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PENSIONS ISSUES IN EUROPEAN MERGERS AND ACQUISITIONS

Pensions-related issues have long been a major concern in M&A transactions in the United States. Issues relating to funding can color the attractiveness of a transaction, and liabilities relating to multi-employer plans and to postretirement medical expenses can have a significant effect on the economic viability of the transaction.

Pension obligations continue to cause problems, particularly given growing longevity, which gives rise to significantly increased costs. The growing global trend towards more disclosure of pension liabilities in company accounts has also moved pensions further up the agenda in corporate transactions.

These matters are of growing concern across Europe, which is experiencing both increased longevity and enhanced disclosure requirements. However, the particular issues are very much country-specific, and it is important to be aware of what particular issues may arise in any specified jurisdiction on an international M&A transaction. The purpose of this *Commentary* is to give a brief overview of the pension provision in a number of European jurisdictions and the issues to be alert to in a transaction involving pension plans in one or more of these jurisdictions.

STOCK SALES

Pensions-related issues arising in stock sales vary significantly between different jurisdictions. The summaries below give an indication of the type of pension provision and the major issues that arise in stock sales in several European jurisdictions.

United Kingdom. The United Kingdom is most like the United States in terms of benefit provision. As in the U.S., businesses in the U.K. that provide pensions usually do so through a trust held separate from the company's assets and, as in the U.S., the company has obligations to ensure the pension plan is properly funded following regular plan valuations, which in the U.K. are carried out every three years.

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The U.K. Parliament has closely followed ERISA in its recent reform of pension funding and, in particular, established a Pensions Regulator and a Pension Protection Fund, which have between them powers very similar to those of the Pension Benefit Guaranty Corporation. However, some of the powers are significantly more expansive, as the U.K. is eager to avoid the deficits that the PBGC is presently facing.

Any acquisition of a U.K. company with a defined-benefit pension plan may raise significant issues. It is worth obtaining local actuarial advice as to the funding level of the plan, as the plan valuations may not be accurate. This is not only because the valuation is triennial and therefore may be very out of date, but because the basis for agreeing valuations changed in 2005 and is significantly more onerous and less predictable as a result.

In addition, the U.K. Pensions Regulator has the power in a number of circumstances, including where it believes the plan sponsor is insufficiently resourced to meet its pension liabilities, to bring a direction against any group company requiring it to fund the pension plan. Group companies and shareholders that may be subject to this requirement include non-U.K. companies and, in fact, the Pensions Regulator is in the process of issuing one such direction against Sea Containers Ltd., a Bermudan company that is presently in chapter 11 bankruptcy proceedings in the United States.

In order to limit the risks from the Pensions Regulator, it is common practice for the purchaser to seek clearance from the Pensions Regulator as a condition of closing. Sellers can be reluctant to agree to clearance, as the Regulator often asks for a payment into the plan, which is usually deducted from the purchase price, in order to grant clearance. If clearance is not granted, the sale may fall away, and the seller has simply alerted the Pensions Regulator to potential problems in its pension plan.

In the U.K. it is common for a group of companies to have a multi-employer pension plan among them. This should be distinguished from U.S. multi-employer plans, which are industrywide, as U.K. plans usually relate only to companies within a group. If the acquisition does not involve all the companies within the group, it is likely that the plan will remain with the seller. In these circumstances, the liability of the target company to the pension plan, measured as a share of the plan deficit on an annuitized or "buyout" basis, becomes immediately due to the plan. This cost can be very significant, usually several times greater than the accounting deficit as shown on IAS19, and can render the transaction uneconomic. It is possible to agree with the plan trustees to pay a lower amount only, but it can be very difficult to reach agreement, and obtaining the requisite approval of the Pensions Regulator can be time-consuming.

In conclusion, an acquisition that involves a U.K. defined-benefit pension plan should focus on these issues early, as the costs may be significant and it may be appropriate to carve out the U.K. part of the business from the transaction to avoid these issues. Otherwise, early discussions with the pension plan trustees and, where appropriate, with the U.K. Pensions Regulator will be necessary to ensure a smooth transaction.

France. In France, most pension contributions are made by way of mandatory contribution to a national social security system that also covers health care and welfare benefits. The contributions are very significant but are a standard cost of employing staff in France and should be reflected in cash flow. Due diligence is important to ensure these costs are understood.

The major concern in France will relate to senior employees, who are often provided with a top-up pension. These benefits can be very generous, although they are tax-advantageous. Appropriate due diligence is necessary to understand the extent of these liabilities and costs.

Germany. There are five different types of company pension provision in Germany, but the most significant, particularly in the context of M&A transactions, is the direct commitment. A direct commitment is an unfunded contractual promise between the employer and the employee to provide a pension. The pension liability is backed by the assets of the company and the liability is actuarial, assessed on what is commonly referred to as "the book reserve method." This effectively is a "pay as you go" scheme, which enjoys tax advantages to the extent that corporate assets are required to guarantee the liability. Alternatively, the pension may be provided through direct insurance or through an independent support or pension fund.

