

Defined benefits

A new conversation for financial sponsors
and pension trustees on M&A processes



A new investor–pension trustee conversation

Acquiring a company with a defined benefit (DB) plan has long been a potential stumbling block for financial sponsors during M&A transactions. Unnecessarily so, as **Nicholas Greenacre** and **Edward Jackson** of global law firm White & Case, and **Andrew Vaughan** of UK pensions, actuarial and administration firm Barnett Waddingham, explain.

For potential investors, pension plans, safeguarded by seemingly more powerful trustees, can be one of the most significant elements of a deal. There is a perception among potential investors that trustees attempt to hinder transactions. That perception has been heightened by the uncertainty created following the recent case of *IBM v. Dalgleish*. It is now more important than ever that when investors realise a particular transaction involves a DB plan, they pay due consideration to their relationship with the trustees and engage with them early in the process.

The DB landscape

Legislative, regulatory and tax changes, a volatile macro-economic climate and increased longevity have rendered DB plans an increasingly unattractive proposition for companies and potential investors. This is due to their spiraling and uncertain cost and potential exposure to the moral hazard powers of The Pensions Regulator (TPR).

TPR has wide ranging powers, the purpose of which is to prevent employers avoiding their funding obligations in respect of DB plans. In particular, TPR can issue (i) contribution notices, which require a person to pay either the whole or a proportion of the funding shortfall; and (ii) financial support directions, which require financial support to be put in place for the purpose of maintaining the solvency of the plan.

Companies themselves, as well as investors, are increasingly keen to divest themselves of burdens inherited from a more paternalistic age when interest rates were higher and lives shorter. Struggling grocery empire

Tesco is set to close its DB plan from November, replacing it with a DC plan. Indian multinational Tata Steel intended to close its plan only to change its mind due to the threat of major strike action orchestrated by the unions.

Around 6,000 companies in the UK participate in DB plans, with total liabilities of £1.5 trillion and assets of around £1.2 trillion. These plans vary in size from the BT Pension Scheme—the UK’s largest private sector pension plan with more than 300,000 members and approximately £40 billion of assets—to smaller plans with only a few thousand members and a few million pounds of assets.

“Early engagement with the trustees is essential

The financial press reports that pension deficits reached a record high at the start of 2015. Funds have been driven into the red by the long-term low interest rates and the effect of quantitative easing pushing down the bond markets, as well as increasing longevity.

Defined contribution (DC) plans are increasingly more prevalent in the market place than DB plans. The employer’s liabilities under DC plans are limited to the contributions they are required to make and the costs of the plan.

The third annual Big Schemes Survey of private sector DB plans in the UK with assets in excess of



£64.7bn

Aggregate DB plan deficit for the FTSE 350 companies in 2014

Source: Barnett Waddingham "Impact of pension plans on UK business," August 2015



£7.2bn

Aggregate DB plan deficit reduction contributions in 2014

Source: Barnett Waddingham "Impact of pension plans on UK business," August 2015



Only 19%

of final salary plans are open to new members

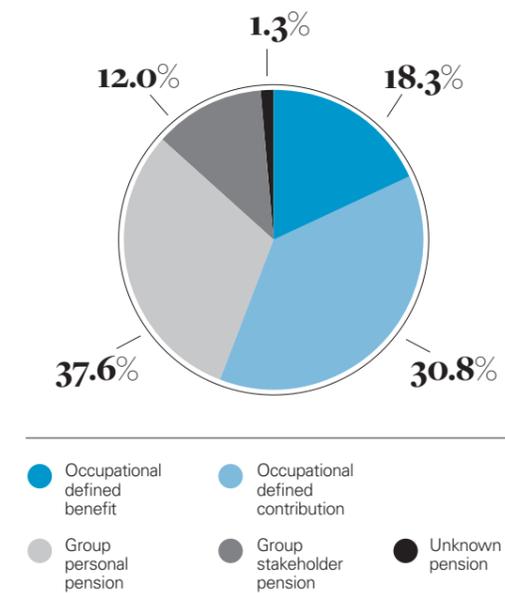
Source: Barnett Waddingham Big Plans Survey: £1bn+, 2014

£1 billion, from pensions specialists Barnett Waddingham, provides a snapshot of the scene. Of the 170 plans covered, 81 per cent were closed to new members, of which approximately a third were also closed to future accrual. Many companies are deciding to close their DB plans to future accrual, which in itself is an expensive and, as can be shown by the IBM case, a complex and risky process. It is made even more complicated in certain cases by a category of employee known as a “Protected Person”, associated with businesses that used to be part of a government-owned industry. Protected Persons are entitled to the accrual of pension benefits on the same generous basis as those they enjoyed at the time of privatisation, and legislation safeguards these benefits, which can only be amended in limited circumstances.

