



# Pensions issues in European mergers and acquisitions

Rosalind Connor,  
Emmanuelle Rivez-  
Domont, Georg Mikes,  
Carla Calcagnile,  
Chantal Biernaux and  
Jesus Gimeno analyse  
the varying impact of  
pensions issues in the  
UK, France, Germany,  
Italy, Belgium and Spain  
in relation to share and  
asset sales.

European pension issues can be of significant concern in mergers and acquisitions, and must be taken into account at an early stage, since they may affect decisions as to both the price and the structure of the transaction. As pension liabilities increase and regulations become more complex, this is likely to remain the case for the foreseeable future.

This article examines:

- The reasons why European pension issues have become more important on M&A transactions in recent years.
- The varying impact of pensions issues in the UK, France, Germany, Italy, Belgium and Spain in relation to both share and asset sales.



## Checklist: pensions pricing issues on M&A

Pensions are now a structuring and pricing issue for both buyers and sellers in M&A transactions, and need to be considered early and in detail. In particular, the following pricing risks must be considered:

- ✓ **Transfer of past liabilities.** Past pension liabilities may come across to the buyer, and it is important that this is factored into the pricing. The sale may even accelerate the funding of those liabilities. Similarly, if there is no transfer, the cost to the seller may make the transaction untenable.
- ✓ **Existing deficits for existing plans.** It is important in pricing to ensure that the liability for any existing plan deficit is fully assessed. This is best done by an actuary and, where possible, should be assessed on a consistent basis between jurisdictions. (Liability assessment is based on a number of assumptions and predictions made by the actuary and therefore is not a guaranteed assessment of future cost. This may be an issue since the seller's and buyer's actuaries may base their analyses on different assumptions, resulting in very different cost assessments.)
- ✓ **Retention of insurance arrangements.** The buyer may be liable for past or future pension provision without the insurance or savings fund available to the seller. Therefore, the seller may have a financial benefit and the buyer a financial cost from the disposal, which needs to be considered in purchase price adjustments.
- ✓ **Unpaid contributions.** Many jurisdictions make the buyer and/or its group liable for contributions that have not been paid in the past. Even without this, good employee relations may encourage the buyer to pay contributions on which the seller previously reneged. These can be significant and affect cash flow and business value.
- ✓ **Regulatory concerns.** In the UK in particular, it is important to be aware of the requirements of the Pensions Regulator, which may impose liability on the buyer and its wider group within Europe for UK pension liabilities. Regulator agreement and clearance may be necessary for a transaction, and may result in a payment into the fund which will affect the value of the transaction for the seller or the buyer.

### What has changed?

European pensions issues have become increasingly important on M&A transactions in recent years, moving from a minor concern requiring specialist understanding of arcane provisions, to one requiring potentially expensive, specialist advice. This change has been driven by the following factors:

- **Developments in international accountancy practice.** There has been a growing trend globally of increased disclosure of pension liabilities in company accounts. In particular, the changes to the provisions of the international accounting standard IAS19 from 2000 onwards have resulted in a much greater provision for pension liabilities both in profit and loss accounts, and in the net assets on the balance sheet. These provisions generally have been adopted by international groups in Europe, resulting in pension funding and liabilities becoming of increased importance.

As a result, IAS19 has become an international basis for assessing the impact of pensions liabilities on the value of companies and businesses, and it is usual on mergers and acquisitions in Europe for pensions to be assessed in terms of the liabilities and expenses represented under IAS19. However, further analysis is still required to fully understand the pension liabilities of the seller, since the differing pension provision systems in European jurisdictions mean that IAS19 cannot provide the full picture.

- **Increased pension liabilities.** Increased longevity is a growing phenomenon in the Western world and has been instrumental in the rising cost of pension liabilities, and, therefore, the importance of this issue in mergers and acquisitions. Pension plans designed to pay benefits for five to ten years following retirement are now catering for much longer periods and are disproportionately affected by life expectancy changes because of their focus on the end of lives. Local efforts to deal with this have increased complexity in many jurisdictions.

Although these trends are universal, assessment of pension provision is location specific. Therefore, local understanding is paramount to assessing the effects of pension provision in each jurisdiction.

This article looks at pension provision in six key European jurisdictions and the issues that arise on both asset and share sales.

