Pension issues on corporate transactions

June 2018 Pension briefing

HIGHLIGHTS

Pension issues in corporate transactions can be complex when a defined benefit (final salary) scheme is involved. Factors to consider include:

- risks of action by the Pensions Regulator – after the BHS and Carillion insolvencies the Regulator is taking a tougher approach and is expected to be given new powers;
- penal fines and criminal sanctions announced in the March 2018 White Paper;
- implications of a share sale – what should buyers and sellers think about;
- implications of a business sale – what pension rights do and don't pass under TUPE; and
- pension issues arising from dividend payments, refinancings, internal reorganisations and other non-M&A transactions.

PENSION PROVISION: THE BASICS

How are pension schemes set up?

Pension provision by UK employers falls into two main categories. First, an employer can establish an **occupational pension scheme.** These are trust-based schemes – where a set of trustees administer the scheme and are responsible for paying benefits to members. Traditionally, this was the model for most larger UK employers. Of late, there has been a shift towards pension provision through **personal pension schemes**. These are contractual arrangements under which an individual invests money for the provision of pension benefits with an insurance company or similar organisation. A number of providers of personal pensions will provide the arrangement on a "grouped" basis, usually where an employer is willing to make contributions to a single provider's arrangements only. These are known as **group personal pensions**.

Occupational pension schemes can provide benefits either on a **defined contribution** (money purchase) basis, or on a **defined benefit** (usually final salary) basis (please see the box below). Personal pension schemes always provide defined contribution benefits.

Key phrases: pension benefits

Defined benefit (DB): the pension payable to the employee is usually defined by reference to a formula that produces a pension of a proportion of final pay, with the proportion depending on the employee's length of service. A typical formula might be 1/60 of final salary for each year of service. DB pension funds are funded according to the value of the assets, and the actuarial assessments of the liabilities.

Other types of DB schemes exist, such as "career average" arrangements providing pensions based on the member's averaged lifetime earnings rather than final salary; and "cash balance" schemes which guarantee a minimum investment return on a member's fund.

The essential feature of a DB scheme is that the employer has made a promise as to what benefits will be paid **out** of the scheme, and is liable to fund the cost of paying the promised benefits if the scheme assets are insufficient to do so.

Defined contribution (DC): pension scheme benefits based on a commitment by the employer to make contributions at a specified rate (for example, 5% of salary) to a fund that is invested on the employee's behalf. At the time of retirement the member may choose how to take the accrued fund (including investment returns) – as one or more lump sums, by "drawing down" the fund through regular or one-off payments, or by purchasing a pension (or annuity) from an insurance company

The essential feature of a DC scheme is that the employer has only made a promise about what is paid **in** to the scheme. The employer does not retain any risk relating to the level of income or lump sums received by the former employee – this will depend on investment performance before (and, in some cases, after) retirement and the retirement choices made by the member.

Valuing a DB scheme – too many numbers?

DB pension schemes must have an "actuarial valuation" at least every three years. The valuation compares the value of the scheme assets against the value of the liabilities to pay benefits.

Whilst valuing the assets is relatively easy, valuing the liabilities depends on the assumptions used (such as the expected rate of inflation, investment returns or members' longevity) and for what purpose the valuation is prepared. Common pension scheme valuation numbers are as follows.

