PENSION ASPECTS OF SALES AND MERGERS

E S TOPPER - ENGLAND

This paper sets out to discuss the role of the actuary in the pension implications arising when a business or company is bought or sold. With the rather unique situation in the UK whereby pension schemes are constituted under a Trust, separate from the assets of the sponsoring employer, the legal and trusteeship issues which can stem from the need to split a pension fund or assess a transfer value can be more time consuming for the actuary than the actual process of "doing the sums".

Part I of this paper introduces the reader to the basic problem that an actuary has in giving his advice, namely knowing to whom his advice is to be targeted. His actuarial expertise may be called upon to disentangle a balance sheet (which can be represented in an actuarial report in one of a dozen or more ways) so as to highlight to his own client the crunch issues which he/she should consider. There may well be a need for different actuaries to advise different interest groups such as Trades Unions, employers or Trustees.

Part II of the paper concentrates more on the actuarial mechanics of striking a transfer value for a large group of transferees. Both the actual method of calculation as well as the actuarial assumptions employed are material to the issue.

In Part III we see that the term "surplus" can have a multitude of meanings and that the size of any surplus depends crucially on the actuarial assumptions being employed.

The British approach of setting pension schemes up under Trust is explored in Part IV of the paper where we see the importance of recognising the different interests of members, trustees and the sponsoring employer. As sale and purchase agreements are invariably agreements between companies, not pension scheme trustees, the conflicts between the various parties can become very significant financially. The hackneyed question arises as to "whose surplus is it anyway?" and the actuary's advice to the various different parties must, in some way, provide comment on that problem.

In Part V of the paper I detail a case study which, I hope, brings to the fore some of the trusteeship problems which can arise.

An essential pre-requisite to understanding the kind of problems which the main body of the paper addresses, is to understand the implications of Trust Law, for the typical UK pension scheme. I therefore include a Prologue to give, in particular, the foreign reader an idea of how the British mind works.

PROLOGUE

The Pension Scheme in the U.K.

Pensions in the U K are generally constituted under Trust. The arrangement is therefore governed by a formal Trust Deed and Rules and is administered by a Board of Trustees whose duty it is to operate the pension scheme in accordance with the Rules for the benefit of the members. By and large the pension schemes are pre-funded so that there is a pool of assets completely separate from the assets of the sponsoring employer which the Trustees are charged to invest and manage. A large number of, but by no means all, pension schemes in the U K are "balance of cost final salary" arrangements. This means that the benefits promised relate to the salary at the time of drawing the benefit and the years of service with the employer up to the point that the benefit is drawn (for example on retirement or on withdrawal from the pension scheme). The members make a fixed contribution to the pension scheme, typically ranging between zero and 6% of salaries per annum, and the employer meets the "balance" of the cost each year as advised by the scheme actuary.

The board of Trustees will normally include the Managing Director and Finance Director of the sponsoring employer together with, perhaps, other company officials such as the Personnel Director. Increasingly, nowadays, there may well be member/Trades Unions representatives although this is not yet obligatory. Many pension funds employ the services of a Corporate Trustee in addition, who might be expected to provide some "expert" advice to what is otherwise a "lay" set of Trustees.

It is the duty of the Trustees to act "as an ordinary prudent man" in the interests of the members. They may, and generally do, delegate some of their activities to professionals so that, for example, the investment of the pension fund monies is usually carried out by an institution such as a merchant bank or an insurance company. The Trustees are, however, responsible for the functioning of the pension scheme and can be sued by the members if it is considered that they have acted in "breach of trust".

This is by no means a theoretical situation; as a simple example, if a pension fund is in surplus one might ask "to whom does the surplus belong?" On the one hand, seeing as we are talking about a "balance of cost" pension scheme the sponsoring employer might consider that the surplus is his. If so, he might wish to utilise that surplus by reducing contributions to the pension scheme for a while or even by taking monies out of the fund back into the company coffers. On the other hand, the whole purpose of constituting pension schemes under Trust, with assets separate from those of the employer, is to distinguish between "members' assets" and "employers assets"; if the employer were to go into liquidation, the pension fund monies would be "safe" and at least employees would not lose their pensions as well as their jobs. Members would consider monies paid into the pension fund to be "deferred pay" and this argument has increasingly gained ground over recent years as legal precedents have emerged in the courts.