### Share sales

Pension-related issues arising in share sales vary significantly between jurisdictions. The summaries below give an indication of the type of pension provision and the major issues that arise in share sales in each of the selected jurisdictions.

#### UK

##### Main types of pension provision

Private pensions offered by employers in the UK are held in a fund separate from the employing entity by way of a trust. The trust is governed by trustees who have fiduciary obligations in respect of the fund and the employees who have rights under the trust. The trustees have the ultimate power to manage the fund and are not likely to act as requested by the employer without their own analysis and due diligence.

Plans may operate on a defined benefit basis or a defined contribution basis:

- Under a defined benefit plan, benefits promised to plan members are calculated on a fixed basis, usually based on years of service and salary at the time of leaving the plan. The employer is obliged to ensure that the plan is fully funded, and a triennial valuation is carried out to ensure that remedial funding is put in place if necessary. Also, in certain circumstances, for example the termination of the plan, the employer is obliged to fund the plan sufficiently to permit the trustees to buy insurance policies to cover all pension liabilities, at a very high cost, well in excess of the accounting liabilities.

- A defined contribution provides benefits to plan members based on contributions and investment returns, with no promise as to the level of benefit provided. Therefore, such plans do not present the same funding problems as defined benefits plans.

##### The role of the regulators

Recent changes in legislation have brought into existence two public bodies that have powers in relation to private pension plans: the Pensions Regulator and the Pension

Protection Fund. The Pensions Regulator has the power to demand payments into the pension plan direct from any group company of a defined benefit pension scheme in a number of circumstances. The Pensions Protection Fund assumes the liabilities of defined benefit plans when the employing company becomes insolvent.

### Key issues on a share sale

Any acquisition of a UK company with a defined benefit pension plan may raise significant issues.

**Inaccurate plan valuations.** 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 because:

- The valuation is triennial and therefore may be out of date.
- The basis for agreeing valuations changed at the end of 2005 and is significantly more onerous and less predictable as a result. Most importantly, it now requires the agreement of trustees.

Most valuations have shown much larger deficits following the change in legislation in 2005, and if the plan has not been valued since that date, the valuation may be misleading as a calculation of future obligations and liabilities.

**Regulatory intervention.** The UK Pensions Regulator has the power in a number of circumstances to bring a direction against any group company requiring it to fund a defined benefit pension plan. For example, it can take action where it believes:

- The plan sponsor is insufficiently resourced to meet its pensions liabilities.
- A transaction is intended to reduce the chances of a pension liability being paid in full. Therefore, a buyer with fewer assets or a lower credit rating than the seller may be at risk of such a claim.

Group companies and shareholders that may be subject to the Pensions Regulator's actions include both UK and non-UK companies. For example, the Pensions Regulator is in the process of issuing a direction against Sea Containers Limited, a Bermudan company that is presently in Chapter 11 bankruptcy proceedings in the US. Although there is some dispute about the possibility of other jurisdictions upholding the Pensions Regulator's orders, the regulator itself has continued to assert that it does

not see this as a specific difficulty, particularly within the EU where the Brussels Regulation applies (*Regulation (EC) No. 44/2001 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters*).

**Limiting the risk of regulatory intervention.** To limit the risk of regulatory intervention, it is common practice for the buyer to seek clearance from the Pensions Regulator as a condition of closing. Sellers may be reluctant to agree to clearance because:

- The Pensions Regulator often asks for a payment into the plan, which is usually deducted from the purchase price.
- If clearance is applied for but not granted, the sale may fall away and the seller has simply alerted the Pensions Regulator to potential problems in its pension plan.
- Clearance can be time-consuming, involving the Pensions Regulator canvassing the views of the plan trustees. Obtaining the agreement of both the trustees and the Pensions Regulator can take several weeks.

**Group plans.** In the UK, it is common for a group of companies to have a single pension plan covering all employees. If an 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 target company will usually leave the plan on the sale, resulting in its share of the annuitised liability to the pension plan becoming immediately payable. This cost can be significant, usually several times greater than the accounting deficit as shown on IAS19, making the transaction uneconomic. It is not uncommon for this amount to be larger than the consideration for the whole transaction.

