A balance of interests

A NUMBER OF HIGH-PROFILE PROPOSED AND ACTUAL CORPORATE DEALS HAS PUT THE SPOTLIGHT ON THE ROLE OF THE PENSION TRUSTEE. **GRAHAM BUCK** REPORTS.

The question of what role the pension fund trustees should play in a proposed corporate deal periodically makes business page headlines. The issue was to the fore during the recent takeover of Cadbury's by US food giant Kraft. The confectionery group is one of the blue chips to still operate a final salary pension scheme (although it closed to new members in 2001), which has 30,000 members.

But even before enactment of the 2004 Pensions Act, aimed at strengthening the protection afforded to pension scheme members, the role of the trustee was moving up the agenda. High-profile cases from that period included private equity firm Permira's bid for WH Smith and entrepreneur Philip Green's attempted takeover of Marks & Spencer. In both instances the bid was reported to have foundered largely due to disagreements on how to address each company's pension scheme deficit, with the Smith scheme trustees insisting that the highly-leveraged bidder provide a sizeable cash injection to plug the gap.

TRUSTEES BECOME MAJOR PLAYERS A series of other high-profile bids that were private equity-leveraged during the boom that ran to mid-2007 also saw the pension trustees become potentially major players in influencing whether a deal was reached.

In 2007 two separate bids for Sainsbury's, by private equity group CVC and Qatar's Delta Two consortium respectively, both failed. Worsening credit markets at that time and the opposition of the Sainsbury family were major factors, but the main obstacle was again the bidders' inability to agree with the scheme trustees on how big a cash injection they were willing to provide towards the deficit.

More recently, trustees of Cadbury's pension scheme, who are independent of the company, sought assurances that a successful bid would not mean the combined group's financial strength and resulting sponsor covenant being adversely affected by Kraft's £7bn debt load.

Cadbury's own scheme had a shortfall of £500m but last December, just weeks before Kraft's improved bid was accepted, the trustees signed a deal with the Pensions Insurance Corporation to transfer the scheme's pensioner liabilities to the insurer after negotiating the terms for more than a year. The timing was coincidental, but the PIC deal was advantageous for Kraft as it closed down a number of liabilities and effectively de-risked parts of the scheme.

In many high-profile bids, the bidder will be keen to engage with trustees of the target company's pension scheme and reassure them because – as demonstrated by Sainsbury – a large pension scheme carrying a sizeable deficit can effectively act as a deal blocker. While the Cadbury's scheme is also substantial, it proved less of an issue. As the bid was hostile, Kraft was only able to conduct due diligence once its improved offer was accepted so any reassurance to the trustees was of limited worth.

As it happens there is still potential for conflict on the pensions issue, despite acceptance of the bid. The trustees are assessing the impact of the takeover and receiving professional advice, while in April there were reports that the US group had told more than 3,000 Cadbury employees either to accept a three-year pay freeze or leave the final salary scheme.

ROLE OF THE TRUSTEES The trustees' role has also surfaced in discussions over British Airways' proposed merger with Iberia and the long-planned demerger of Cable & Wireless. The pension schemes of both FTSE 100 companies have sizeable deficits, so the trustees needed to negotiate with businesses on which assets were available to repair the funding gap.

BA's total pension scheme deficit is £3.7bn and the company contributes £131m annually to progressively reduce the figure. On this basis, it would take nearly 30 years to eradicate the shortfall. The company had agreed a deal with various unions on staff pension contributions. This will help to cut the cost of providing pensions going forward, but without other measures it will not have an impact on the existing huge deficit. BA was also working with the trustees on a recovery plan for the scheme, to be presented to the Pensions Regulator by the end of June, and Iberia

has the option of walking away from the merger if it is dissatisfied with the pensions deal.

The company operates two defined benefit pension schemes; the first, the Airways Pension Scheme, closed in 1984 and largely comprises pensioners, while the larger New Airways Pension Scheme (NAPS), which closed in 2003, still has 30,000 active members. More recent employees have only been eligible for the cheaper defined contribution scheme.

