ASSOCIATION OF PENSION LAWYERS

By email to supportgroup@thetakeoverpanel.org.uk

The Secretary of the Code Committee of The Takeover Panel
10 Paternoster Square
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28 September 2012

Dear Sirs,

Public consultation paper PCP 2012/2 - Pension Scheme Trustee Issues

We refer to the above public consultation paper and this letter comprises the response of the Legislative and Parliamentary Sub-Committee of the APL.

The APL is a not-for-profit organisation whose members comprise over 1,000 UK lawyers, including most of the leading practitioners in the field, who specialise in providing legal advice on pensions to sponsors and trustees of pension funds and others, including the largest pension funds in the UK. Its purposes include promoting awareness of the importance of the role of law in the provision of pensions and to make representations to other organisations or governments on matters of interest to APL members.

A. General points

1. Are the proposed changes necessary? We note that the decision to propose these changes for consultation was an on balance decision by the Code Committee (2.4 of PCP 2012/2) and we also note that it is acknowledged in the consultation papers that the Takeover Directive does not require the changes that were made in relation to employee representatives to be extended to trustees of pension schemes. Whether ultimately the Panel decides to make these changes is a matter clearly for its judgment in the light of the consultation responses and we do not wish to lobby either for or against but we would like to make some points about the likely practical effect of the changes if made.

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2. We would also note that in practice the statements that have been made since the employee changes made to the Code in September 2011 have often included statements about pension scheme benefits, a topic on which employee representatives will frequently be as able to comment as trustees, at least as far as employees are concerned (see also B1 below).

3. **Market practice?** In the experience of members of this Committee, it is common market practice on any non-hostile public takeover, where the offeree pension scheme is defined benefit and is of a material size in the context of the market capitalisation of the offeree, for there to be discussions between the offeror and the offeree trustees, often involving the offeree board as well, prior to the formal bid being made.

4. This would be the case particularly where the offeror has a more leveraged structure than the offeree does but in our experience it is not limited to those situations.

5. The main purpose of such pre-bid discussions is for the offeror and the trustees to reach agreement as to the funding of the scheme post bid (or at least to reach some understanding as to the offeror's intentions in relation to the scheme). It may also be possible for the trustee to have some involvement in agreement of any security structure although often that is already in place by the time of the discussions and so not readily amendable.

6. It would be common for a binding agreement as to funding to be put in place although it should be noted that the trustees have a number of grounds on which they are likely to be able to come back for more (under the scheme's provisions, statute and the general law of trusts); the offeror would not have such an escape route.

7. **Existing trustee levers if no discussions with offeror?** If the offeror is reluctant to enter into these discussions then trustees have a number of levers at their disposal including in particular:

    - publicity in the press or writing directly to members;
    - writing directly to the offeror's board;
    - invoking powers under the trust deed and rules, if applicable – under some (certainly by no means all) schemes trustees have unilateral powers e.g. to wind-up the scheme, to demand contributions or augment benefits, either generally or specifically on a change of control; and
    - the trustees may ask the Pensions Regulator to get involved either at the time of the bid discussions or thereafter although it is recognised that the ability of the Regulator to take action pre bid can be limited.

8. Where the offeree has **more than one pension scheme** then the discussions could be limited to the main pension scheme or they might, to keep a level playing field, include all the schemes once a decision has been made to include the main scheme.

9. **Defined contribution schemes** would not, in our experience, be considered as in principle their assets should equal their liabilities if funded (and unfunded defined contribution schemes are rare).

10. **What schemes would typically not be caught by current market practice?** The categories that occur to us are:

- offerees with pension schemes which are less material by reference to the market capitalisation of the offeree;
- defined contribution schemes;
- the case of a hostile bid where the offeree board does not facilitate a meeting between the offeree trustees and the offeror and /or there is not time for such discussions to take place and any agreement as to funding to be reached. It may also be said that if the pension scheme is material in the context of the offeree that a hostile bid is less likely if the offeror and the trustees are unable to meet and reach agreement as to funding; and
- the offeror's own pension scheme(s) who may be as concerned as the offeree scheme in terms of diminution of the employer covenant post bid – we mention this last category for completeness and note that it is probably beyond the scope of this consultation.