At present, it is only possible to avoid this liability if an agreement is entered into with the plan trustees to pay a lower amount, with a guarantee from another party. The approval of the Pensions Regulator must be sought and this will require the parties to demonstrate that the agreement increases the chances of pension liabilities being paid in full. Obtaining approval can take several months. Following a number of delays, new regulations are expected shortly to provide other options, all of which will require the consent of the trustees and/or the Pensions Regulator. Without that consent, the debt will become due on the sale.

**Timing.** An acquisition involving a UK defined benefits pension plan should focus on the above issues early in the transaction, as the costs may be significant and it may be appropriate to carve out the UK part of the business to avoid these issues. Otherwise, early discussions with the pension plan trustees and, where appropriate, with the UK Pensions Regulator will be necessary to ensure a smooth transaction.

## France

### Main types of pension provision

Most pension contributions are made by way of mandatory contribution to the national social security system, which also covers health-care and welfare benefits. The contributions are significant, but are a standard cost of employing staff in France, and should therefore be reflected in cash flow. Due diligence is important to ensure these costs are understood and factored into staff costs. A transaction in relation to a French employer will not alter these contribution rates and therefore historic due diligence should be sufficient.

### Key issues on a share sale

The major pensions issue relating to mergers and acquisitions involving a French employer will relate to senior employees who are often provided with a top-up pension. These benefits are provided by the company to enhance the state provision, generally on a defined contribution basis. There are significant tax advantages to these pensions but, as they can be generous, the cost can be substantial. Appropriate due diligence is necessary to understand the extent of these liabilities and costs.

## Germany

### Main types of pension provision

There are many different types of company pension provision in Germany, the most significant of which, particularly in the context of mergers and acquisitions, is the direct commitment. A direct commitment is an unfunded contractual promise between the employer and the employee to provide a pension, with no third party involvement. The assets of the company back



## Comparative table: treatment of pension rights on business transfers in the EEA

*PLC Pensions*

### Background to the acquired rights requirements

For many years, European legislation has aimed to protect employees following the transfer of their employer's business to a new owner. In 1977, the Acquired Rights Directive 77/187/EEC (*ARD 1977*) was enacted to ensure that the laws of the member states safeguarded employees' rights on the transfers of undertakings, businesses or parts of businesses (as opposed to the sale and purchase of the target company's shares). The original directive was amended by Directive 98/50/EC and then repealed and replaced by Directive 2001/23/EC (*ARD 2001*).

Article 3 provides that the transferor's rights and obligations arising from a contract of employment (or from an employment relationship existing on the date of a transfer) should be transferred to the transferee. Additionally, the transferee should continue to observe the terms and conditions agreed in any collective agreement on the same terms that applied to the transferor under that agreement.

But the *ARD 2001* (in similar fashion to its predecessor) specifically excludes occupational pension schemes from the general principle that the terms of the transferring employees' contracts of employment survive the sale of a business. Paragraph 4 of Article 3 provides that the provisions concerning the automatic transfer of employment rights shall not apply to employees' rights to old-age benefits "unless member states provide otherwise".

### Treatment of pension rights on business transfers: national legislation

Different member states (including the European Economic Area (EEA) states) have adopted different approaches in relation to Article 3 of the *ARD 2001*. Some states have written the pensions exception into their national law, for example, the UK. Others have required that supplementary pension rights receive the same protection on a business transfer as other employment rights that transfer. The table below summarises the treatment adopted in each EEA state (except Romania and Bulgaria). Comments on variations in treatment in certain member states are also included.

the pension liability and the liability is actuarially 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. Germany contrasts with the UK model, in that there is no obligation on the employer to set aside specified funds for its pension liability. Also, the liability for the pension may have become over-proportional in comparison to a business downsized over the years.

Where the pension is not granted by way of a direct commitment, there will always be some element of third party involvement, for example, in case of the direct insurance, an insurance company. Where a support fund is used, the fund may be a commercial fund that is open to most or all German employers, or one exclusively set up by the employer or the employer's group for its own employees. The precise details of these third party arrangements will be decisive factors in determining how easy (or difficult) it will be to stay in the sellers' system, or to have assets transferred out into another system.

Generally, German pension provision is provided on a defined benefit basis. Pure defined contribution schemes are not permitted, since the employer must guarantee at least the pension value equal to the sum of the amounts paid into the scheme.