The ACT's former president Paul Spencer, who recently completed four years as head of National Savings & Investments, is now chairman of BA's pension trustees. As The Treasurer went to press BA announced it had reached agreement with the trustees on a plan to reduce the deficit that plan would avoid the closure of its two final salary pension schemes. Keith Williams, BA's chief financial officer, was reported in late June as saying: "The trustees understand that the airline is unable to increase its contributions in the current financial climate but we have agreed a recovery plan that avoids closing the pension schemes.

"[It] gives NAPS members choice over their future pension accruals, and increases the prudence of the assumptions employed in managing the scheme." Iberia now has three months to reach a decision on the recovery plan. Failure to agree a mutually acceptable solution would also have forced the Pensions Regulator to devise one of his own that all parties would have been obliged to accept.

The situation with Cable & Wireless is different, as it does not result from a bid but rather a corporate decision to effect a demerger and split the group into its respective UK and international businesses. The group now consists of two separate companies; Cable & Wireless Communications and Cable & Wireless Worldwide – each with its own pension arrangements.

C&W worked with advisory group Gazelle in devising an arrangement – which included a cash injection totalling £30m – acceptable to both the pension fund trustees and the Regulator, whereby members' benefits were not adversely affected by splitting the fund between the resulting new businesses.

"We had to judge the different risk profiles of the two new schemes when compared to the existing scheme," says Donald Fleming, managing director – pensions advisory at Gazelle. "It created different characteristics, so we devised a contingent funding agreement to bridge the gap between the scheme's risk profile and the company's risk profile that took into account risk changes created by the demerger."

"A letter of credit was drawn up and there was considerable interaction with the banking covenants. The trustees demonstrated their sophistication in tailoring contingent funding agreements to work alongside bank and bond instruments."

BA'S TOTAL PENSION SCHEME DEFICIT IS ESTIMATED AT £3.7BN AND THE COMPANY CONTRIBUTES £131M ANNUALLY TO PROGRESSIVELY REDUCE THE FIGURE. ON THIS BASIS, IT WOULD TAKE NEARLY 30 YEARS TO ERADICATE THE SHORTFALL.

IMPLICATIONS OF REGULATOR APPROVAL Another company whose future is tied up with its pension fund is the chilled foods group Uniq. It is waiting on the approval of the Regulator of a scheme recovery plan recently agreed between the group and its pensions trustee. The company has around 2,200 staff, but 21,000 pension scheme members and a deficit of more than £400m – making the scheme Uniq's biggest unsecured creditor.

The emergency survival plan proposed by the company and agreed by the trustee would see Uniq make no contributions towards reducing the deficit until 2013 and focus instead on raising funds from shareholders to expand the business through acquisitions. From 2013, the scheme would receive a proportion of earnings from currently-owned businesses, but nothing from newly-acquired ones.

At this rate, it would take an estimated 50 years to clear the deficit – far longer even than BA's recovery timetable – and way beyond the 10 years usually regarded as acceptable by the Regulator for repairing funding gaps. Were he to approve this innovatory proposal it could be seized on by other cash-strapped companies keen to put off addressing their own pension scheme deficits. At the same time, if the Regulator withheld approval Uniq could join other corporate casualties such as Woolworths in applying, as a last resort, to the Pension Protection Fund (PPF).

Since 2008 the Regulator has also been involved in attempts to settle a dispute over the pension scheme at embattled music company EMI and was due to issue a final report in June. EMI was acquired by private equity firm Terra Firma in 2007, but the deal was completed before an agreement was reached over the financing of the scheme.

"A concrete funding deal was apparently not reached at the time; possibly because the scheme trustees opted instead to await the next triennial evaluation," says David Lane, a partner of Lane Clark & Peacock. "The date for this has come and gone, but an agreement between the trustees and the company on the scheme has still not been reached." In the meantime the pension deficit is estimated to have ballooned to £250m.

The chief negotiators initially were Quentin Stewart, representing Terra Firma's chief, Guy Hands, and Ian Smellie, chairman of the pension scheme trustees. However, Stewart has since been replaced by Terra Firma's chief executive, Tim Pryce, and last year, in a controversial move, Smellie was ousted and Hands appointed a respected

independent pensions fund specialist, Clive Gilchrist of BesTrustees, to the post. While this was viewed as a move to resolve the situation the deadlock remains, and it is becoming increasingly likely that the Regulator will have to intervene and rule on the future funding.