11. **Would the proposed changes to the Takeover Code result in such discussions and funding agreements being put in place for schemes where they would not be today?**

12. We think this is the right question to ask. We do not see the point of the changes being made to the Code unless they would produce this effect.

13. Part of the answer to this question would involve speculation as to whether offerors would follow market practice or not in the case of a particular takeover. Putting that aside, we have listed below what we think are the arguments for and against the proposed changes to the Code having this effect.

14. We recognise that this is at odds with the description at 2.5 of PCP 2012/2 as to what the Code Committee considers would be the collective effect of the proposals if implemented. In summary, this collective effect is stated to be:

- creating a framework for
  - potentially debating the effects of an offer on the offeree pension scheme; and
  - potentially giving an opportunity to the three main parties to express their views

- with the result that post change of control issues could then be considered by offeree shareholders "and others" (incidentally, we are not sure who is meant by this).

15. Will the offeree shareholders be very interested in the offeree trustees' views? Clearly there is an indirect financial interest in that the offeree pension scheme could affect the bid price or the timing or certainty of completion, but those points already get played out during the course of a bid without the need for the reports suggested.

16. We would therefore challenge this proposed effect as being the appropriate aim for the changes and would suggest that a better aim is that set out at A.11 above. If, on the other hand, the aim is to remain that described at 2.5 of PCP 2012/2, we do not think that the proposed changes to the Code are necessary to achieve this aim.

17. **The points which would support an argument that the changes to the Code are likely to produce the effect at A.11 above:**

(a) The right for the trustees to make a report at the scheme's expense (ultimately at the offeree's expense as it will bear the scheme's costs) will give trustees an extra lever to add to those referred to at A7. above.

(b) The requirement that the offeror makes a statement about its intentions regarding the offeree scheme could, in principle, put pressure on offerors to make positive statements.

(c) Having a mandatory process for these offeror and offeree trustee reports creates a minimum standard of reporting and information sharing in takeover situations for large or small offeree pension schemes, leveraged or unleveraged offerors and hostile or friendly takeovers.

18. **Points which suggest that changes to the Code are not likely to produce this effect:**

(a) There is no requirement for the offeror and the trustee to meet or to agree anything regarding the offeree pension scheme (and indeed it would be difficult to impose one).

(b) As far as the trustee is concerned, their ability to say anything about these topics (assuming both benefits and covenant are to be covered) will depend to a great extent on what engagement there has been. If the offeror has not engaged with the trustee then it will be very difficult for the trustee to say much at all which is not speculative not least because the financing structure of the bid is so important to covenant.

(c) The obligation on the offeror to state its intentions regarding the offeree pension scheme. Even if this were worded more precisely, if the offeror has simply not engaged with the trustee and/or has not received adequate information from the offeree about the offeree pension scheme then the offeror will be able to say in good faith that it has no intentions regarding the offeree pension scheme which

will not be a very useful statement. Even if the offeror has intentions, the wording proposed is not clear whether the intention relates to the benefits of pension scheme members and/or to the ability of the offeree to fund any funding deficit under the scheme post takeover. We suggest more clarity is needed - see further at B1 below.

(d) The obligation on the offeree board to comment on the offeror's intentions – we do not support this proposal – see B2. below.

19. **Trustee role – under the proposed Code changes** The trustees are in any event able to, and do, send communications in the context of takeover bids to their scheme membership. They will want to continue to do so and may even find the obligation to attach a report to go to offeree shareholders as a distraction if it is required to cover only particular topics and differs from the approach that the trustees would take when communicating with their members.

20. The trustees are also fiduciaries as regards their relationship to scheme members; arguably scheme beneficiaries include the sponsoring company (i.e. the offeree) as well but it would be a stretch to say that the trustees owed fiduciary obligations also directly to shareholders of the offeree company. So, it is a rather odd construct from the trustee point of view to require them to produce a circular solely for the benefit of shareholders of their sponsoring company rather than the audience with whom they are primarily concerned which is the members of their scheme.