### Key issues on a share sale

**Valuation.** German direct commitment pensions can cause significant valuation problems for foreign buyers, since the provision in the German company financials for pension liabilities may not necessarily be calculated on a similar basis to that used in the buyer's home jurisdiction, for example, the US or the UK.

In particular, the German book reserve method involves a calculation of liability on a statutory basis which gives rise to tax deduction. As a result, it is not in the interests of the authorities for the liabilities to be overstated and liability calculations are frequently significantly lower than they would be in the US or the UK. This can cause problems in international transactions where the liability is being compared between jurisdictions and for buyers coming from other jurisdictions who are used to a different calculation basis.

**Third party pension plans.** In a share acquisition, a buyer will assume all liabilities for pensions for present and past employees and therefore must be aware of the costs that will be incurred. However, if the pension is offered by use of a third party (other than direct insurance), it cannot be assumed that:

- The pension fund or support fund that backed the employer's liability will automatically transfer, as this may be connected to the wider selling group.
- The buyer is automatically entitled to

stay as an external member in such a pension fund or support fund, nor that the fund will transfer assets covering the liability.

In these circumstances, the buyer will have to negotiate to stay in the seller's system, obtain a transfer of funding assets, or a purchase price reduction in light of the pension liability. It may have to run the pension provision with no supporting fund as if it were a direct commitment right from the beginning, or obtain new funding from its own pension or support fund. The loss of the benefit of the support fund should be factored into the consideration paid for the German entity.

**Labour law considerations.** German labour law provisions can make it extremely difficult to alter benefit provision for the future. Even if a pension benefit is changed or amended for future accrual with the consent of employees, there is a risk that they may be able at a future date to successfully challenge the amendment and demand the benefit be treated as if it had continued. As a result, rationalising benefits to fit with the global benefits structures and policies of the buyer may be problematic.

### Italy

#### Main types of pension provision

Italy has a similar pensions system to France. There are compulsory contributions that must be made on behalf of all employees to the National Social Security Institute to provide for pensions and

EEA member state	Do supplementary pension rights qualify as acquired rights that transfer automatically under national legislation?	Comments
Austria	Yes	The transferee can object to the transfer by giving sufficient advance notice
Belgium	No	But supplementary pension rights transfer if part of a collective agreement
Cyprus	No	
Czech Republic	No	National legislation only regulates supplementary schemes that receive state contributions
Denmark	No	No specific provision on the transfer of supplementary pension rights in the national legislation
Estonia	No	
Finland	Yes	Supplementary pension rights are treated in the same way as other employment rights
France	Yes	
Germany	Yes	
Greece	Yes	
Hungary	No	Supplementary pension schemes are not occupational schemes, so no link to the employer
Iceland	No	
Ireland	No	No specific provision on the transfer of supplementary pension rights in national legislation
Italy	Yes	
Latvia	Yes	
Liechtenstein	No	
Lithuania	No	But supplementary pension rights transfer if part of a collective agreement
Luxembourg	No	No specific provision on the transfer of supplementary pension rights in the national legislation
Malta	Yes	
The Netherlands	Yes	If the transferee operates a pension scheme it can choose whether transferring employees have membership of its own scheme or the transferor's scheme
Norway	Yes	The transferee can require transferring employees to remain in their original scheme instead. Also, if membership of an existing scheme cannot be maintained, the transfer must ensure the transferring employees can join another scheme.
Poland	Yes	
Portugal	Yes	
Slovak Republic	No	Supplementary pension schemes are not occupational schemes, so no link to the employer
Slovenia	No	No specific provision on the transfer of supplementary pension rights in the national legislation
Spain	Yes	
Sweden	No	But supplementary pension rights transfer if part of a collective agreement
UK	No	National legislation imposes minimum pension requirements on the transferee (see sections 257 and 258 of the Pensions Act 2004)

*Source: Annex to Commission report on Council ARD 2001/23/EC of 12 March 2001 on the approximation of the laws of the Member States relating to the safeguarding of employees' rights in the event of transfers of undertakings, businesses or parts of undertakings or businesses, 18 June 2007.*

other social security benefits. 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 of what voluntary contributions (if any) are being made.

The ability to make voluntary contributions was recently enhanced with effect from 1 January 2007 (*Legislative Decree No. 252 of 5 December 2005*). Therefore, supplementary pensions are likely to become more common in the future.