- **Accounting basis:** employers are required under accounting standards to disclose pension liabilities. A mandatory set of assumptions is used, so allowing investors to compare different companies on an equal basis. Accounting numbers are usually irrelevant for funding purposes, however. Also, they typically understate the liabilities compared with the other methods.
- **Ongoing valuation basis (sometimes called the "technical provisions" basis):** schemes must have a valuation on this basis at least every three years. The assumptions used are usually negotiated between the employer and trustees (unless the scheme rules give trustees unilateral powers) and must include an element of "prudence". This valuation determines the level and duration of any contributions the sponsoring employer(s) must pay to the scheme (including contributions to make good any deficit). The numbers for asset value and liabilities are rolled-forward for the inter-valuation years.
- **Self-sufficiency basis**: broadly, a scheme is considered self-sufficient if its assets are expected to be adequate to pay all benefits as they fall due, without further contributions from the sponsoring employers. The level of assets required to meet this basis is usually greater than for the ongoing funding basis but less than for the buy-out basis.
- **Buy-out basis (also known as the "section 75" or "solvency" basis")**: this basis is calculated as the level of assets which would be needed to buy-out benefits in full with an insurance company. As insurers have very prudent assumptions, and will build in a profit margin, this is the most expensive way of valuing pension scheme liabilities. The buy-out basis is used when calculating a sponsoring employer's "section 75" debt (please see the box below).

Employer covenant

For a DB scheme, the concept of employer "covenant" is critical. The covenant is an assessment of the legal obligations, and financial ability, of an employer to contribute to the scheme.

Strong covenants include situations where either (i) the employer itself is financially strong; or (ii) the employer is weak, but another group company which is strong has provided a legally-binding guarantee.

Trustees will usually give very little weight to the strength of the wider group if there is no legal obligation on strong group companies to support the scheme.

Trustees – and the Regulator – will typically assess on corporate transactions whether the covenant has weakened. If it has, they will look for action to be taken to mitigate that (see below).

REGULATION OF PENSION SCHEMES

There are two key regulators for pension schemes in the UK: the Pensions Regulator (the "**Regulator**") and the Financial Conduct Authority (FCA). Broadly, the Regulator is responsible for overseeing occupational pension schemes, and the FCA oversees personal pension schemes.

In addition, DB occupational schemes must pay an annual levy and supply certain information to the Pension Protection Fund (PPF). The PPF is effectively a mandatory pension insurance arrangement which provides compensation to members of DB schemes whose sponsoring employers become insolvent and whose pension schemes are insufficiently funded to pay a minimum level of benefits. For most members, PPF compensation is less than the benefits which would have been due to them under their scheme rules.

PENSION REGULATOR ACTIVITY

What powers does the Regulator have?

The default legal position is that only a "sponsoring employer" – that is, a legal entity which has employed individuals who are members of a DB pension scheme – has any liability to fund that scheme. The exceptions are where:

- another party has liability under contract (for example, having provided a guarantee of a sponsoring employer's obligations) or under the trust deed and rules governing the scheme; or
- the Regulator exercises its powers to impose liability on a non-employer.

The Regulator can impose financial support directions or contribution notices (please see the box below) on a sponsoring employer, or anyone who is associated/connected with a sponsoring employer, of an underfunded DB pension scheme.

These powers have been exercised formally in seven cases – four where financial support directions were imposed (eg the Nortel and Lehman Brothers schemes), and three where contribution notices were imposed (eg the Bonas and Carrington Wire schemes). In addition, the existence of these powers gives the Regulator considerable leverage to require increased contributions or other support without the powers being formally exercised (eg in respect of the BHS and MG Rover schemes).

The Regulator also has powers to intervene in scheme valuation negotiations, and has powers to impose its own valuation assumptions or employer contributions.

There is at present no mandatory notification or clearance regime for corporate transactions. There is a voluntary clearance regime, but use of this has declined in recent years.

The Regulator's "moral hazard" powers

Contribution notice (CN): a notice issued by the Regulator requiring the recipient to make an immediate financial contribution to a DB scheme.

Financial support direction (FSD): a direction issued by the Regulator requiring the recipient to put financial support in place in relation to a DB scheme (which could be a financial contribution, or a guarantee/contingent asset).

Clearance: parties concerned about intervention by the Regulator may apply for clearance which, if granted, provides comfort that it will not exercise its powers in relation to a particular transaction. Clearance is usually only granted if the scheme trustees support the application and if either there is no weakening in the employer covenant, or if "mitigation" is provided where the covenant is weakened.