21. **Size and type of scheme to which the proposals should apply if implemented** We think it is important that, if the proposals are implemented, they only apply where there is a sufficiently material defined benefit scheme in the offeree. They should not apply if there is an immaterial defined benefit scheme or a defined contribution scheme. We simply do not think that the fees, management time and trustee time would be worth it. We make a specific proposal at the end of B1. below.

22. **Group pension schemes** Is it the intention that only pension schemes of which the listed offeror company itself is principal employer should be covered by the proposed amendments? If so, this will produce arbitrary results because it will be happenstance whether the principal employer of a pension scheme is the listed company or an unlisted subsidiary of the listed company.

23. **Conclusion**

In summary, we would comment as follows:

(a) it is already common market practice for funding agreements to be entered into by the offeror where the target has a material defined benefit pension scheme;

(b) the main weakness with the proposal is that it does not require funding agreements to be entered into;

(c) arguably, the proposals give the offeree scheme trustee more leverage to obtain a funding agreement but we think that the levers open to offeree scheme trustees in this regard are already fairly significant, albeit that the exact strength of these levers can depend on the precise terms of the trust deed of the scheme;

(d) if the proposals are to be implemented, we are strongly of the view that it would be pointless to apply them in relation to defined contribution schemes and unnecessarily burdensome to apply them unless the defined benefit scheme is a material scheme;

(e) if the changes are to be implemented then it should not make any difference whether the entity which is the principal employer of the scheme in question is the offeree listed company or a subsidiary of that company;

(f) if the changes are to be implemented then we think it needs to be much clearer what it is that the offeror and the trustee are to comment on in their respective statements; and

(g) we do not think that it makes sense also to impose an obligation on the offeree board to make a statement because the views of the offeror and the trustee board are the significant ones and having a third view which may or may not be consistent with the other two is likely to lead to confusion and also have created difficulties for the offeree board in determining the basis upon which they are required to form the views necessary to give the statement.

B. APL response to specific questions raised

Q1. Do you have any comments on the proposed amendments to Rules 24.2(a) and (b) relating to the requirement for an offeror to disclose, among other matters, its intentions with regard to the offeree company's pension scheme(s)?

B1. It seems to us that the phrases "intentions" and "likely repercussions" are so broadly worded as to be capable of widely different interpretations. The two main areas which these phrases could be relating to are (a) the benefits which the scheme provides (see below) and (b) the ability of the offeree to make future contributions to the scheme (its "financial covenant").

Benefits As far as benefits are concerned, it is sensible to consider accrued benefits and future service benefits separately.

Accrued benefits If the scheme has been closed to future accrual then all the members will be pensioners or deferreds (and so usually former employees) and, whilst there may be some scope to amend benefits, there will not be much scope.

Future service benefits If the scheme remains open to future accrual then it is possible that the offeror will wish to terminate accrual of benefits for the then existing active employee members.

Funding As far as funding is concerned, the trustee's view as to the ability of the offeree to pay post-takeover will very much depend on the financing structure of the bid, what security if any is being given to lenders or bond holders by the offeror and over what time horizon the position is looked at. It would be perfectly possible for the offeror and the trustee to come to opposite views on the strength of covenant against the same factual background.

If it is only intended to cover benefits, then it could be argued that this be left to employee representatives (see A2. above).

Even if Rule 24.2 is amended to clarify that the reference to intentions and repercussions is to cover both benefits and employer covenant, it will still be possible for the three proposed statement providers – offeror, offeree board and trustee – to approach compliance with their respective disclosure obligations in a light touch and anodyne way, at one extreme, or by appointing external advisers and producing lengthy reports at the other extreme. Either way, for the reasons noted above, it is not clear that the production of such reports would serve a useful purpose.

It also seems to us that, if the proposed changes are to be implemented, they should only apply where there is a material defined benefit scheme in the offeree group. Material should be defined by reference to a minimum proportion of total liabilities on, say, the buy-out basis as revealed by the most recent actuarial valuation of the offeree's largest defined benefit pension plan divided by the market capitalisation of the offeree; alternatively, by reference to a minimum £ amount of liabilities (on the same basis) or minimum number of scheme members. It does not seem to us worthwhile to go through the cost and trustee and management time involved in the process proposed if there is not a material defined benefit scheme in the offeree.