**Key issues on a share sale**

It is important to ensure that the seller has made contributions when due. Contributions that are required can be very significant and a liability for back-payments can affect the value of the deal. It may be appropriate to seek an indemnity on this issue from the seller.

**Belgium**

**Main types of pension provision**

In common with many European countries, Belgium provides pensions by way of:

- A social security system.
- Employer pension schemes.
- 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. However, recent legislation has attempted to increase participation in employer pension schemes and make them more widely available to workers (*Law of 28 April 2003 on Occupational Pension Schemes, on the Tax Regime of such Pensions and of certain Additional Benefits concerning Social Security and its Royal Decrees*).

**Key issues on a share sale**

**Plan funding.** Until the legislative changes of 2003, the regulation of company funding of their pension promises to employees was limited. As a result, several companies still have historical liabilities that have not been fully funded, significantly affecting

the value of these companies. Appropriate due diligence, with actuarial advice, may be necessary to assess the affect on the value of the Belgian target.

**Labour law considerations.** If the buyer already has Belgian employees, it is required to ensure that benefits for its existing and new employees are equivalent, to avoid potential discrimination claims. At the same time, neither group's benefits may be reduced. As a result, benefits consultants and lawyers are generally employed to structure benefits for both groups of employees that are equivalent but involve no reductions. This can increase the future operation costs of both the Belgian and the existing company.

**Spain**

**Main types of pension provision**

Spain has a system of mandatory payments into social security funds, similar to those discussed for France and Italy. Also, private pensions in excess of this are quite common.

Occupational pensions are relatively rare as they are heavily regulated and plan investment is jointly in the hands of employers and employees.

As a result, the most popular form of additional pension is employer contributions into employees' personal pension plans.

**Key issues on a share sale**

The buyer will need to continue to provide pension benefits after the acquisition and a proper understanding of the ongoing costs must be obtained to assess the value of the target company. From a legal standpoint, it would be typical to review any existing agreements between the employer and its employees and any pension benefit scheme documentation to verify that the provisions of the scheme comply with those agreed. In addition, if the volume of the private pensions existing in the company is considerable, it would be advisable to have these analysed by an actuary to verify that the economic conditions of the pension plan are adequate.

**Asset sales**

Under a share sale, the employing company is transferred with all employees and their terms of employment intact. However, under an asset sale, employees transfer under the provisions of the Acquired Rights Directives (*Directives 77/187/EEC,*

98/50/EC and 2001/23/EC) (ARD).

The ARD imposes a number of obligations on the parties, including an obligation on the seller to consult with employees about the transfer and any proposed changes to their terms of employment, and greater protections for employees against dismissal. However, the transfer of pension benefits is not necessarily covered by the ARD, which excludes benefits provided on "old age, disability or death".

Despite the fact that this obligation arises as a result of European legislation, the treatment of pensions on asset sales varies significantly between jurisdictions (see also, *Comparative table: treatment of pension rights on business transfers in the EEA*). Particular difficulties arise in four of the jurisdictions considered: the UK, Germany, Italy and Spain.

**UK**

In the UK, it is not necessary to replicate an occupational pension plan (that is, one provided under a trust) for employees transferred under an asset sale. Instead, employees who enjoyed occupational pension provision before the transfer are given the right to a contribution of up to 6% of salary matching their own contributions into either a personal pension plan or an occupational plan. It is possible to provide employees with a defined benefit plan, but this is relatively rare, given the high liabilities associated with such plans.

This relatively simple situation has been complicated by a number of European Court of Justice decisions over the last decade, in particular *Beckmann v. Dynamco Whicheloe Macfarlane Ltd (Case C-164/00)* and *Martin and others v. South Bank University (Case C-04/01)*.

These cases held that the exclusion from the ARD of benefits provided on old age, disability or death, which permitted the UK 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 (since these are not benefits provided on old age, disability or death). As a result, it is not clear what should happen to these benefits on an asset sale.




Many occupational pension plans do not provide any enhanced benefits on early retirement or redundancy. But for those that do, there is apparently a right for employees to continue to accrue benefits to be paid out only 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 claim (should a successful case be brought), places the buyer at considerable risk. As a result, it is usual market practice for the buyer to ask for an indemnity from the seller in respect of this liability, and it is usually provided.