Mitigation: trustees are expected, in return for their support for a transaction, to agree measures (known as "mitigation") to compensate for the reduction in employer covenant.

How has the Regulator's approach changed recently?

The Regulator has received a lot of critical media attention recently – particularly following the collapse of BHS and Carillion – about how it has exercised its powers historically. We have noticed the Regulator taking an increasingly tough approach on both valuations of DB schemes and corporate transactions.

Additionally, in May 2018 the Regulator provided updated guidance (not legally binding) for trustees to take into account when negotiating DB scheme valuations with their employers. The Regulator targeted the balance between contributions to the scheme and dividends to shareholders, concluding that:

- *"Trustees need to ensure that ... legal obligations to the scheme as a creditor are recognised ahead of shareholders with no legal entitlement to dividends, but who may exert pressure on the employer to obtain them."*
- where the employer's total distributions to shareholders are greater than the deficit repair contributions to a scheme, the deficit should be repaid within a short period of time, otherwise it may open an investigation: "*Where we believe that there is sufficient affordability to increase contributions to the scheme, we will take steps to ensure that an appropriate balance is struck between the interests of the scheme and shareholders by the employer*".

New powers for the Regulator in relation to corporate transactions?

The Department for Work and Pensions published a White Paper in March 2018. This promised:

- a consultation on punitive fines and a new criminal offence for those who have "*committed wilful or grossly reckless behaviour in relation to a pension scheme*";
- new requirements for DB schemes to have a long-term objective – such as buy-out or self-sufficiency , to be included in a new Regulator Scheme Funding Code of Practice; and
- requiring employers to make a "statement of intent" before certain business transactions take place that they have appropriately considered the impact of any potential risk to the pension scheme.

Given the government's Brexit priorities, and its lack of a Parliamentary majority, no new primary legislation concerning pensions is expected until 2019/20 at the earliest. In contrast, new Regulator Codes of Practice can be adopted without legislative change. Despite the delay with new legislation, the direction of travel seems clear.

Key interventions by the Regulator

Lehman Brothers: the Regulator imposed financial support directions on six Lehman companies in 2010. The matter settled in August 2014 when some Lehman companies agreed to repay the scheme's entire **£184million** deficit in full.

Carrington Wire: in August 2015, the Regulator imposed a contribution notice for **£380K** on an **individual** who was a director of Carrington Wire and who, through a new company, had purchased the business of Carrington Wire for £1.

BHS: the Regulator dropped its investigation into Sir Philip Green and various Arcadia group companies in return for a settlement of up to **£363million**. Proceedings continued against Dominic Chappel, who also received a **criminal conviction** in January 2018 for failing to provide information when requested by the Regulator.

Coats Group: the Regulator was seeking financial support directions against Coats Group plc for financial support for three pension schemes in its wider corporate group, but settled for a **£329.5million** immediate contribution plus a **full parent-company guarantee**.

KEY ISSUES ON ACQUISITIONS

The pension implications for a purchaser differ depending on whether the acquisition is by way of a share sale or a business (asset) sale. They also vary depending on the type of scheme in which employees of the target employer participate.

In general, a 60 day consultation is required where employees' pension rights are to be changed.

SHARE PURCHASES: IMPACT OF DB SCHEMES

Where the target participates in a DB scheme, detailed legal and actuarial due diligence is essential to check how the scheme has been valued and managed. Suitable warranty/indemnity protection should also be negotiated.

- **Regulator intervention in the purchase:** if the Regulator (or trustees) believes the transaction is materially detrimental to the scheme, the Regulator may become involved and look to exercise its moral hazard powers. A proper understanding of these powers and the likely consequences will help the parties decide how to respond and what (if any) mitigation to offer to the trustees. Following the purchase, companies in both the seller's and the purchaser's groups may be within the scope of the Regulator's powers.
- **Negotiations with the trustees:** even if the Regulator is not involved in a transaction, DB scheme trustees will want to understand its implications for their scheme. Depending on the structure of the deal the buyer or seller, or both, will need advice on the approach to take negotiating with the trustees (or whether to refuse to enter negotiations).
- **Employer covenant changes:** "covenant" is the term used to describe the ability (and legal obligations) of the sponsoring employer(s) to support the scheme. Where a transaction weakens the employer covenant, both the Regulator and trustees will have concerns.

