Company Acquisitions in the U.K.
How Important are Pensions?
by Richard Chapman and Rodney Jagelman (United Kingdom)

1. Introduction

In the U.K., pensions come low on the list of priorities when an acquisition is being considered. Purchasers prefer pension matters to look after themselves and vendors are more than happy if the takeover terms are arrived at without reference to the pension scheme. What is perhaps surprising is that the pensions aspects of takeovers and mergers give rise to few financial problems for either purchaser or vendor. In this paper we examine the role of the consulting actuary and consider how the pension aspects are dealt with in practice.

2. Who are the parties to the negotiations?

2.1. The pattern of negotiations leading to an acquisition depends very much on the status of the purchaser and the vendor. In what follows, we use the term "Quoted" to mean a public company whose ordinary shares are quoted on the U.K. Stock Exchange and "Unquoted" to mean a closed company whose shares are held by a small number of individuals. The three main types of acquisition are:—

Type	Purchaser	Vendor
1	Quoted	Quoted
2	Quoted	Unquoted
3	Unquoted	Unquoted

2.2. **Type 1**
When one quoted company "A" acquires another quoted company "B" the proceedings are governed by the stringent rules of the Stock Exchange and the "Takeover Code". Generally Company A will make a public offer to the shareholders of Company B to acquire their shares on specified terms. Frequently these terms will have been determined by Company A and its advisers without the benefit of anything more than published information about Company B (such as its annual accounts). In the U.K. a company is not obliged to publish any details about its pension arrangements (other than very limited information in relation to pension costs for directors). It follows that the terms offered by Company A will more than likely have been fixed without any reference at all to Company B's pension arrangements. Notwithstanding this, one of the practices encouraged by the Takeover Code is that employees should be told that they will be no worse off as a result of the acquisition and in this context "no worse off" includes pension rights.

2.3. **Type 2**
Unquoted companies in the U.K. are usually companies with a small number of shareholders. The company's annual accounts must be filed and available for inspection at the Registrar of Companies but it may be in arrears in complying with this requirement.

A feature of a takeover of an unquoted company by a quoted public company is that the terms of the sale and the purchase price will usually be the subject of advance negotiations. These negotiations are not hampered by any Takeover Code restrictions and will usually be conducted behind closed doors.

Unquoted companies are by their nature usually small employers and if a pension arrangement is operated at all it is likely to be an insured scheme. One exception is that the directors of an unquoted company may operate a "small self-administered pension scheme" for their own benefit, such schemes being very much in vogue at present.

2.4. **Type 3**
Takeovers of one unquoted company by another are again likely to be the subject of behind the scenes negotiations. Whereas a public company may have a City merchant bank adviser who brings likely acquisitions to its attention, smaller companies are likely to be brought together by a local accountant or bank manager. To this extent each party to the negotiations is likely to be given access to reasonably full information about the other party's business and accounts.

2.5. **Other Types**
Very seldom will an unquoted company acquire a quoted public company. More likely is the acquisition of an unincorporated business such as a partnership by a quoted or unquoted company. However, such acquisitions have no special features and may be considered as Type 2 or Type 3 depending on the status of the purchaser.

2.6. The negotiations may involve as professional advisers to the purchaser and vendor:—

Accountants
Actuaries
Merchant Bankers
Solicitors

2.7. A firm of accountants is likely to be involved if the acquisition is of Type 2 or Type 3. In such cases the purchaser may call on his accountants to report on the financial position of the target company. A worthwhile report could only be prepared with the co-operation of the vendor which would be unusual in a Type 1 acquisition.

2.8. A firm of consulting actuaries is most likely to be involved if either or both sides to the acquisition operates a directly invested pension arrangement. On the other hand, if both parties operate insured schemes (as is usual for small employers) an insurance broker or pension consultant would probably be involved. The level of involvement of the firm of actuaries will depend on the type of acquisition. In a Type 1 acquisition Stock Exchange regulations and Company Law are such that no "(share) price sensitive" information may be acted upon before the offer for sale is made. For this reason, and because pensions are low on the list of priorities, the purchaser's actuary is not normally a party to advance discussions about the offer terms. The actuary's role in these circumstances is, therefore, limited to sorting out any pensions problems if the acquisition goes ahead. In particular, the actuary will usually advise on possible methods of solving the frequently difficult problems of integrating the vendor's pension arrangements with those of the purchaser.