Trustee intervention

There are few actions that a company can take in respect of a DB plan without the support of its trustees. Trustees’ powers include (i) adopting a more conservative investment strategy; (ii) withholding agreement to employer contributions (some may even have a unilateral power to determine contributions), with the threat of TPR intervention; and (iii) in some circumstances the nuclear option of winding up the plan and triggering a Section 75 debt (this is payable as a lump sum and is calculated by reference to the “buy out” cost, which is the cost of securing the members’ benefits by purchasing an annuity from an insurance company). So getting them on board with any proposed change is essential.

UK private sector employees with workplace pensions by type of pension, 2014



Source: Annual Survey of Hours and Earnings (ASHE) - Office for National Statistics

The trustees’ aim in negotiations is generally to secure clearance of the deficit (on the statutory basis) as soon as possible, ideally on completion of the transaction, and/or to leapfrog unsecured creditors in ranking priority with some form of guarantee or other security.

The trustees appointed to administer a pension plan have a statutory duty to safeguard the members’ financial interests. Where a company is being acquired, they will need to assess the impact of the transaction on the employer’s covenant to discharge its obligations under the pension plan and ensure the deal is in the best interests of the members.

While the role of trustees is fundamentally unchanged, the regulatory environment and legislation regarding funding and governance of plans, coupled with the fluctuating financial markets, have put more pressure on trustees to make sure plans’ assets cover their liabilities. This has resulted in a more cautious and interventionist approach from trustees.

Traditionally, trustees were viewed as custodians of purely past (rather than future) pension benefits. However, the IBM case may result in trustees seeking more assurances

around members’ “reasonable expectations” and the underlying motives behind the business case for change. While trustees cannot explicitly block a deal from going ahead, they are able to create difficulties in the future, which can lead to increased costs for an investor—for example if the trustees switch to a more conservative investment strategy, thereby increasing the deficit and requiring a higher contribution.

IBM implications

The backdrop to the IBM case was a purported suite of changes by the employer to IBM’s DB plans, including closure to future accrual. The High Court considered the duty of good faith owed by employers to their employees and pension plan members, and last year ruled that IBM had breached this duty.

In the judgment, which IBM is appealing, Mr Justice Warren held that the conduct and statements to members by IBM in previous plan restructurings had created “reasonable expectations” about the future of the DB plans, which no reasonable employer would have ignored, and IBM had also misled members during the consultation process prior to the plan’s closure to future accrual, having decided in advance what it was going to do. The judge has subsequently ruled that an employer that closes its plan to future accrual without complying with the appropriate consultation process can be made to unravel those changes, and damages can be awarded for the failure to conduct a proper consultation.

While the IBM case concerned a consultation process that was held to be flawed, the case has wider implications for those acquiring a business and then looking to change pension benefit provisions. It demonstrates the need to be mindful of any previous communications to employees and the dangers for an employer seeking to renege on any assurances given in such communications that could be seen to give “reasonable expectations” as to what will happen to the plan in the future. This judgment has given trustees an extra string to their bows when it comes to the negotiating table, as the IBM case suggests that trustees have a role in protecting members’ future pension benefits as well as their accrued rights. We have found that some trustees’ advisers have cited this

case as a means of attempting to leverage more favourable terms in a transaction.

As the IBM case is being appealed, there is still much uncertainty as to what the connotations are and how they affect the trustee’s role. Until certainty is reached, it is likely that at the negotiating table trustee advisers will still continue to quote “reasonable expectations” to attempt to get the best terms for their plan. Parallels can be drawn with the introduction of the pension “moral hazard” powers in the Pensions Act 2004. These powers were introduced to impose financial deterrents on an employer to prevent them from avoiding their financial obligations to a DB plan.

Whilst the legislation is widely drawn and uses subjective “reasonableness tests,” it does not give trustees themselves any power to prevent a transaction from taking place. However, on the introduction of the powers, trustees felt empowered and used the uncertainty as to the extent of their and TPR’s powers to their advantage in negotiations, acting as if they had a legal power to prevent deals from happening. This ultimately became a self-fulfilling prophecy, and the parties to transactions would often end up being forced into meeting trustees’ demands in order to facilitate the deal.