Direct commitment pensions can, in particular, cause significant problems in M&A transactions because the provision in the company financials for pension liabilities may not necessarily be calculated on a basis similar to that used in the United States or the U.K. Because the book reserve method involves a calculation of liability on a statutory basis that gives rise to tax deduction, it is not in the interests of the authorities for the liabilities to be overstated. Accordingly, liability calculations are frequently significantly lower than they would be in the United States. This can cause problems in international transactions, where the liability is being compared between jurisdictions.

In a stock acquisition, a purchaser will assume all liabilities for pensions for present and past employees and therefore must be aware of the costs that will be incurred. If provision prior to the transaction had been through a pension fund or support fund, this may cease to be available upon closing of the acquisition if the target company moves out of the appropriate group, and a new form of funding will be required.

Following acquisition, it is often extremely difficult to make changes to the future provision of benefits offered by the German company, and changes to the benefit structure, even if made, may be at risk from a challenge by employees at a much later date. As a result, amending benefits in the acquired group in order to conform to the acquirer's global benefits policy can be particularly problematic.

Italy. As with France, in Italy there are compulsory contributions to be made to a national social security system to provide for pensions and other social securities. In addition, the employer or the employee may make voluntary contributions to supplementary pension schemes. As is the case with France, it is important to be aware what, if any, voluntary contributions are being made.

It is also important to ensure that contributions have been made when due by the seller. Contributions that are required can be very significant, and a liability for back payments can affect the value of the business.

Belgium. Belgium has a social security system, coupled with employer pension schemes and the opportunity for private pension provision by individuals. Employer pension schemes cover only about one-sixth of the workforce and have traditionally been available to higher-paid, white-collar workers. Recent legislation has attempted to increase participation in these schemes and make them more widely available to workers.

In a transaction, two major issues may arise. The first is the common concern about plan funding. In particular, until the legislative changes of 2003, the regulation of the funding by companies of their pension promises to employees was limited. This means that several companies still have historical liabilities that have not been fully funded, significantly affecting the value of these companies.

Second, if the acquirer already has Belgian employees, it is required to ensure that benefits for its existing and new employees are equivalent, to avoid claims of discrimination. At the same time, neither group's benefits may be reduced. As a result, benefits consultants and lawyers must ensure that the benefits are equivalent but not reduced, requiring some complex structuring to be put in place.

ASSET SALES

Asset sales, as opposed to sales of stock, have a number of additional concerns that need to be considered. There are significant differences with respect to European asset sales compared to those carried out solely in the United States. In particular, European employees automatically transfer employment to the acquirer of the business to which their employment relates, and there is no opportunity to dismiss employees by not transferring them. As a result of the European Union's Acquired Rights Directives, employees who are transferred in this way enjoy particularly strong rights to the same terms and conditions of employment, and it is particularly difficult to dismiss them without the risk of claims for unfair dismissal in these circumstances.

Despite the fact that this obligation arises as a result of European legislation, the treatment of pensions on asset sales varies significantly between jurisdictions. Particular difficulties arise in three of the jurisdictions we have referred to above.

United Kingdom. In the United Kingdom, it is not necessary to replicate an occupational pension plan—that is, one

provided under a trust—for employees transferred in conjunction with an asset sale. Instead, employees who had enjoyed occupational pension provision prior to the transfer are given the right to a contribution of up to 6 percent of salary matching their own contributions into either a personal pension plan or an occupational plan.

This relatively simple situation is complicated by a number of European Court of Justice cases of the last decade. These cases held that the exclusion from the Acquired Rights Directives, which permitted the U.K. legislature to exclude occupational pensions from the rights to be provided to transferring employees, does not extend to benefits provided on early retirement or redundancy through the pension plan because these are not benefits provided on old age, disability, or death. As a result, there is very little clarity as to what should happen to these benefits. Many occupational pension plans do not provide any enhanced benefits on early retirement or redundancy. For those that do, however, there is apparently a right for employees to continue to accrue benefits only to be paid out in those specific circumstances (although it is not clear exactly which benefits should accrue).

The significant level of doubt as to the meaning of these cases, coupled with the potential for a large liability should a successful claim be brought, places the purchaser at considerable risk. Consequently, it is usual market practice for a purchaser to ask for an indemnity from a seller in respect of this liability, and some such indemnity is ordinarily provided.

Germany. Asset sales can be very unattractive to the seller because, although liability for active members transfers to the purchaser, the liability for the deferred and pensioner members of the plan (*i.e.*, those no longer employed) remains with the seller. It is not possible, even with the agreement of both parties, to transfer liabilities for the members who are no longer employees, as the members themselves have not consented to the transfer. As a result, it may be unattractive to sell a business by way of asset sale in Germany, and this will affect the attractiveness of any purchase price offered.

Italy. Liability to make payment either to the national social security system or to private pension funds vests jointly in the seller and the purchaser. Therefore, a purchaser is primarily liable for the previous defaults by the selling employer in failing to make payments. These provisions cannot be altered by the contracting parties and, accordingly, this liability will remain with the purchaser as well as the seller.

SUMMARY

European pensions issues can be of significant concern in M&A transactions and may affect decisions as to both the price and the structure of the transaction. As pension liabilities increase and regulations become more complex, this will likely remain the case for the foreseeable future.

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