwary purchaser may find that he has accepted some expensive and administratively burdensome benefit guarantees. All of this can be avoided if early attention is paid to the question.

Employees

15. One of the most difficult issues arising is what happens to the employees' pension rights. First of all we need to be clear about the distinction between employees' rights and expectations. An employee's basic rights in a UK scheme will typically be based on service to date and pay at date of exit, together with at least the statutory minimum revaluation introduced by the Social Security Act 1985, the revaluation required in respect of guaranteed minimum pension in the case of a "contracted out" scheme and any guaranteed post-retirement increases provided by the rules of the scheme. This is however well below the employee's expectations, which will be based on service to date but, in a final salary scheme, on pensionable pay at retirement, and will also often include an expectation of discretionary pension increases. There are those who take the view that employees have no right to expect more than the scheme rules provide for them to receive in the event of leaving the scheme or the scheme winding up, but in my view this falls short of what scheme members reasonably expect, and are encouraged to expect by what is printed in explanatory literature.

16. Because basic rights are often at a much lower level than expectations, employees are particularly vulnerable to loss in pension takeovers. In theory a worsening of terms of employment could be the basis for a claim of "constructive dismissal"; in practice this has not been tested in the courts. Worsening might occur in a number of ways:

    (a) a lower scale of benefits in the new scheme;

    (b) discretionary pension increases in the new scheme inferior to the old scheme;

    (c) back service rights not being fully protected because of inadequate funding (i.e. the purchaser seeks to reduce benefits to what the transfer payment will cover on his basis).

    In my view (a) and (b) are understandable where the employer is seeking to bring benefits into line with those for other employees and, within limits, may be acceptable but (c) is unjustifiable: past service benefits should always be maintained as far as possible and an appropriate adjustment made to the sale price if necessary to allow for any difference on account of the level of funding.

Funding levels

17. The difference between rights and expectations is also a source of potential loss for companies. Many if not most of the larger employers in the UK choose to fund for the full expected cost of benefits, and broadly in line with members' benefit expectations. Not only is that seen as providing better security for the members' benefits but it is less likely to leave the company with problems in later years if the scale of its operations reduces. For example this level of funding will protect employees better in takeover situations and enable redundancy programmes to be implemented much less painfully. Other companies may fund at a lower level. Whatever funding strategy the purchaser or vendor happen to have settled on however, the starting point for the purchaser should always be the level of assets needed to cover the full expected cost of past service benefits. If he chooses not to **fund** his scheme on the basis of the full expected cost this does not mean that the full expected cost will not in due course arise. Purchasers should therefore be particularly wary of schemes where the funding is at a lower level than the full expected cost.

Rights and expectations

18. One important theme to emerge from considering pension takeovers therefore is to question whether it is satisfactory for there to be such a difference between guaranteed and expected benefits. In the UK it has become a common practice for at least the larger schemes to make discretionary increases in pensions

after retirement to offset partially the effects of inflation. Even where scheme rules include provision for automatic increases at the rate of perhaps 3% or 5% per annum (subject usually to increases in line with the cost of living if lower) discretionary increases beyond the guaranteed rate are common. This practice reflects the substantial concern felt about the purchasing power of pensions during the high rates of inflation experienced in the 1970s, in an environment where public sector pensions (covering about half of the population in occupational schemes) are subject to automatic increases in line with the cost of living.

Pension increases

19. In the past employers have shied away from making more positive commitments to increase pensions, fearing that another spiral of inflation could create onerous liabilities in the pension scheme which would not necessarily be offset by the investment performance. However since 1982 index-linked Government stocks have been available for funds to invest in and although the amount in issue is relatively small these at least provide a comparative measure of the returns available from other investments. This has given some employers the confidence to make a more positive commitment regarding pension increases subject always to appropriate caveats regarding investment performance. Until such time as more employers move in this direction the situation in the UK is that where employers wish to adopt a funding programme whereby the expected cost of benefit accruals, including allowance for the future expectation of discretionary increases, is met as the benefit promises accrue, funds are built up a significant part of which may relate to future discretionary benefits and not contractual entitlements.

Protection from predators

20. One of the aspects of pension takeovers which is currently of great topical interest in the UK is how to ensure that employees' pension rights and expectations are adequately protected should the employer be taken over. This is of particular interest at present as, apart from the point about advance funding for discretionary pension increases mentioned above, many schemes are in actuarial surplus. Surplus could be an added incentive to a predator to make the acquisition.

21. A number of employers have taken steps to strengthen the security of the pension benefits against the possibility of a predator removing the surplus from the fund hence potentially worsening the position of the employees. The following list includes some of the alternatives.

    (a) Introduction of a rule providing for guaranteed increases in benefits both before and after vesting, typically at the rate of 5% per annum or increase in cost of living if less.

    (b) The introduction of increases as above but only applying following the winding up of the scheme.

    (c) Priority to be given to past service rights of existing members on a winding up which takes place following a takeover.