With this somewhat unique British approach to pension provision, the actuary in the U K can, and does, find himself involved in legal battles where he is called to the witness box to defend the advice that he has given. The field of company sales and purchases is an area, in particular, where the lawyers rejoice and the actuary must beware.

PART I

"KNOW YOUR CLIENT"

Most newly qualified actuaries in the UK attend a Professionalism course run by the Institute or Faculty of Actuaries. The essential message of the course is "Know Your Client".

It is not uncommon in the UK for an actuary to be called upon to advise simultaneously in more than one capacity. In such situations he must decide whether it is actually feasible to do that (although one could certainly argue that it never is). Increasingly, in a sale and purchase situation, up to 4 actuaries can be involved in the negotiations, an actuary advising the purchasing company and another one advising the Trustees to the purchaser's fund, with two counterparts on the vendor's side.

Consider the pension fund actuary who is asked to give advice concerning a fund which is in surplus and whose balance sheet looks like this:-

	£M
Liabilities	100
Assets:	
Fund	60
Future contributions at 25%	80
	140
"Surplus"	40

There appears to be a healthy "surplus" of £40,000,000. Depending upon whom the actuary is advising, the advice may appear obvious:-

* If, as is almost universal in the UK, the pension fund is set up under a separate Trust and the actuary is advising the Trustees, then the advice might be to improve the benefits by 40%.

* If the advice is being given to the sponsoring employer perhaps the long term contributions should be cut by half to 12.5%.

* If advice is being given to a prospective purchaser then perhaps there is potentially £40,000,000 surplus to "asset strip".

* If the actuary is advising the vendor then perhaps the purchase price of the company should be increased by £40,000,000 to compensate for the surplus in the pension fund.

I will re-visit this area, which is a legal minefield, at the end of this paper.

PART II

"THE OPTIONS AVAILABLE"

Consider a situation where a company is selling off one of its subsidiaries and needs to pay a transfer value in respect of the ceding employees from its pension fund.

As part of the overall sale and purchase agreement between the companies a Pensions Clause will be included which should set out the details of the method and actuarial assumptions which should be used in calculating the transfer value from the one fund to the other. It is fundamental to appreciate, however, that this is an agreement between companies not Trustees. Take an example where the sale and purchase agreement between the companies specifies a transfer value of £1,000,000; if, for whatever reason, the actuary advises the exporting Trustees to pay a transfer value of only £750,000 then the shortfall of £250,000 would have to be made up by the vendor company out of its own resources. On the other hand, perhaps there is a surplus in the vendor's fund and the exporting actuary advises a transfer value of £1,500,000 to reflect that surplus. In that case the vendor company should demand that the excess transfer value is reflected in the purchase price being offered for the company. A "shortfall clause" and an "excess clause" should therefore be included in the formal sale and purchase agreement and a basic reason why such clauses are required is that the interests of the Trustees and companies on both sides of the deal may well differ.

Let us look at the broad options available to an actuary when negotiating the pensions clause of the sale and purchase agreement.

* Wind-up liability.

The vendor company will probably wish to pay as little as possible over to the purchaser by way of the transfer value. His starting position might therefore be to offer the wind-up liability as the transfer value. The wind-up liability would exactly cover the leaver benefits which the ceding members are entitled to under the Trust Deed and Rules of the vendor's scheme. Such liability is generally based on the service to the date of transfer and the salary at the date of transfer. There are complex rules which set out a minimum level of revaluation of such benefit from the date of transfer to the member's retirement date but this would generally not compensate in full for the level of salary increases which the average member would have enjoyed over that period had he not left the pension scheme. From the purchaser's point of view, if he receives such a transfer value, then it would only enable him to replicate all the contractual liabilities based on frozen salaries for the membership transferring into his scheme. The purchaser's pension scheme would be acting, in effect, like an insurance company receiving a bulk transfer value and being able to promise fixed benefits in return.

* Past Projected Liabilities.

The problem with the wind-up liability as a transfer value is fairly obvious from the transferring members' point of view. In the vendor's scheme, they could be said to have accrued a benefit at the date of transfer based on their service at the date of transfer but their salary projected through to retirement date. This might well have been the members' "expectation" (assuming they are in a Final Salary scheme) even though such expectation is rarely, if ever, reflected in the actual governing Trust Deed and Rules.