- **Employee rights to future pensions:** it is unusual for employment contracts to give employees the right to a particular level of future pension accrual from an occupational pension scheme, but this should be checked as part of the due diligence process. If the employment contracts do confer specific pension rights, then employees must be provided with the same benefits going forward, or variation of their employment contracts should be agreed.

Additional issues which can arise, depending on whether the target has its own (single employer) DB scheme or, instead, participates in a multi-employer scheme, are described below.

Share purchase – target has its own DB occupational pension scheme

If the target has its own occupational pension scheme, that scheme (including all its liabilities) will remain with the target after the acquisition, unless alternative arrangements are agreed.

Particular areas to consider include:

- undisclosed liabilities (eg failure to equalise benefits properly between men and women), which will remain the responsibility of the target;
- any special powers for the trustees to impose the level of contributions from the target or to trigger a section 75 debt (please see the box on valuing a DB scheme above);
- if the scheme is still open to future benefit accrual, whether there are any restrictions in the scheme rules which would limit the ability to close the scheme to accrual in future, or which would require provision of enhanced benefits for active (employee) members;
- the financial position: the numbers used to value a DB scheme in an employer's accounts are rarely relevant for determining what contributions are actually paid to the scheme (please see the box below);
- how the purchase is to be financed: if this is by debt secured against the target, then the trustees and Regulator are likely to be concerned as this debt would usually rank above obligations to the trustees should the target become insolvent.

Section 75 debts

A scheme's section 75 deficit is the difference between the value of its assets and the value of the liabilities, calculated on the buy-out basis (please see the box above).

Each sponsoring employer participating in a DB scheme has a potential (contingent) liability to pay a "section 75 debt".

A sponsoring employer's section 75 debt is its share of the overall section 75 deficit, determined broadly by reference to the value of the benefits built up by its employees compared to the value of the total benefits under the scheme.

A sponsoring employer's 75 debt will become due when:

- the scheme goes into winding-up;
- the employer becomes insolvent (or goes into solvent winding-up); or
- where a scheme has multiple employers, one of the employer stops employing active members (employees currently earning pension benefits) when the scheme continues to have active members employed by other employers.

Share purchase – target participates in a multi-employer DB scheme

If the target participates in its group's occupational multi-employer scheme (in other words, a scheme in which a number of other group companies participate), responsibility for that scheme will not transfer to the purchaser when the target is sold unless the parties explicitly agree that this will happen.

The following are likely to occur in respect of a DB scheme:

- the target will cease to participate in the scheme (it may need to serve notice to achieve this);
- if the scheme is still open to future accrual, the target's employees will stop earning additional benefits under the scheme and will become deferred members (with a right to draw their benefits when they reach the scheme's pension age) – the purchaser will need to decide what ongoing pension provision to offer;
- if the scheme is closed to future accrual, the target's employees will already be deferred members and their rights to draw benefits from the scheme in future will not usually be affected by the transaction; and
- a section 75 debt will become payable if the scheme still has active members. Even if no section75 debt becomes due, however, the purchaser may wish to trigger a section 75 debt and offset this against the purchase price.

In addition, the purchaser will want to consider the Regulator's moral hazard powers, although in the context of a purchase where the target has paid its section 75 debt in full this is unlikely to be an issue. It should also seek comfort (through warranties and indemnities if appropriate) that the scheme was properly run.