Open and transparent

Early engagement by the investor with the trustees is essential, as is a meaningful discussion demonstrating how any proposals can benefit the business and, in turn, the plan. If the investor is looking to make changes to the plan, they must carry out an open and transparent consultation, which should be a genuine consultation and not merely a *fait accompli*.

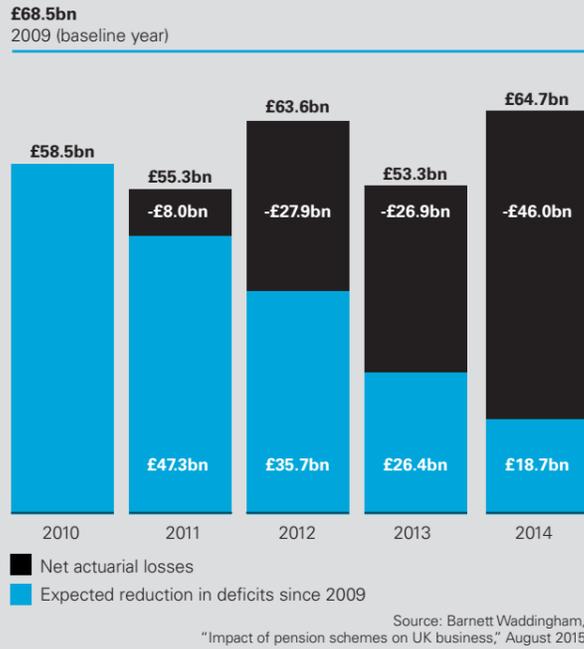
In particular, TPR expects employers to: (i) provide as much information before the consultation as possible; (ii) allow an appropriate time for members to respond; (iii) listen to member responses before any final decisions are made; and (iv) for there to be no coercion or inducement run from abroad.

It is important for an employer to appreciate that the IBM case was fact-specific and that by following the approach suggested above an employer should not be afraid to push back in negotiations with trustees when the concept of “reasonable expectations” is raised.

