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Essential pension issues for buyers of a company or business

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Pension briefing

HIGHLIGHTS

Pension issues in share and asset sales can be complex, particularly when a final salary (defined benefit) scheme is involved. Buyers of companies have always had to investigate a target company's pension provision as part of their due diligence, particularly in recent times when poor investment returns have adversely affected funding. But the new powers and compliance obligations of the Pensions Regulator have added to the complexities.

This note outlines the different scenarios and actions for the purchaser depending on whether there is an asset or a share sale and the type of pension provision.

PENSION PROVISION: THE BASICS

The liabilities of a Purchaser are different depending on whether an acquisition is by way of a share sale or asset sale. They also vary depending on the type of scheme in which employees of the target employer (Target) participate.

Pension provision by UK employers falls into two main categories. First, an employer can establish an Occupational Pension Scheme through which pensions are provided. Until quite recently, 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 – see box**.** Personal Pension Schemes always provide defined contribution benefits.

Previously, employers of five or more employees who did not provide membership of a qualifying pension scheme had to provide their employees with access to a stakeholder pension scheme (similar to Personal Pension Schemes). An employer did not have to make contributions to a stakeholder pension scheme. From October 2012, the requirement to provide access to a stakeholder pension scheme was replaced by Auto-enrolment, under which all employers, regardless of size, have to enrol workers automatically into pension schemes meeting minimum quality requirements and pay contributions for them. Auto-enrolment is being phased in over several years; each employer has been given a "staging date" based on PAYE size on 1 April 2012.

Key phrases

- **Defined contribution**: a pension scheme 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 accrued fund (including investment returns) is used to purchase a pension (or annuity) from an insurance company or from the scheme itself. The employer does not retain any risk relating to the pension received by the former employee; this will depend on investment performance before retirement and on annuity rates offered by insurers.
- **Defined benefit**: 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 usually depending on the employee's length of service. A typical formula might be 1/60 of final salary for each year of service. Defined benefit pension funds are funded according to actuarial assessments of the liabilities and of the assets that are required to meet those liabilities. There are other defined benefit schemes that are not as common as final salary schemes, such as cash balance schemes.

SHARE SALES

The issues that need to be considered on a share sell depend on the specific pension arrangements that Target is involved with. The key scenarios are set out below.

Target's employees are provided with Personal Pension Schemes

Target's obligation to provide and contribute to the Personal Pension Schemes will continue as before.

Target has its own defined benefit Occupational Pension Scheme

If Target has its own occupational pension scheme, that scheme (including all its liabilities) will remain with Target after the acquisition unless alternative arrangements are agreed. The Purchaser will want to understand the current and potential future liabilities attaching to the scheme, for instance:

- The funding position for accrued benefits
- The cost of providing future benefits
- Whether scheme benefits comply with legislation (for instance sex and age equality legislation)
- The powers of the trustee – in particular whether the trustee can cause a Section 75 Debt to become payable (see box)

The Purchaser will want to establish the extent of these liabilities by due diligence (see box). The Purchaser will

typically require warranties and/or indemnities (see box) from the Seller to protect it from unanticipated costs.

Key phrases

- **Due diligence**: the process by which prospective purchasers investigate Target's records and pension scheme documents in order to find out matters relating to value, including the funding and liabilities of the pension scheme in which Target participates.
- **Warranties**: contractual statements by the seller that a particular state of affairs is true (eg that the scheme has always complied with legislative requirements). A breach of warranty will give rise to a successful damages claim if the Purchaser can show that the value of the company acquired is dismissed as a result.
- **Indemnities:** a promise by the seller to reimburse the Purchaser in respect of a particular liability should it arise.

The Purchaser should also give consideration to the power of the Pensions Regulator to issue Contribution Notices and Financial Support Directions (see box) on employers participating in a defined benefit scheme (Target would be a participating employer) and any "associated" and "connected" parties (which the Purchaser and others would be).

The Purchaser will need to consider whether the immediate sale potentially exposes Target and the Purchaser group to action of this nature. An assessment can only be given on a case by case basis but the Pensions Regulator is particularly concerned where an acquisition is funded by secured debt which would rank above the pension scheme on the insolvency of Target. In such circumstances, it is usual to seek clearance from the Pensions Regulator (see box) that he will not use his powers. It is normally a requirement that the scheme receives some benefit (for instance a cash payment) before the Pensions Regulator will issue the clearance.

The Purchaser should also note that in future it will need to give consideration to these powers when it undertakes future activities (for instance if Target was to pay a dividend or provide security for any of its debt obligations).

The Pensions Regulator's anti-avoidance powers

The Pensions Regulator can impose **Financial Support Directions** or **Contribution Notices** on an employer or anyone who is **Associated** or **Connected** to an employer of an underfunded pension scheme. In this way, not only can an employer be responsible for funding a scheme but entities who never agreed to assume a responsibility to the scheme can be made liable.

Contribution Notice: a notice from the Pensions Regulator requiring a sum of money to be paid immediately to the trustees of a pension scheme. The sum could be anything up to the full cost of buying out the scheme's benefits with an insurance company. It can be imposed on those who have been party to an act/omission:

- that was materially detrimental to a scheme’s ability to pay members’ benefits
- the main purpose of which was to prevent a section 75 debt becoming due or being paid (or reduce its amount).

It can be imposed on connected/associated persons (widely defined as in insolvency legislation) which includes directors and employees of an employing company and other companies in the same group. The Regulator must consider it "reasonable" to issue the notice.

Financial Support Direction: a direction from the Pensions Regulator requiring the recipient to put in place a system for supporting the pension scheme. It can be imposed if the sponsoring employer is a service company or is otherwise "insufficiently resourced". It can be imposed on associated/connected companies but not generally on directors/employees.