SHARE PURCHASES: IMPACT OF DC SCHEMES

Share purchase – target has its own DC occupational pension scheme

In relation to a DC scheme, the potential risks are much fewer. DC schemes do not have funding deficits and are not subject to the Regulator's powers to issue contribution notices and financial support directions. However, the purchaser will still be concerned to:

- understand the costs associated with the scheme; and
- confirm that the scheme has been run properly and complies with its legal requirements (and seek appropriate warranties and indemnities).

Share purchase – target participates in a multi-employer DC occupational scheme

The issues that arise if the target participates in its group's DC occupational pension scheme are much easier to deal with:

- the target will cease to participate in the scheme (it may need to serve notice to achieve this);
- the target's employees will cease having contributions added to their DC pot within the scheme and will become deferred members;
- the target will need to determine what future pension provision to provide for its employees (which must at least as generous as the minimum legislative requirements).

The purchaser will also be concerned to ensure that the scheme was properly run and should seek protection (through warranties and indemnities) that this was the case.

Share purchase – target's employees are provided with personal pension schemes

The target's obligation to provide and contribute to the personal pension schemes will continue as before.

KEY ISSUES ON BUSINESS (ASSET) PURCHASES

Pension issues also need to be considered when acquiring a UK business. In brief, where employees are transferring under TUPE to another entity, the legal position is that:

- **most** rights to pension benefits (including membership of a DB scheme) **do not** transfer;
- **some** rights – particularly rights to redundancy benefits and special early retirement terms **do** transfer; and
- there are **minimum** statutory pension benefits which have to be provided on a TUPE transfer (but it is not necessary to provide a DB arrangement); and
- employers receiving transferred employees must also ensure that they comply with the minimum legislative requirements.

Understanding what rights do and do not transfer, and negotiating suitable indemnity or warranty protection, is crucial.

Business sales can also give rise to some of the same issues as for share sales. For example, covenant concerns (and Regulator intervention) can be applicable on a business sale.

Key points: pension rights under TUPE

TUPE: The Transfer of Undertakings (Protection of Employment) Regulations 2006 safeguard employees' rights in the event of a transfer of a business (or a part of a business) or change in service provision (such as outsourcing, insourcing or reassigning an outsourcing contract). TUPE does not apply to share sales.

Employee rights are protected by automatically transferring the employees from the seller to the purchaser on their original terms and conditions. However, there is an exception for occupational pension scheme rights, which do not generally transfer. Instead, the purchaser must provide the transferred employees with access to one of the following:

- a DB scheme with specified minimum benefits;
- a DC scheme with employer contributions which match the employee's contributions (up to 6% of basic pay); or
- a DC scheme with employer contributions which at at least equal the level of contributions paid by the transferring employer before the TUPE transfer.

Business purchase – target's employees are members of an occupational pension scheme

The starting point with an asset sale is that employees lose their right to be provided with future pension benefits under the target's occupational pension scheme. They cease to earn future benefits under the scheme and become deferred members. The employees are entitled to a minimum amount of pension provision after the TUPE transfer but this does not need to reflect the original arrangements (please see the box above).

There are, however, circumstances where the purchaser can be required to provide greater benefits than the minimum required under TUPE:

- if transferring employees are employees of a privatised industry (for instance they work in the electricity, railway or coal industry) then they may have special rights to future benefits at a particular level; or
- if the seller feels strongly (or is under pressure from its workforce or a union), it may require an undertaking from the purchaser to provide pension benefits at a particular level. This could include providing identical ("mirror") benefits under the purchaser's scheme. The purchaser's scheme may also be expected to accept a transfer of liabilities to pay benefits to transferring employees built up during their service with the seller. This is common on transfers from the public sector as well.

Business purchase – target's employees have redundancy or early retirement rights under an occupational pension scheme

Although occupational pension scheme rights do not transfer under TUPE, this exception applies only to employees' rights to "old age, invalidity or survivors' benefits". (This wording is from the EU Directive from which TUPE derives.) As a result of two European Court cases in 2002 and 2003, *Beckmann v Dynamco Whicheloe Macfarlane and Martin v South Bank University*, some early retirement rights provided under a scheme will transfer because they fall outside the exception. However, the judgments left considerable scope for doubt about the precise ambit of the benefits that transfer or do not transfer under TUPE.