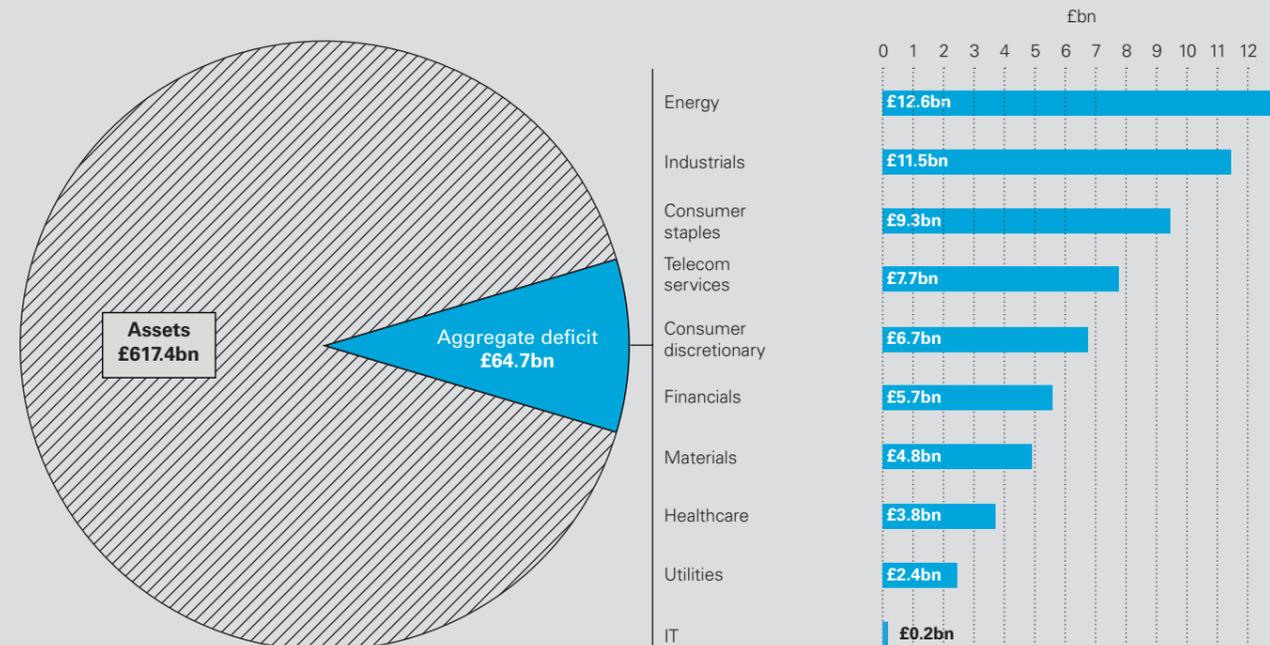
The UK DB pension deficit

With low interest rates and QE pushing down bond yields, UK DB pension plans have seen deficits rise in recent years

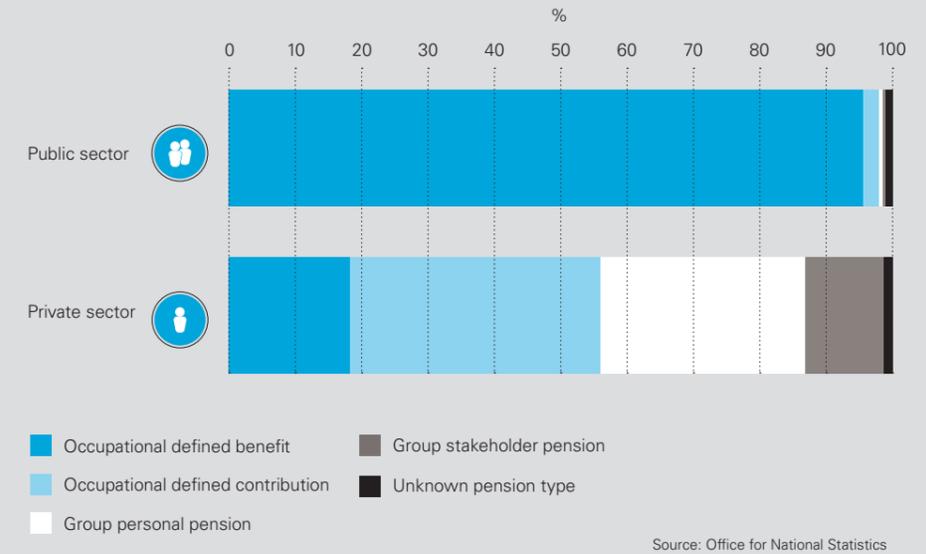
Progression of aggregate DB plan deficit since 2009