Clearance: the Pensions Regulator has power to issue clearance statements, confirming that particular circumstances will not attract the issue of contribution notices or financial support directions. If granted, a clearance statement binds the Pensions Regulator not to issue contribution notices or financial support directions in relation to the circumstances described in the application for clearance. Although the clearance procedure is not mandatory, an applicant for clearance is entitled to a determination either way from the Pensions Regulator.

Target has its own defined contribution Occupational Pension Scheme

In relation to a defined contribution scheme, the potential risks are much fewer. Defined contribution schemes do not have funding deficits and are not subject to the Pension Regulator's powers to issue Contribution Notices and Financial Support Directions. However, Purchaser will still be concerned to:

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

Target participates in a defined benefit Occupational Pension Scheme

If Target participates in its group's Occupational Pension Scheme (in other words, it is a scheme in which a number of other group companies participate), responsibility for that scheme will not transfer to the Purchaser when Target is sold unless the parties explicitly agree that this will happen.

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

- Target will cease to participate in the scheme (it may need to serve notice to achieve this)
- Target's employees will stop earning future benefits under the scheme and become deferred members (with a right to draw their benefits from the scheme in the future)
- Target will need to decide on future pension provision (see box)
- A "section 75 debt" (see box) will almost certainly become payable from Target to the scheme.

Future pension provision: employees have contractual right	Future pension provision: employees do not have a contractual right
Target must provide same benefits, or agree variation of contracts with employees. If a scheme is provided, Target will need to consider if employees should be allowed to transfer deferred benefits to it.	Target can provide alternative benefits. The minimum required is Auto-enrolment, if it applies to Target. Changes to pension provision will generally require a 60 day consultation with employees

The Purchaser will also want to consider the Pension Regulator's anti-avoidance powers (although in the context of a sale where Target has paid its debt in full this is unlikely to be an issue) and seek comfort that the scheme was properly run.

Section 75 debts

What is it?

A statutory debt payable to the scheme imposed on an employer of a defined benefit pension scheme.

When is it triggered?

It is triggered if a defined benefit pension scheme does not have sufficient assets to purchase annuities to cover all its liabilities and:

- the employer suffering an insolvency event or voluntarily winds-up
- the scheme starts to wind-up

In addition, in a scheme with more than one employer, where an employer stops employing any active members whilst other employers continue to, a debt will become due.

How is it calculated?

Section 75 debts are measured on a "buy-out" basis: the cost of buying-out the liabilities by purchasing annuities. This is the most expensive basis of valuing liabilities - even schemes which are considered to be adequately funded will often have a deficit on a buy-out basis.

In a scheme with only one employer the section 75 debt will be the difference between the scheme's assets and the costs of securing annuities.

In a scheme with more than one employer, the section 75 debt will be a share of this deficit. In these circumstances it is sometimes possible for a reduced debt to be paid but this requires steps to be taken and the agreement of trustees and sometimes the Pensions Regulator.

Target participates in a defined contribution Occupational Pension Scheme

The issues that arise if Target participates in its group's defined contribution Occupational Pension Scheme are much easier to deal with:

- Target will cease to participate in the scheme (it may need to serve notice to achieve this)
- Target's employees will cease having contributions added to their defined contribution pot and will become deferred members
- Target will need to determine what pension provision to provide for the future - see box.

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

ASSET SALES

Different issues arise on asset sales depending on whether employees are provided with Personal Pension Schemes or Occupational Pension Schemes.

Target's employees are provided with Personal Pension Schemes

The obligation to provide and contribute to a Personal Pension Scheme will pass under TUPE (see box) to the Purchaser if Target's employees had a contractual right to the arrangements. If not, the Purchaser can provide alternative benefits and, as a minimum, must provide Auto-enrolment, if it applies to the Purchaser.

Key phrases

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. But there is an exception to this for Occupational Pension Scheme rights which do not generally transfer. Instead, the Purchaser is required to provide either:

- a defined benefit pension scheme with minimum benefits, or
- access to a defined contribution scheme or stakeholder pension scheme with an employer contribution equal to either (a) that of the employee's (capped at 6% of basic pay) or (b) the transferring employer's contributions for money purchase benefits for the employee.

Auto-enrolment obligations are in addition to (and operate separately from) TUPE.

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 an Occupational Pension Scheme. They cease to earn future benefits under the scheme and become deferred members. The law provides that these employees are entitled to a minimum amount of pension provision after the TUPE transfer but this does not need to reflect the original arrangements - see box.

There are however circumstances where the Purchaser can be required to provide greater benefits:

- where the Purchaser, but not Target, is subject to Auto-enrolment
- 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

- 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 mirror benefits and accepting a transfer of past liabilities.

A 60 day consultation should be undertaken although this is frequently ignored.

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 (ECJ) 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. But the ECJ 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 the High Court offered guidance on some of these grey areas. 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 defined benefit section of P&G's pension scheme.

The issue the High Court had to consider was whether the transferring employees' rights to early retirement benefits transferred under TUPE to the buyer and, if so, what liabilities would be assumed by the buyer and how those liabilities should be valued for the purpose of the purchase price under the sale and purchase agreement.

The High Court held that:

- 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 buyer 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 transfer under TUPE of the full early retirement pension liability would have resulted in "double recovery" or windfalls for the employees; hence the buyer was liable only for the early retirement enhancements (which were not provided for in the deferred pension from the seller's scheme).
- The buyer 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, regardless of the fact that the pension might first have come into payment before NRA.

The main effect of *Beckmann* has been in the due diligence process and this is unlikely to change. 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 and this is likely to remain the position going forward.

This note is written as a general guide only. It should not be relied upon as a substitute for specific legal advice.

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