



Pensions

Key pension issues on a takeover

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This briefing considers issues from an English law and regulatory perspective in respect of defined benefit schemes based in the UK. If you require specific advice about pension schemes based abroad, please speak to your usual Clifford Chance contact.

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Key pension issues on a takeover

Introduction

This briefing aims to highlight the key issues that are likely to arise from a pensions perspective in the context of a takeover bid. There are several types of pension arrangements (defined benefit, defined contribution, group personal pension scheme) that a target company may sponsor but for the purposes of this briefing, we will be focusing on a defined benefit occupational pension scheme (**DB scheme**) because of the funding risks that the bidder is likely to assume.

The structure and administration of defined benefit schemes

Structure

DB schemes are set up under trust and will generally require contributions to be paid by the members, with the balance of cost of providing scheme benefits to be met by the employer (hence these schemes are also known as 'balance of cost' schemes).

In a DB scheme, the risk is on the employer as it has a legal obligation to ensure that the members receive their pre-defined pension benefits as and when they fall due. In other words, if there is a funding shortfall in the DB scheme, the employer will be required to meet it. A DB scheme therefore represents a very open-ended risk to the employer.

Role of trustees



The trustees appointed to administer the pension scheme have a fiduciary duty under trust law to consider the members' best interests which is generally taken to mean their best financial interests.

Their powers to run the scheme are set out under rules of the pension scheme and applicable law. Although they can act in conjunction with the employer (depending on how their respective powers are balanced under the scheme's governing documentation), trustees must ensure that they maintain genuine independence as far as their duties to members are concerned.

Key powers of trustees

On a takeover, trustees of DB pension schemes in the target group will usually need to assess what impact the transaction will have on the strength of the sponsoring employer's

covenant to discharge its obligations to the pension scheme. This is particularly apposite where the scheme is in deficit and the trustees are concerned that the takeover will weaken the sponsoring employer's covenant (i.e. its ability and willingness to fund the scheme going forward). The bidder will wish to understand the key powers of the trustees by reviewing the governing documents of the scheme to assess the trustees' negotiating position.

	Power	Implication
	Do the trustees have the power unilaterally to determine the contributions (see also Funding below) that the employer is required to pay into the scheme?	If the trustees consider that a transaction has weakened their position, they may demand a cash injection into the scheme.
	Is the power to wind up the scheme solely vested in the trustees?	If so, the trustees may have a stronger bargaining position in any negotiation with the employer. Should the trustees decide to wind up the scheme, the employer would be legally required to settle outstanding pension liabilities which are calculated on a buyout basis (see Valuation methods).

Funding

Trustees do have significant powers under statute in relation to the funding of a DB scheme. Among other things, they are required by law to reach an agreement with the employer over key funding decisions including, where relevant, the level of employer contributions, failing which, they can appeal to the Pensions Regulator. As part of this funding process they will need to make an assessment of the employer's covenant, both at the time of the transaction and in the future.



Valuation methods

There are different valuation methods for calculating the funding level of a DB scheme, for example:

Valuation method	Assumptions
Buyout basis	The scheme is wound up on the valuation date and all members' benefits are secured with an insurance company which is then responsible for paying out the promised benefits to members until the last member dies. This is the most conservative funding basis and is an expensive method of valuing pension scheme benefits. Few schemes are funded on this basis
Ongoing basis	The scheme is continuing and all future benefits of members are paid. Note that there is no fixed method for calculating liabilities on this basis – it will depend on the circumstances of the particular scheme (and may change as a result of a takeover)
Section 179 basis	Applies the restrictions relating to the compensation paid by the Pension Protection Fund (PPF), the UK's pensions 'lifeboat' for underfunded DB schemes where the employer becomes insolvent. The "lifeboat" only protects a percentage of members' benefits and therefore this funding basis is less demanding

Although a scheme may be referred to as being 'fully funded', it is important to distinguish the basis for the assessment of funding, as being fully funded on an ongoing basis will not necessarily mean that all members' benefits can be paid out in full as would be the case if the scheme were fully funded on a buyout basis.

The Pensions Regulator

The Pensions Regulator is the statutory body responsible for regulating work-based pension schemes. In particular, it has a number of wide-ranging powers at its disposal to ensure that employers do not avoid their funding obligations in respect of underfunded DB schemes (referred to as the “moral hazard” provisions).

Under the “moral hazard” provisions, the Pensions Regulator has the power to extend liabilities for DB schemes beyond actual employing companies to their “associates” and “connected persons”, including, for example, other members of an employer’s group and substantial shareholders. Given this reach, bidders for target companies with DB schemes in deficit cannot assume that they will be able to ring-fence pension liabilities within the target group.