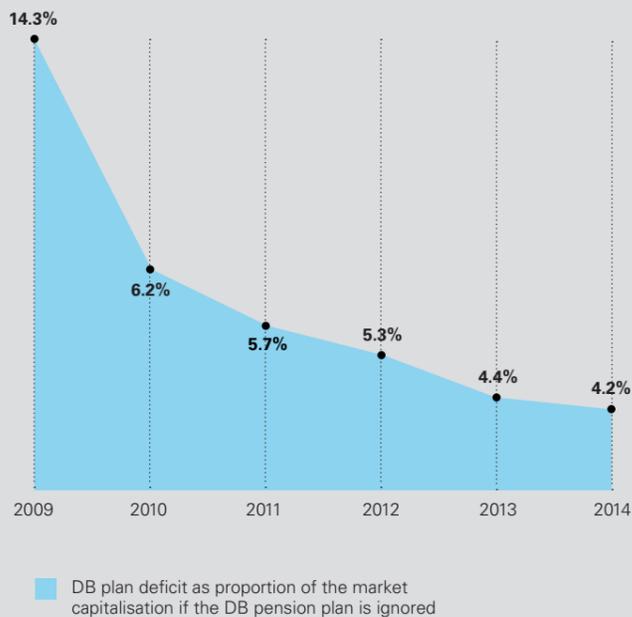
Aggregate DB plan deficits by sector



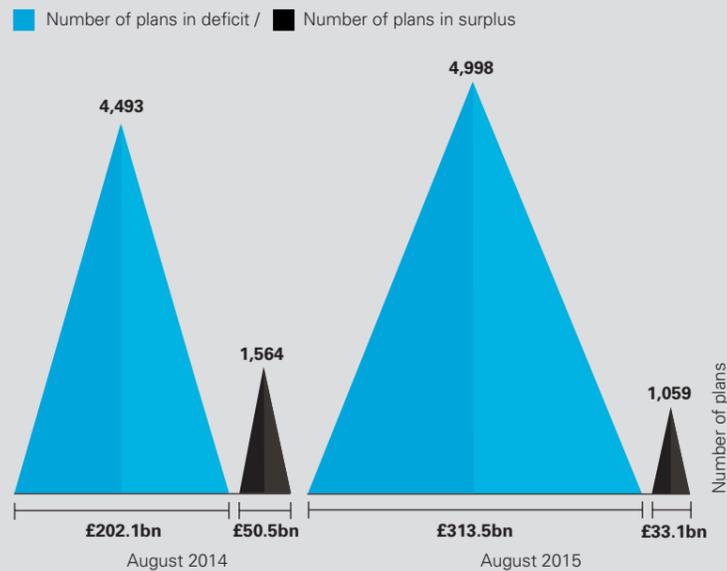
Employees with workplace pensions: percentages by type of pension, 2014



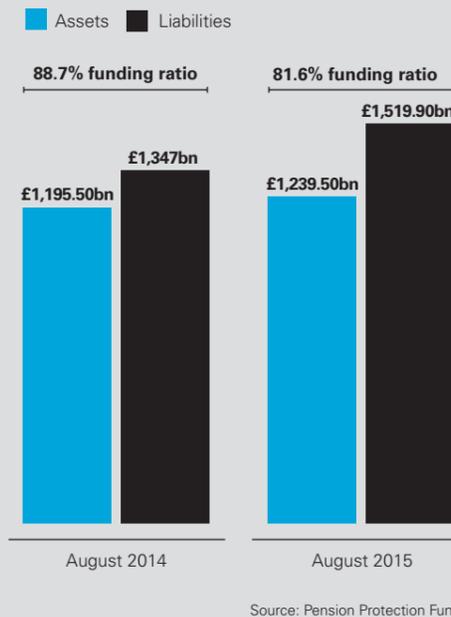
Impact of DB plan deficits on company balance sheets



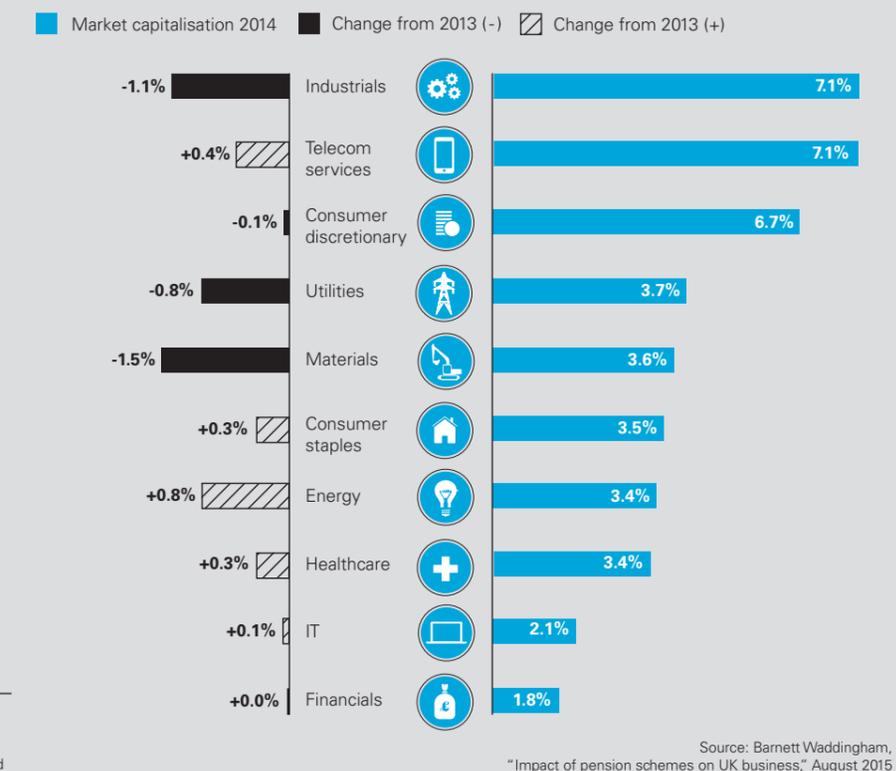
Deficit/surplus among plans in the PPF 7800 index



Funding comparison among plans in the PPF 7800 index



DB plan deficits as % of market capitalisation by sector



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