In *The Procter & Gamble Company v Svenska Cellulosa Aktiebolaget SCA* in 2012 (please see the box below) the High Court offered guidance on some of these grey areas.

***Procter & Gamble* case**

Procter & Gamble (P&G) agreed to sell one of its businesses under an asset sale and purchase agreement. This involved the TUPE transfer of P&G employees. The transferring employees were active members of the DB section of P&G's pension scheme.

The High Court held the following.

- The transferring members had a right (pre-transfer) to take early retirement with the employer's consent, so what passed under TUPE was the right to have a request for early retirement benefits considered in good faith.
- The purchaser would not be liable for the full amount of any early retirement benefits. The transferring employees became deferred members of the seller's scheme as a result of the TUPE transfer, entitled to a deferred pension valued up to and payable at normal retirement age (NRA). The purchaser was liable only for the early retirement enhancements (which were not provided for in the deferred pension from the seller's scheme).
- The purchaser only had to bear the cost of any early retirement benefits until NRA. Benefits paid after NRA, to support the recipient after retirement, constitute "old age benefits" so do not pass under TUPE.

The main effect of *Beckmann* and *Procter & Gamble* has been in the due diligence process. The purchaser's advisers must look very carefully at the scheme documentation to see what (if any) redundancy or other early retirement enhancements it may have to replicate. The purchaser may ask the seller to indemnify it for any *"Beckmann"* liabilities. In practice, sellers expect prospective purchasers to factor the cost of any redundancies (including the full pension scheme cost) into their bid prices.

Business purchase – target's employees are provided with personal pension schemes

The obligation to provide and contribute to a personal pension scheme will pass under TUPE (please see the box above) to the purchaser if target's employees had a contractual right to the arrangements. If not, the purchaser can provide alternative benefits.

ISSUES FOR SELLERS: DB SCHEMES

Trustees of DB schemes, and the Regulator, are likely to be alert to any reduction in the value of the covenant of the sponsoring employers (and any guarantors) which support the scheme. At first glance, the sale of a subsidiary company or a business for full value should not give cause for concern – before the transaction the seller had a subsidiary or business worth £X, after the transaction it has £X in cash. However, concerns may arise in several scenarios, including where:

- the proceeds of sale are distributed as dividends (or to senior executives as bonuses), rather than being used to support the pension scheme or to reinvest in the employer's business;
- the sale was for non-cash consideration (eg shares), which may not be readily realisable or whose value may rapidly change; or
- the company or business sold was a strong generator of income (which could have been directed into pension scheme contributions), which may not have been adequately reflected in the purchase price.

Trustees may decide to carry out a review of the employer's covenant before and after the transaction, to gain better insight into the impact on the pension scheme. Where the trustees are concerned, they may alert the Regulator and may call for additional contributions or the provision of security to support the funding of their scheme.

IMPACT OF DB SCHEMES ON TRANSACTIONS MORE WIDELY

The presence of a DB pension scheme can impact transactions more widely than simply on corporate sales/acquisitions. Common examples include the following.

- **Granting new security**: this could see the pension scheme as a creditor drop down the insolvency priority order.
- **Paying a large/unusual dividend**: monies transferred out of the group (in particular to individual shareholders whose holdings are too low for them to be a target for Regulator action) could weaken the sponsoring employer covenant (and the balance between dividends and deficit contributions is something the Regulator is focused upon – see above).
- **Internal reorganisation**: if value-generating businesses are moved away from the pension scheme through an internal reorganisation, that might weaken the employer covenant (unless there is a legal commitment from other group companies, such as a guarantee). Similarly, a reorganisation might unintentionally trigger section 75 debts.

Where scheme trustees are concerned, they may undertake a review of the employer's covenant strength before and after the transaction, to assess the impact on the scheme.

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