This applies even more so in the case of defined contribution schemes where in all cases the assets should equal the liabilities and which are unlikely to be materially amended post bid.

Q2. Do you have any comments on the proposed amendments to Rule 25.2(a) relating to the requirement for the offeree board to include in the offeree board circular its views on, among other matters, the effects of implementation of the offer on the offeror company's pension scheme(s)?

B2. We are not clear why the opinion of the offeree board on the offeror's statement regarding the offeree's pension scheme is relevant or useful. Certainly as far as market practice is concerned, the offeree board plays a limited role and discussions and agreements are between the offeror and the trustee.

It is perfectly possible that the offeree board will have a different view on the offeror's proposals to that of the trustee. If the bid is successful then post bid the views of the offeree board will cease to be relevant at all.

So we would question the logic in imposing any requirement on the offeree board.

There is also a practical question as to what is intended here. Does the proposed statement by the offeree board have to be based solely on what is in the offeror's statement or does the offeree board have to go further and, for example, take advice on the structure of the offeree pension scheme and seek the views of the trustee, in order properly to give its own views on the offeror's statement?

Q3. Do you have any comments on the proposed amendments to Rules 2.12(a), 212(b), 24.1, 25.1, 32.1, 32.6(a) and 27.1(b), and to Note 6 on Rule 20.1, in each case relating to the information to be disclosed to the trustees of an offeree company's pension scheme(s)?

B3. No.

Q4. Do you have any comments on the proposed amendments to Rule 25.9 (and Note 1 on that Rule) and to Rule 32.6 regarding the rights of the trustees of an offeree company's pension scheme(s) to make known their views on the effects of the offer on the scheme(s)?

B4. If these proposed changes are made, then our only comment on the language of these revised provisions is the same comment as we make at B1. above on the language of the proposed disclosure requirement on the offeror which is that it needs to be clearer what the meaning is of "the effects of the offer on the pension scheme(s)".

Q5. Do you have any comments on the proposed amendments to Rule 2.12(d) and to Rule 32.1 regarding the requirement for the Trustees of the offeree company's pension scheme(s) to be informed of their rights under the Code to make known the effects of the offer on the scheme(s)? Do you have any comments on the proposed amendment to Rule 19.2 relating to directors' responsibility statements?

B5. No.

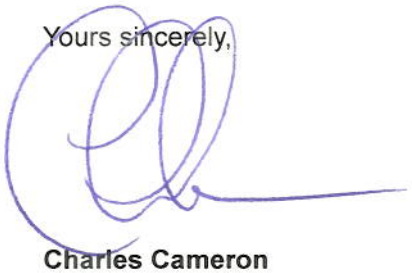
Q6. Do you have any comments on the proposed new Rule 24.3(d)(xvi) and new Rule 26.2(i) relating to the requirement for the offer document to include a summary of any agreement between the offeror and the offeree company's employee representatives or the trustees of the offeree company's pension scheme(s) in relation to any of the matters described in Rule 24.2 and to the requirement for any such agreement(s) to be put on display?

B6. In our experience, typical practice here is for trustees to disclose to their members particular funding or financial undertakings contained in agreements that are entered to by the offeror and the trustee. However, it is also usual for the documents themselves to remain confidential as they may contain provisions which are commercially sensitive and not directly of interest to the individual scheme members – for example, they may contain security arrangements with the trustee or they may reveal directly or indirectly the offeror's own lending/security arrangements. So, a requirement to disclose the actual agreement reached may indirectly give rise to a disclosure requirement which

goes beyond simply the agreement as to the funding of the scheme which ought to be the central point.

So, we would suggest that a preferable proposal would be for a disclosure of any specific funding obligations only. This would be consistent with the disclosure regime for occupational pension schemes which requires disclosure of funding documents produced as part of actuarial valuations (i.e. statement of funding principles, actuarial valuation report, schedule of contributions and recovery plan) – in most if not all cases the schedule of contributions would, in any event, need to be amended to reflect any funding agreement reached.

Yours sincerely,



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