It would be possible, and in many ways fairer, to reflect the expected salary growth in the transfer value and pay over a "past projected liability" or a "past service reserve". This would be a transfer value reflecting the benefit accrued at the date of transfer but salaries projected right through to retirement age. If the purchaser receives such a transfer value it should enable him, in theory, to replicate the benefits under the vendor's scheme so that the transferring members would not "lose out" on transferring between the two schemes in respect of service to date.

* Share of Fund.

Suppose the vendor's scheme was in surplus and the exporting Trustees wish to pay a transfer value reflecting that surplus. In that case, a transfer value could be based on a "share of fund"; such a share would be calculated as a relevant proportion of the market value of the fund's assets at the time of transfer. The proportion might be calculated by reference to past projected liabilities or by reference to the wind-up liabilities of the ceding members compared to the total membership of the vendor's scheme.

If, the vendor's scheme was actually in deficit, then a "share of the fund" could well produce a lower transfer value than either the past service reserve or the wind-up liability. A "share of the fund" obviously means a share of the deficit as well as the surplus!

THE ACTUARIAL ASSUMPTIONS

The method which an actuary uses to determine a transfer value must be looked at in conjunction with the actuarial assumptions. Part of the actuary's role in a sale and purchase situation will be to negotiate an appropriate set of actuarial assumptions on behalf of his client. The assumptions are clearly very material; for example if a past projected transfer value is agreed the amount of the transfer will be crucially dependent on the allowance for future salary increases which is incorporated into the calculations. In addition the actuary must negotiate a discount rate, the mortality and withdrawal assumptions and, important in the UK, any "market value adjustment" which needs to be applied to the transfer value to convert it into a market value of assets. (This latter adjustment is generally required as actuaries tend to use a discounted income approach to valuing assets.)

PART III

THE BALANCE SHEET REVISITED

Let us put the previous sections in context by revisiting the balance sheet looked at earlier. The balance sheet showed liabilities of £100,000,000 but of more interest, in the sale and purchase situation is the break up of the liabilities between past and future service. Suppose the past service liability amounted to £80,000,000 of which £60,000,000 covered wind-up liabilities, the balancing £20,000,000 being the additional reserve for future salary increases. We can now draw up a past service balance sheet which looks like this:-

PAST POSITION

Liabilities		Assets	
Wind-up	60	Fund	60
Salary projection	20		
	80		60

You can now see that so far as assets and liabilities accrued to date are concerned, the fund does not enjoy a surplus of £40,000,000 but in fact is only just solvent on a wind-up and has a deficit if future salary projection is taken into account. The Trustees of the exporting scheme can therefore only afford to pay a transfer value reflecting a wind-up liability and the shortfall clause would therefore be very crucial from the purchaser's point of view. Having looked at the balance sheet in this way there would, of course, be no question of the purchaser paying a further £40,000,000 to "reflect the surplus in the fund".

This simple analysis illustrates the importance of drawing up the sale and purchase agreement correctly and of taking proper actuarial advice as to whether or not there is indeed a "surplus" in the fund.

We can, and should of course, go further and ask what actuarial assumptions have been used in drawing up the past service balance sheet above. If these assumptions are unduly liberal then perhaps the funding position of the scheme is even worse than pictured above, or maybe the balance sheet has been drawn up extremely conservatively in which case the purchaser's problems are not quite so marked. The important consideration, in this context, is the demographic profile of the members being transferred.

The balance sheets we have looked at hitherto have referred to the whole of the membership of the vendor's scheme but in practice he might only be selling a subsidiary reflecting a small subset of the overall membership. If the transferring members are very young, on average, then the inclusion of a generous allowance for salary projection in a past service reserve would be to the benefit of the purchaser; if a very heavy withdrawal decrement is factored into the calculations then the transfer value would be correspondingly reduced; it will be apparent to the reader that any "share of the fund" would also be materially affected by the age profile of the transferring members in conjunction with the assumptions factored into the calculations.

PART IV

THE LEGAL IMPLICATIONS

Significant sums of money can revolve round the issue of what transfer value should be paid from the vendor's scheme to the purchaser's scheme. Indeed, it is not uncommon for this to be the single most important item in the overall negotiations between the two companies and could in fact be more significant than the actual companies themselves. The fact that pension schemes are constituted under a Trust in the UK, completely separate from the rest of the sponsoring employer's assets, is a crucially important factor to be borne in mind. The role of the Trustees to the pension fund is to look after the interests of the members of the pension fund not to act as servants of the interests of the sponsoring employer. The actuary must always bear in mind that he is advising the Trustees how to act in the interests of the members of the pension scheme and this can create certain conflicts of interest, particularly as it is the sponsoring employer who generally pays the actuary's fees.