If the sale removes all the employees from a company that has a defined benefit pension scheme, it is likely to result in a payment of the annuitised liability of the company into the plan, dependent on the structure and rules of the plan in question. This liability does not transfer to the buyer, but a liability on the seller may make an asset sale unattractive in the UK.

## Germany

Asset sales may be unattractive to the seller because, although liability for active members transfers to the buyer, the liability for the deferred and pensioner members of the plan (in other words, those no longer in employment) remains with the seller. This is a result of the transfer of undertaking rules (which will only apply to active employees) and strict and inflexible rules on insolvency protection. It is not possible to transfer liabilities for the members who are no longer active employees, even with the agreement of both parties and the deferred or pensioner member. As a result, it may be unattractive to sell a business by way of asset sale in Germany and this will affect the purchase price offered. At the same time, it may be of interest to a buyer only to as-

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<b>Know-how topics</b> - drawn from the index to all information on our website		
Cross-border: acquisitions		<a href="http://www.practicallaw.com/9-103-1077">www.practicallaw.com/9-103-1077</a>
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sume pension liabilities relating to transferred employees, but not individuals it has never employed itself.

As in the case of a share sale, complex issues can arise if the pension is provided through a third party (like a pension fund or a support fund) which belongs to the seller's group and is not open for "external" members.

## Italy

Liability to make payments either to the National Social Security Institute or to private pension funds is an obligation on both the seller and the buyer. Therefore, a buyer may find itself primarily liable for payments which the seller, as the previous employer, has failed to make to the Institute to the extent that the debts result from the mandatory accounting books of the enterprise. The contracting parties cannot alter these provisions and, accordingly, this liability will remain with the buyer as well as the seller.

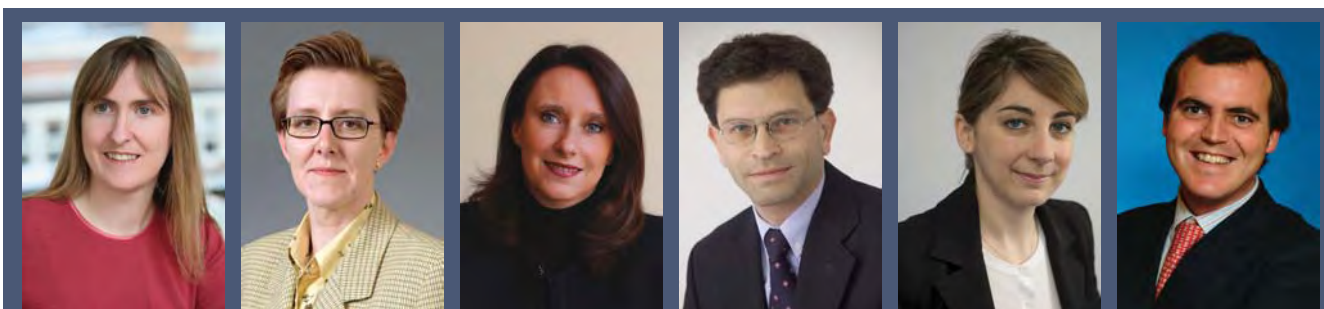
## Spain

In Spain the pension benefits must be replicated on an asset transfer, but the provider and the plan do not necessarily transfer. Time and effort must be put in to ensure that a replicated plan is put in place. It may be that the same provider is willing to replicate or transfer the plan, but this is not automatic.

Also, the buyer and the seller will be jointly liable for three years after the transaction for the seller's obligations in relation to pension provision for unpaid contributions due before the transaction. Therefore, a buyer involved in an asset transfer will have to value not only the cost and time required for a transfer or replication of the plan, but also the possible responsibility that could arise if the seller did not duly comply with the agreements with its employees.

## France

In France supplementary pension benefits must be replicated on an asset transfer, but the provider and the plan itself do not automatically transfer. The buyer will have



Rosalind Connor is a partner at Jones Day, London. Chantal Biernaux, Emmanuelle Rivez-Domont and Georg Mikes are of counsel to the firm based in Brussels, Paris and Frankfurt respectively. Carla Calcagnile is an associate in the Milan office and Jesus Gimeno is an associate in the Madrid office.