Even when an agreed deal to repair a pension scheme fund deficit has been reached by the company and the scheme trustees, the Regulator may not give its blessing. When BT announced in February that trustees had approved its plans to address a £9bn deficit in the pension scheme by injecting a further £525m per year over three years, the Regulator expressed "substantial concerns" over the proposal.

PENSION SCHEMES HAVE TRADITIONALLY HAD ONLY LIMITED EXPOSURE TO BANKS AND BONDHOLDERS, BUT BOTH ARE NOW INTERESTED IN HEARING THE TRUSTEES' POINT OF VIEW.

RESPONDING TO REGULATION The current duties and responsibilities of pension trustees reflect the raft of regulation introduced over the past two decades – after Robert Maxwell's demise in 1991 revealed how the press tycoon had raided his company's pension funds.

The Pensions Act 1995 was intended to strengthen the protection afforded to pension scheme members and set up the Occupational Pensions Regulatory Authority (OPRA). However, after several years both the Act and OPRA had come to be regarded as inadequate and the 2004 Act aimed to rectify the shortcomings.

OPRA was succeeded by the Pensions Regulator, whose office was created in April 2005 and given two basic responsibilities; first to ensure that companies honour their obligations to retired employees and secondly to limit claims made on the PPF, the employer-financed 'lifeboat' set up at the same time to provide compensation through an annual levy for members of eligible defined benefit schemes when the sponsor company fails.

As the Regulator's website observes: "Some corporate transactions could affect the sponsors' ability to meet their obligations to the pension scheme either on an ongoing basis or in the event of insolvency and would, as a result, be detrimental to the scheme. These transactions could, potentially, be seen as falling within the remit of our anti-avoidance powers."

The Regulator sets out the basic steps board members need to take when considering any business decision "that affects the company's finances or underlying structure". These requirements are that the board works with the pension scheme trustees to understand the nature and impact of the decision and whether it needs to offer "appropriate mitigation" to the pension scheme, and conflicts of interest are managed appropriately – which may require both employers and trustees to seek independent professional advice; and that a systematic approach is adopted that includes keeping a record of advice, decisions and outcomes.

Merger and acquisition deals can go through without the Regulator's approval, unless there is a specific approach by the buyer and/or the seller to seek clearance. However, the Regulator has to review agreements between the trustees and employer to repair pension scheme deficits within a reasonable period of time, which are known as "scheme-specific funding arrangements".

CONFLICTS OF INTEREST The Regulator has also had to address the issue of potential conflicts of interest, which can arise when a company director also serves as a trustee of the pension fund. The overriding duty of the trustee is to act in the best interests of scheme members, and to be seen to do so. So decisions made by the trustees where such a conflict exists may be called into question, and even when they are not there is an onus on the trustee to demonstrate that any decision reached was fair and reasonable in the circumstances.

In many companies the treasurer also serves as a trustee of the pension scheme. Finance directors also often took on this dual role, but Fleming says that for many FTSE 100 companies this is no longer the case due to the potential for conflicts of interest. "Indeed, it can also be difficult for a treasurer to fulfil both roles satisfactorily," he adds. Several major blue chips have a policy of using independent pension scheme trustees to minimise the potential for such situations.

"There has been much thought devoted to good governance and how best to form a trustee board," adds Fleming. "Although the general governance framework has been in existence for decades it has been steadily refined, with the role of both the treasurer and the FD tending to move away from the trustee board to make way for other individuals with a finance or treasury background.

"Pension schemes have traditionally had only limited exposure to banks and bondholders, but both are now interested in hearing the trustees' point of view."

So the role of the pension scheme trustee is growing and a revision of the Takeover Code could accelerate the process. There are also clearer guidelines on what exactly scheme trustees should be doing. This includes getting a seat at the board table to discuss, as counterparty, the effects of any actual or proposed corporate transaction on the interests of the scheme members they represent.

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