In a sale and purchase situation, the purchasing company's actuary is probably trying to secure as large a transfer as possible whereas the vendor company's actuary would be trying to negotiate as small a transfer as possible. The actuaries to the respective Trustees should have different interests; the vendor Trustees must act fairly and impartially between the interests of the transferring members and the remaining members. The purchaser's Trustees would want to use whatever transfer value is received for the benefit of the members for whom it was paid.

Consider an example where the vendor's pension scheme is in surplus, as measured against past projected liabilities. The exporting Trustees may well wish to pay a "share of the fund" so as to reflect that surplus in the transfer value paid. This would treat the transferring members no differently from those remaining in the vendor's scheme in that all members would enjoy the same proportion of surplus. On the other hand, it could be argued that the surplus is only a temporary phenomenon in the vendor's scheme; the sponsoring employer might be on a total contribution holiday so that over the course of time the "surplus" would disappear. Is it right to crystallise the transferring members' share in such a transitory surplus?

From the point of view of the receiving Trustees, they should grant benefits in the purchaser's scheme which reflect the full transfer value received. This is not only fair to the transferring members but also fair to members already in the purchaser's scheme who should neither benefit nor lose out on account of the transfer; in particular, they would not wish to pick up any unfunded liabilities in respect of the transferring members. However, life is never that simple and the Trustees may be requested by the purchaser to take on liabilities for which they have received an "inadequate" transfer value. How should they act?

The respective companies will have different considerations. The vendor company will wish to pay over as small a transfer value as possible and might attempt to reflect only a wind-up liability in the sale and purchase agreement. The vendor company would then be calling the "excess" clause and demand further monies from the

purchaser to reflect the surplus which is being passed over. This would be a surplus not just over and above past projected liabilities but over the wind-up liabilities in respect of the transferring members. The purchasing company will naturally wish to secure as large a transfer value as possible and would not be happy with an "excess" clause in the agreement in the first place. He would probably not agree to a transfer value merely covering the wind-up liabilities (unless it could be demonstrated that the exporting scheme is in fact extremely poorly funded and cannot afford any more monies). In the event that a surplus (on whatever definition) is paid over to the purchaser's scheme, the purchaser might prefer to use this to finance a contribution holiday in his own pension scheme or maybe to finance benefit improvements for pre-existing members not just for transferring members.

Should the exporting pension scheme be in deficit then the purchasing Trustees will be particularly concerned not to take on any unfunded liabilities as this would reduce the security of benefits for the members already in the purchaser's scheme. The purchasing company (and purchasing Trustees) will probably wish to be able, at least, to replicate the benefits under the vendor's scheme and will therefore want a transfer value at least equal to the past service reserve. If the transfer value were insufficient to cover this then the purchaser could cut back on the past service benefit offered to the transferring members but that would not enhance industrial relations at what is anyway often a highly charged time.

We can see why the Institute and the Faculty of Actuaries impress upon newly qualified people the importance of "knowing who your client is".

PART V

FINAL EXAMPLE

I would like to finish with a further example illustrating the importance of Trust Law and how this impacts on an actuary's role.

Consider the scenario that you are actuary to a pension scheme with 500 lives and a number of pensioners and preserved pensioners which was massively in surplus at the last actuarial valuation. On the rather conservative basis which the Trustees have used for the last actuarial valuation the past projected liabilities were covered some 130% by the assets. In monetary terms this surplus amounted to about £5,000,000.

The sponsoring employer, aware of the conservative nature of the valuation had received "informal" alternative valuations on different sets of actuarial assumptions and in particular had focussed in on a more middle-of-the road actuarial basis which showed a surplus of some £10,000,000. Even on this basis the past projected liabilities of £40,000,000 were 125% covered by the assets.

In view of the surplus the sponsoring employer went on a contribution holiday and suspended employee contributions in addition for a limited period of time.