The Pensions Regulator has statutory powers to require the persons mentioned above to pay into or support a pension scheme. The Pensions Regulator has the power to issue either a contribution notice (**CN**), where steps have been taken to avoid pension liabilities or a financial support direction (**FSD**), where an employer’s resources are below a certain level.

During a takeover, if the trustees are not happy with the assurances offered by the bidder with respect to the pension scheme, they can call on the Pensions Regulator to decide whether further financial contributions are required. It should be noted, however, that the Pensions Regulator will not have a formal role in the negotiations unless the bidder seeks clearance (see **Pensions Regulator Clearance**).

Contribution Notice

A CN, which can relate to a series of acts as well as to a single act, requires the person upon whom a CN has been imposed (which includes both individuals and corporate entities) to pay either the whole or a specified proportion of the funding shortfall (commonly referred to as the ‘employer debt’) in a DB scheme.

The Pensions Regulator has the power to issue a CN where the ‘material detriment’ test is met, i.e. if it is of the opinion that the *effect* (regardless of the intent) of a transaction is to weaken a scheme materially. The scope of the power is potentially very wide.



Financial Support Direction

An FSD requires other companies which have sufficient resources within a group to provide financial support to the DB scheme in circumstances where one company in the group participates in that scheme but is unable to meet its funding liabilities.

This support may include arrangements under which all the companies within the employer's group are jointly and severally liable for the whole or part of the employer debt in relation to the scheme or the holding company of the employer's group is liable for the whole or part of the employer debt. Other forms of support such as bank guarantees will also qualify as financial support.

Although no culpability is required in order for the Pensions Regulator to impose an FSD, it can only do so if it considers it reasonable to do so.

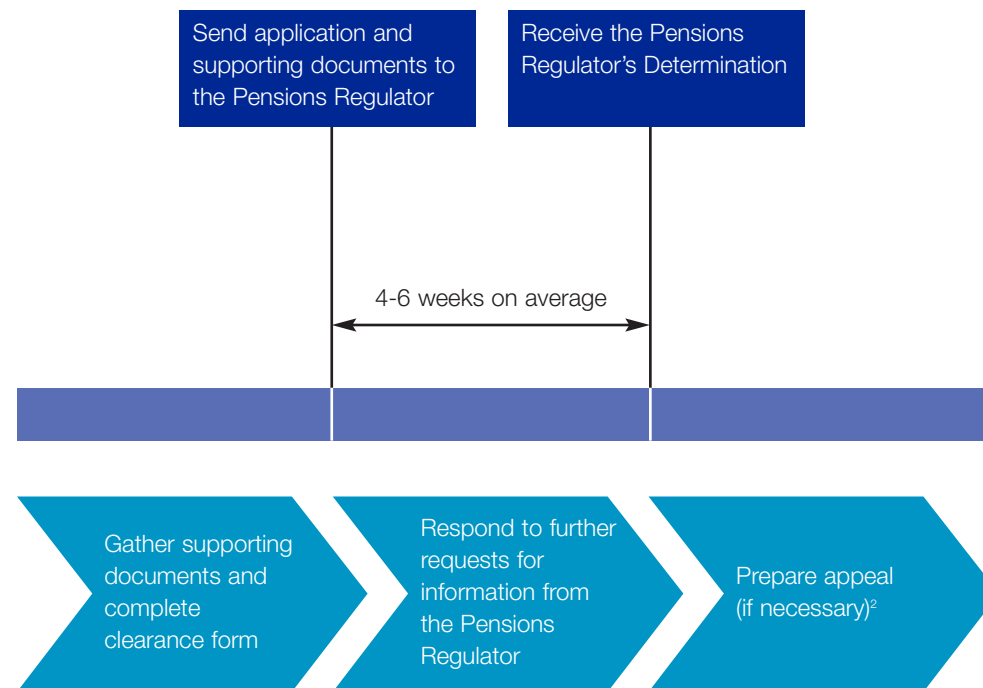
Pensions Regulator Clearance

A bidder or the target board can apply on a voluntary basis to obtain a clearance statement from the Pensions Regulator that it will not issue a CN or FSD in relation to a particular transaction that could be detrimental to the ability of the DB scheme to meet its pension liabilities. The clearance is binding so long as circumstances are not materially different from the contents of the application. Note that the trustees of the scheme will be involved in the clearance process.

A takeover may be detrimental because it impacts on the ability of a sponsoring employer within the target's group to meet its ongoing funding commitments to the scheme. This could be because of the effect of the takeover on the employer's cash flow or balance sheet as a result of the target's dividend policy, intra-group arrangements or debt repayments. A highly leveraged bid is therefore more likely to weaken the sponsoring employer's covenant and at some stage have an impact on funding. A bidder may wish to seek clearance to determine likely future funding levels before the bid is launched.