    (d) Provision that on takeover an actuarial valuation is to be made on the basis of which the ability of the then existing assets to provide for future pension increases would be determined; this rate of increase would then be guaranteed in relation to past service rights of existing members.

    (e) Provision that on takeover an actuarial valuation is made and the employer has to make any shortfall in the amount needed to provide pension increases at a minimum level.

    (f) Provisions inserted in the rules that new entrants may only be admitted following a takeover if the rate of contribution recommended by the actuary is paid, thus preventing any dilution of the accumulated assets.

    (g) Provision in the scheme rules for the fund to be closed to future new entrants unless the trustees at their discretion and without the consent of the employer decide otherwise.

    (h) Provision that following takeover the trustees appoint their own successors.

    (i) Power given to the trustees to wind up the scheme without the consent of the employer, or possibly such power given but limited to circumstances where a takeover has taken place.

    (j) Appointment of an independent trustee company to administer the scheme.

    (k) Appointment of an independent trustee to act alongside the normal trustees possibly with powers to act only in certain connections such as winding up of the scheme and admission of future participating companies.

22. Whilst these measures have the effect of ensuring as far as possible that the intentions of a company prior to takeover are honoured by a successor company, they can be criticised as fettering the powers of future company management. Indeed changes of this nature are best avoided if the sponsoring company is already the subject of a bid, as they could well fall foul of the Takeover Code. The guiding principle here seems to be that the duty of the directors of a company are primarily to the shareholders, whose interests take precedence over those of the employees (a subject for debate in itself!).
    Apart from this, some of the measures prescribes may not prove very robust in practice, whilst there is in any case a danger that if the position of pension scheme members is protected to a degree considered unreasonable, that an acquiring company will be less favourably disposed towards maintaining and improving benefits for future service. For example, it might decide to leave existing employees in a closed scheme with no possibility of future improvements.

23. The position is not helped by the fact that the provisions of winding-up rules vary considerably between schemes, often reflecting the era in which the fund was originally established. The usual pattern is for the winding-up rule to provide for certain priority benefits to be secured and then for any remaining assets to be dealt with. It is rare for there to be any solvency guarantee on winding up, i.e. the benefits provided will only be what

the assets are sufficient to provide. Otherwise however provisions vary between two extremes. Older established schemes frequently provide for the whole of the assets after priority provisions have been met to be used in augmenting benefits up to Inland Revenue maximum benefit levels. (Indeed, at one time, Inland Revenue practice was to require winding up provisions to provide for the whole of the assets to be used in the provision of benefits without any possible reversion to the employer. Since the 1970 Finance Act however Inland Revenue practice has been to insist that excess assets are returned to the employer.) In a number of schemes however the assets in excess of those needed to meet the **priority** provisions would automatically be returned to the employer without any scope for augmentation.

24. A large number of schemes fall between the two extremes and provide for assets in excess of the priority level to be used at the discretion of the trustees, employer, or both, in the augmentation of benefits. The position where the winding-up provisions do not clearly specify what level of augmentation is appropriate is thought by some to be unsatisfactory and in drafting winding-up provisions for newly established schemes it is now considered good practice to define the level of assets to be applied at the trustees' sole discretion in augmenting benefits. Possible ways of doing this are:

(a) to provide for a specified level of future increase in the priority benefits;

(b) to provide that the assets required on an ongoing basis to cover past service liabilities would be applied fully in providing winding up benefits;

(c) to provide for the priority benefits to be secured on an indexed basis linked either to prices or to earnings. (There are a number of UK insurance companies prepared to write price index-linked business for pension scheme wind-ups whilst there is at least one understood to be prepared to write earnings index-linked business.)

Conclusion

25. The aim in this paper has been to describe the background to UK pension takeovers, which no doubt has features not seen in other territories, and to highlight some of the issues arising. Perhaps the main points to emerge are the following:

(a) Matters should be so arranged that employees suffer no loss of expected benefit, including reasonable expectation of pension increases after retirement, at least in respect of past service. Future service benefits should be maintained as far as possible, although some variation may be acceptable in the interest of conforming to the purchaser's general pension policy.

(b) The purchaser should investigate the adequacy of the assets to be transferred to cover the benefit promises undertaken, having regard to the partial dissolution provisions of the vendor's scheme, which should be designed to provide transfer payments which are appropriate to the circumstances. Agreement on the actuarial principles if not the transfer value should always be reached before the sale agreement is signed.

(c) The significant difference which there can be between an employee's strict rights under a scheme and his reasonable expectations should be a cause of concern both to employees, who are thereby at risk of a diminution of their benefits, and to employers, as advance funding for discretionary benefits may be raided by a predator. It would be preferable for employers to make more of a commitment regarding pension increases. This does not have to be in the form of writing automatic increases into the scheme rules, which once inserted can hardly be removed, but could take the form of a statement of intent subject to appropriate safeguards, such as satisfactory investment performance. There are also steps which can be taken in respect of the winding-up provisions of schemes which have the effect of ensuring as far as can be that assets put aside are ultimately used in accordance with the original intention.