The company is now in negotiation to effect a significant purchase; if all the members concerned were to transfer into the receiving scheme this would double the membership to 1,000 members. The exporting scheme actuaries have offered a past projected transfer value using the more liberal assumptions on which you have based your informal valuation for the purchasing company. This transfer value would amount to £40,000,000.

What are the Trustee issues involved here which you need to raise? The following points should be of interest:-

(i) The receiving Trustees need to be assured of the adequacy of the transfer value being offered. You are certainly able to certify that the valuation basis being offered is "reasonable"; indeed it coincides with the more liberal, long term assumptions which the purchasing company has informally accepted for his own pension fund valuation.

(ii) Despite the above assurance to the receiving Trustees, were the transfer value to be accepted as offered, the percentage cover of the past service benefits in the combined larger scheme would be significantly reduced. To see this, consider the past projected balance sheets before and after the take over:

Before		£M
Past Projected Liabilities		40
Value of Fund		50
"Surplus"		10

After		£M
Past Projected Liabilities	= 40+40	80
Value of Fund	= 50+40	90
"Surplus"		10

Before the take-over, the past projected liabilities amounted to £40M; the value of fund stands at £50M and therefore there is a surplus of £10M. The ratio of the value of the fund to the value of the liabilities is 50/40 or 125%. After the transfer value of £40M is accepted whilst the surplus is maintained at £10M the percentage cover, or the measure of solvency of the scheme, reduces to 90/80 which is 112.5%.

The question therefore arises as to whether the Trustees of the receiving scheme can be said to have had the existing members' interests at heart in allowing such a dilution of solvency. Whilst the level of surplus remains constant at £10M in monetary terms, this is now spread amongst twice the membership.

(iii) In addition, to the above scenario, the Trust Deed & Rules of your client's pension scheme specifically details that in the event of a wind-up half of the surplus must be used to improve members' benefits and the other half can be refunded to the employer. In the event of a wind-up immediately post the acquisition what would the interests of the newly acquired members be in the surplus that was there prior to the acquisition? What is the position of the Trustees in this regard? Whilst it would be possible, in theory to track the £10M surplus that was there at the take-over and use this "solely and exclusively" for the benefit of members actually in the scheme prior to the acquisition, in practice this would be a very difficult exercise as the years rolled on.

(iv) One solution might be to transfer the 500 newly acquired members into a completely separate pension scheme governed under a separate Trust Deed & Rules. Such a new pension scheme would clearly be adequately funded as the transfer value of £40m received would exactly match the liabilities of £40M taken on. The problem here is that whilst the pension scheme would certainly be "reasonably" funded it would certainly not be "over-funded" and therefore it would be necessary for the sponsoring employer to pay contributions into that scheme in the fairly near future. As regards the old pension scheme, however, this has a surplus sufficient to support an employer contribution holiday for many many years into the future. From a commercial point of view the sponsoring employer would no doubt prefer to merge the two schemes and use what he would view as "his surplus" to finance a suspension of contributions across the whole of his 1,000 employees. Whilst the £10M surplus would support a contribution holiday across the combined membership for only half the period of time, this approach might well be of considerable commercial interest to the acquiring company particularly if the economic climate is bleak.

Do the receiving Trustees have any problems in using the existing pension scheme surplus to finance a contribution holiday in respect of transferred employees?

PART VI

CONCLUSION

Over recent years, with the intensive take-over activity in the 1980s the role of the actuary in mergers and acquisitions has come to the fore. In the UK the press has been full of articles of pension funds in surplus which have been "asset-stripped" by predators. Actuaries have found themselves in the witness box "justifying" their apportionment of funds and having to explain their modus operandi. The profile of actuarial advice has risen sharply in the eyes of Finance Directors and other company directors who are beginning to appreciate that pension fund matters cannot be relegated to last minute discussions before a sale and purchase agreement is signed; the issues involved in the transfers or otherwise of pension fund surpluses is as vital, if not more so, than the issues involved in valuing the stock in hand, the plant and machinery and the other aspects covered in the sale and purchase agreement.

At the same time, the profile of the Trustee has risen as it is appreciated that their interests may be different from those of the company and Trustees can find themselves in the dock just as easily as the company or its advisers can.

I hope this paper provides a brief taster for the actuarial issues involved in take-overs and mergers and perhaps more interestingly, in the context of the Trust Law framework of UK pension funds, I have attempted to give a feel for the legal and trusteeship issues which often arise.