The Pensions Regulator has published detailed guidance on how the voluntary clearance facility should operate. In particular, the Pensions Regulator expects sponsoring employers to understand the full effect of any corporate transaction on the security of the scheme, to involve and work with the trustees of the scheme from an early stage and to consider whether appropriate mitigation to the pension scheme needs to be made.

Indicative Pensions Regulator Clearance Timeline¹



Notes:

- 1 Actual timescale will depend on a variety of factors, including how quickly the applicant is able to gather the supporting documents for the clearance form, how complicated the relevant transaction is and how busy the Pensions Regulator is.
- 2 An appeal is likely to be unrealistic in the context of a bid timetable.

Conditionality

Bidders are not allowed to make a formal bid conditional on clearance from the Pensions Regulator; this is because the process is voluntary and is not a regulatory requirement. Bidders must therefore obtain clearance (should they opt for the voluntary process) ahead of issuing the firm intention announcement on a bid. Pensions Regulator clearance can, however, be a pre-condition in a possible offer announcement.

Since the introduction of the automatic 28 day put up or shut up (**PUSU**) deadline which requires target involvement to obtain an extension, Pensions Regulator clearance will probably only be something that can be guaranteed to be obtained prior to a firm intention announcement on a recommended bid.

Involvement of pension scheme trustees in takeover bid

Whether or not an application is made for Pensions Regulator clearance, a takeover target should expect the pension trustees of its DB scheme(s) to become involved at some point in the bid process. Pension trustees will usually seek confirmation that the takeover will not have a materially detrimental impact on the target's ability to fund the pension scheme and any deficit over the longer term.

Bidders and targets need to consider at what point to involve the trustees in the process. It is not uncommon for trustees to be brought over the wall before a bid is announced, principally so that the potential bidder has certainty over what approach the trustees are likely to take. Whilst technically the trustees' agreement is not necessary outside any Pensions Regulator clearance process, they do have wide powers in relation to scheme funding and could increase the obligations of the target to fund the scheme if they feel that the covenant of the company is likely to be weakened following the takeover (for example, on a highly leveraged bid) or request other forms of mitigation such as improved priority among creditors.

The UK Takeover Code (the **Code**) contains strict rules on secrecy. An announcement may be required when negotiations or discussions relating to a possible offer are about to be extended to include more than a very restricted number of people (outside those who need to know in the parties concerned and their immediate advisers). This is known as the "Rule of six"; a bidder is allowed to approach up to six parties and, except with the Panel's consent, the pension scheme trustees will count as one such party. The Panel must be consulted if more than 6 parties are to be wall crossed ahead of an offer announcement.

New rights of DB scheme trustees

At the time of the Panel's overarching review of the Code following the Kraft/Cadbury takeover, various respondents suggested that provisions of the Code relating to target employee representatives should be extended to apply to trustees of target's pension schemes.

The Panel's aim was to help ensure that the effects of the offer on the target's pension scheme(s) could be discussed by the relevant parties at an early stage, with the result that any issues which might arise as a consequence of the potential change of control of the company could then be considered by target shareholders and others. Whilst the Pensions Regulator has significant powers, it does not have the power to (i) require a bidder to disclose publicly its intentions regarding the target's pension scheme(s); (ii) require a party to an offer to provide information to the pension trustees; or (iii) allow pension trustees to provide their own opinion on the bid in the public bid documentation. The Panel has stepped in to provide these rights. It should be noted, however, that the new rights do not provide trustees with additional powers to block a bid.