2.9. The actuary is more likely to be involved at an early stage in a Type 2 or Type 3 acquisition. Often, however, there is not sufficient time for a thorough review of the vendor's pension arrangements and the actuary may be called upon to advise on the inclusion of a clause in the purchase and sale agreement designed to indemnify the purchaser against significant underfunding of past service pension rights.

2.10. As a separate aspect of an acquisition in which one (or more) of the parties operates a directly invested scheme the actuary will be involved in advising the trustees of the pension scheme about the procedures laid down in the legal documentation governing the scheme. In practice the actuary will combine his role of advising the company with that of advising the trustees of the pension scheme. There may be occasions (although none has arisen in the authors' personal experience) when a conflict of interest arises between the company and the trustees.

2.11. Merchant bankers are normally the principal advisers to the purchaser in a Type 1 or Type 2 acquisition. Working in conjunction with the company's stockbrokers they will guide the purchaser through the procedures to comply with the Takeover Code and Stock Exchange regulations. The bank may have standing instructions from the company to

look for likely acquisitions and would do the groundwork necessary to arrive at a recommendation to the company as to the offer terms in those cases where a purchase was thought worthwhile.

2.12. The legal advisers to both purchaser and vendor will be fully involved in drafting either the public offer documents in the case of a Type 1 acquisition or the purchase and sale agreement for Type 2 or Type 3 acquisitions.

3. What is the role of the actuary?

3.1. The major task of the actuary to the vendor is to carry out the procedures required in relation to the transfer or partial dissolution rules of the vendor's pension scheme. This will normally entail the calculation either of the share of the assets of the scheme which is attributable to the employees of the company which is being sold or the value of the individual benefits of the employees concerned.

Having assessed the benefits payable in respect of employees of the seceding employer the actuary will then have to examine the funding of the scheme as it continues in force for the remaining employees.

3.2. A second task which may arise in a Type 2 or Type 3 acquisition is the initial consideration of the pensions clause of a draft purchase and sale agreement and the conducting of any negotiations with the actuary to the purchaser which arise out of the terms of the final agreement. These negotiations could arise if the purchaser wishes to include a section in the purchase and sale agreement providing for a "shortfall" payment by the vendor over and above the amount of any transfer value payable from the vendor's pension scheme.

3.3. The transfer payment from the vendor's pension scheme to the purchaser's pension scheme may on occasions be more than the purchaser requires to provide equivalent past service benefits. Where the "excess" transfer value is substantial, the actuary may advise the trustees of the vendor's scheme that it is not in the members' best interests to proceed with the transfer but to pursue some other course provided under the rules of the scheme. It may, for example, be permitted to use the appropriate portion of the assets of the vendor's scheme to provide accrued pension benefits in respect of past service either through the scheme or through an insurance company. Neither approach will, however, provide the members with the same protection against inflation as final salary type benefits and this will be a major disadvantage, especially to the younger members.

3.4. The actuary to the purchaser is likely to be called upon to give advice in two interconnected areas. The first relates to the level of pension benefits which might be offered to transferring employees. The second relates to the funding of the benefits which have been decided upon. The two areas are interconnected because the cost of funding is one of the considerations which will determine the level of benefits to be granted, particularly in relation to previous service with the vendor.

3.5. Ideally the actuary to the purchaser would wish to give advice based on his own independent calculations, using data supplied by the vendor. It may, however, be possible to give some guidelines to the purchaser based on the advice given by the actuary to the vendor in the form, for example, of actuarial valuation reports. It may be that such reports may not be made available to the purchaser or that the information contained therein is too out-of-date to be helpful. Nevertheless, in many circumstances the actuary to the purchaser will be able to assess whether the funding criteria adopted by the vendor are in line with those adopted by the purchaser for its group arrangements.

3.6. A particular problem arises in relation to all acquisitions if the purchaser discovers that the benefits provided for employees of the vendor are better than the benefits under his own pension arrangements. The actuary may then be called upon to advise whether the purchaser should:

- continue the vendor's scheme in force, possibly as a closed scheme, or
- bring the transferring employees into his own scheme on special terms to compensate for the lower standard benefits, or
- admit the transferring employees to his own scheme on normal terms.

These options must be considered by reference to any expression of intent given to the employees at the time of the takeover such as "pension rights will be safeguarded". This latter expression is commonly used in Type 1 acquisitions although its meaning is not defined and is open to various interpretations. For example, it could be taken to refer to accrued pensions based on current salary, to full past service rights based on near-final salary or to the maintenance of overall expectations.

4. What happens in practice?

4.1. There is little statutory pension protection for employees involved in takeovers and mergers and, in the absence of any specific promises made by the purchaser in the course of the acquisition, the past service benefits to be provided are likely to be determined by the amount of any transfer payment and the future service benefits by the resources made available by the purchaser subsequently. So far as protection of past service benefits is concerned, members of large, directly invested, schemes and of money purchase arrangements are probably the best placed. Nevertheless, even in such cases former employees of the vendor may find themselves provided with nothing better than the benefits to which they would otherwise have become entitled on termination of service at the date of acquisition. Whilst this result may in many cases be unjust, improved statutory protection of the rights of members involved in acquisitions would have to have regard to the related problems of other groups of members whose terms and conditions are also subject to involuntary change, for example on redundancy.

4.2. The progressive purchaser may be expected to seek to fulfil the employees' expectations in relation to past service and to provide benefits for future service broadly in line with his general group policy. Two potential problems then arise. First the purchaser may discover that inadequate funds have been set aside by the vendor to meet such past service liabilities. Second the purchaser may find that his own pension arrangements are inferior to those of the purchaser so that problems of comparability and integration arise. Ideally such a purchaser would obtain early actuarial advice which would enable him to reflect any resulting extra pension costs in the purchase price. Failing that the purchaser could attempt to negotiate a "shortfall" provision in the purchase and sale agreement which would operate if the amount available from the vendor's pension scheme did not meet the purchaser's expectation.

4.3. Where an acquisition is accomplished by an offer by one public company for another the likelihood is that the purchaser will proceed without any knowledge or safeguard about the level of funding of the target company's pension arrangements. This surprisingly relaxed attitude stems, we believe, from the assumption by the purchaser that the vendor's pension scheme will have achieved the unwritten 'minimum' funding standards of final-salary, directly-invested pension schemes which usually result in accrued benefits for past service being more than adequately funded if no allowance is made for future increases in earnings.

If reasonable allowance were to be made for earnings increases only a minority of schemes would be in a position where the assets covered the liabilities in respect of past service. Nevertheless, the "minimum" funding levels do limit the risk to the purchaser in granting full past service entitlements.

4.4. Another relevent feature of funding of directly-invested pension schemes in the U.K. is the frequent use of the "aggregate funding" method for determining company costs. Under aggregate funding the assets of the scheme including the value of future members' contributions (if any) are deducted from the value of prospective pension entitlements in respect of total service. The employers' contributions are set at a level necessary to meet the balance of liability. Employer contributions are usually expressed as a percentage of members' earnings. If, following an acquisition, a new employer started to participate in the purchaser's group pension scheme, the aggregate funding method would be unlikely to result in a significant increase in contribution levels even if the vendor's pension scheme was funded at close to the minimum level.

4.5. The conclusion in 4.4. would be quite different if the funding criterion was that past service benefits, standing alone, should be fully funded with allowance for future earnings increases. In that event a low level of funding in the vendor's scheme could result in a shortfall leading to an immediate deficit in the purchaser's scheme. If this funding criterion was applied more generally, for example as a result of accounting requirements, pensions would advance higher up the list of priorities when an acquisition is being considered.