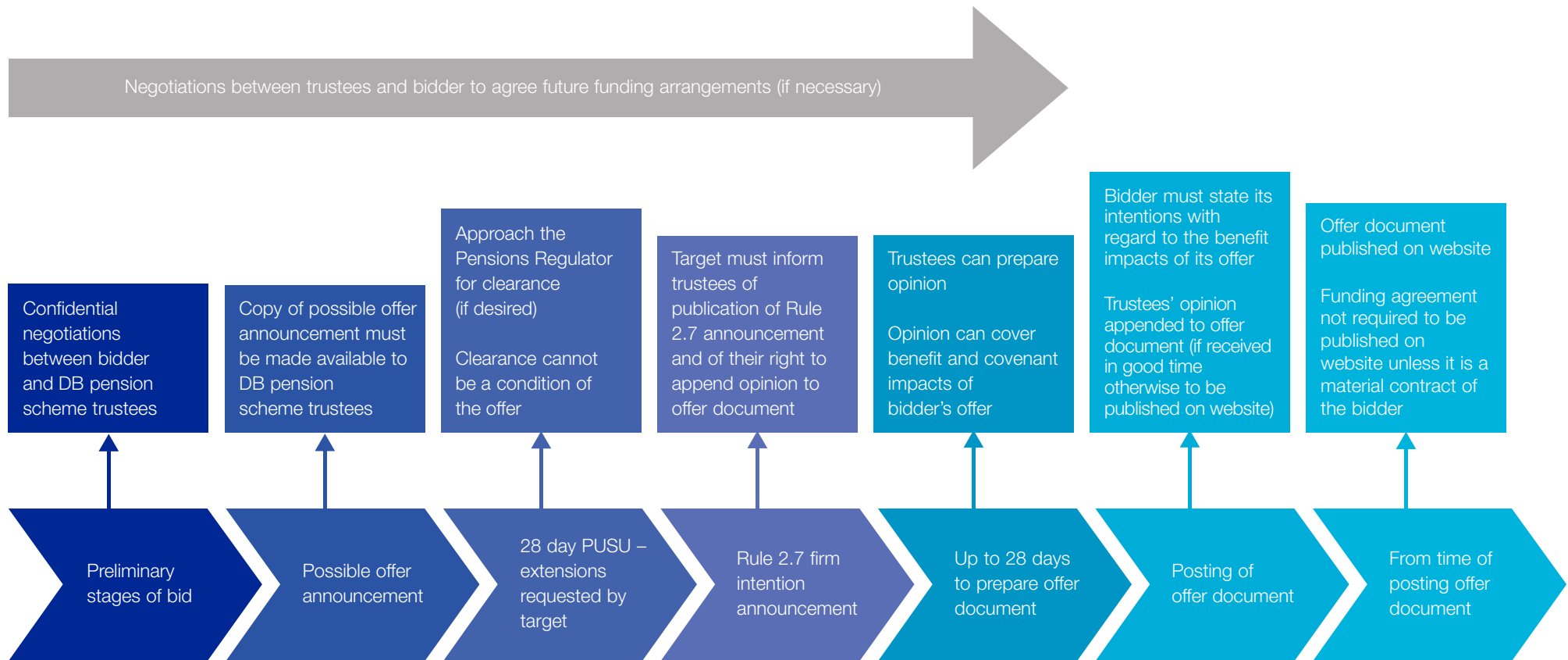
Since May 2013, bidders have been required under the Code to:

- provide pension scheme trustees with the same information regarding the bid as employees receive, for example, being given access to announcements and bid documentation
- provide pension scheme trustees with the right to have their opinion on the effects of the offer on any target DB schemes (which can include the benefit and covenant impacts) to be appended to the offer document (or published on a website)
- include a statement in the offer document of its intentions with regard to the benefit impact of the offer i.e. the impact on employer contributions (including the current arrangements for deficit funding), benefit accrual and the admission of new members.

The Code changes apply to:

- all funded target pension schemes with a defined benefit element irrespective of materiality of the scheme within the target group
- UK and overseas DB schemes of the target on a group-wide basis.

Indicative Pension Issues Timeline



Conflicts of interest

Where one or more directors of the target board are trustees of the target's pension scheme, any conflict of interest that may arise will be a matter for the director(s) concerned, the target company and the pension scheme trustees to resolve.

It is important that the conflicts are appropriately managed as the Pensions Regulator takes a strong interest in expecting these to be resolved at the earliest opportunity and recommends that trustees seek legal advice in those cases where material conflict is identified to ascertain the best way to proceed. It is also recommended that records of advice and minutes of meetings where decisions have been taken should be retained as they could form part of a statutory defence against the imposition of a CN by the Pensions Regulator under the 'material detriment' test.

Glossary

CN	Contribution notice
Code	The Takeover Code issued by the UK Panel on Takeovers and Mergers
DB scheme	Defined benefit scheme
firm intention announcement	bidder's announcement of a firm intention to make an offer under Rule 2.7 of the Code
FSD	Financial support direction
'material detriment' test	The test applied by the Pensions Regulator to determine whether the effect (regardless of the intent) of a transaction is to weaken a scheme materially
possible offer announcement	announcement of a possible offer under Rule 2.4 of the Code
PPF	Pension Protection Fund
PUSU	put up or shut up - a bidder has 28 days within which to clarify its intentions – (i) a "put up" is communicated by way of an announcement of a firm intention announcement; (ii) a "shut up" by way of a no intention to bid statement; or the target can request an extension of the deadline with the consent of the Panel

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