Why merge?

In this time of economic uncertainty there is a strong temptation to save costs wherever possible. Employers might see the streamlining of pension schemes into one arrangement as a worthwhile cost-saving exercise. Costs can be saved on advisers’ fees (legal, actuarial and investment), administration fees and management time. One larger asset base can lead to better investment options and possibly improved returns, though don’t quote me! Sounds quite attractive so far, but a word of warning.

Before embarking on a merger, employers should plan carefully and consider the up front cost. The merger of two or more pension schemes needs managing and takes time and effort by all parties. Valuable management time could be consumed if there is no obvious project plan or project manager. Up front costs can be high compared to possible savings, i.e. if scheme funds need to be topped up pre-merger or if negotiations are protracted (often the employer is expected to pay all fees associated with mergers). A project plan, realistic timescales and proper engagement with the trustee boards involved is a must, otherwise misunderstandings and delays can ensue.

That said, how can merger be achieved?
There is no such thing as a scheme merger, but we all use the term anyway. What happens is one scheme is used as the vehicle for all of the other schemes’ assets and liabilities to be transferred into. The empty trusts of the transferring schemes are then wound up. Each scheme’s deed and rules is likely to allow the transfer and receipt of all assets and liabilities of the transferring scheme. If there are any restrictions, it may be possible to amend these provisions pre-merger.

Mergers are almost always done without the consent of the members of any of the schemes. Legislation allows this, provided the actuary to the transferring scheme certifies that the benefits under the receiving scheme for the transferring members are broadly no less favourable after the transfer. Also required is an announcement confirming the details of the transfer to the transferring members at least one month before the transfer.

Commonly, members’ accrued benefits in the transferring scheme are transferred unchanged to the receiving scheme. Benefits for future service can either be the same or different. Sometimes the receiving scheme is sectionalised so that the transferring scheme assets and liabilities remain separate for the future. Alternatively, transferring members are given pensionable service credits in the receiving scheme which equal the value of their benefits under the transferring scheme. Their benefits for past and future service can then be based on the benefit structure of the receiving scheme. If employers want to adopt this approach, they should check that contracts of employment do not give employees specified pension rights (although this is quite unusual). Note that it is possible to merge closed and frozen schemes.

A merger deed containing the terms of the merger agreed between the trustees of the transferring scheme and the receiving scheme and the sponsoring employers of each scheme will achieve the legal transfer of assets and liabilities to the receiving scheme. Other legal documents may be needed in addition to transfer certain assets, i.e. insurance policies or real property.

The duty of the transferring scheme trustees is to protect the benefits already accrued pre-merger by members of the transferring scheme. They do not have a duty to protect benefit accrual for future service under the receiving scheme. The transferring scheme trustees’ main concern is to maintain the security and level of the benefits they are transferring. They need to
undertake a review of the covenant of the employers of the receiving scheme. They also need to ensure that the funding level of the receiving scheme is similar to that of the transferring scheme at the point of merger. If the security of the benefits transferring might be compromised, the trustees should consider trying to improve security, i.e. by sectionalisation of the assets and liabilities in the receiving scheme or requesting additional security from the employer.

If the transfer is to be made without member consent, the trustees must ensure, with the transferring scheme actuary, that the accrued benefits are broadly no less favourable post-merger. The trustees will also consider whether the balance of powers under the receiving scheme is similar to their own scheme, i.e. not weighted much more heavily in favour of the employer.

In short, the transferring scheme trustees should consider whether, in the round, the merger is a good deal for their members, remembering that they are not there to frustrate the legitimate aims of the employer and that the receiving scheme and its trustees are also governed by trust law.

**Receiving scheme trustees**

The duty of the receiving scheme trustees is to protect the members of the receiving scheme by not diluting the security of the receiving scheme by accepting underfunded liabilities. They need to ensure the funding level of the transferring scheme is similar to the receiving scheme at the point of merger. If the transferring scheme is in deficit, they need the advice of their actuary on how much the employer will need to top up the transfer payment before they can accept the transferring scheme liabilities. There will be a process of negotiation with the employer on the level and method of top-up payment, i.e. the employer may ask the trustees to accept additional payments through the recovery plan rather than a lump sum.

The receiving scheme trustees need to know exactly what liabilities they are taking on in the merger. Where benefits are complex, the transferring scheme trustees could be asked to sign off a detailed specification of the benefits under the transferring scheme and to undertake a data cleanse pre-merger. The receiving scheme trustees should also get a warranty in the merger deed from the transferring scheme trustees, confirming the transferring scheme has been administered in accordance with UK and European legislation.

**Indemnity and discharge**

The trustees of the transferring scheme and the receiving scheme should seek an indemnity from the employers for claims in respect of the merger.

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The receiving scheme trustees could try to seek an indemnity from the employers to cover any claims in respect of the transferring scheme, since there will be no scheme assets to call on once the transferring scheme is wound up. They may not get it.

If trustees have indemnity insurance in place, employers will want to limit the indemnity they give to claims not covered by that insurance. Employers will also want to keep control of any claims which may become payable under the indemnity, i.e. by including provisions in the merger deed that trustees inform them of a potential claim as soon as possible, do not make any admission of responsibility and allow the employer sole conduct of the claim.

Once all of the assets and liabilities of the transferring scheme have been transferred to the receiving scheme, the transferring scheme can be wound up. At this point, the transferring scheme trustees should ensure they receive a full discharge from any liability to and in respect of members of the transferring scheme.

Possible pitfalls of merger

Equalisation

Merger discussions can highlight possible sex equalisation issues. There have been several cases recently which examined the equalisation solutions put in place following the Barber judgment in 1990. The receiving scheme trustees will be alert to this. If there are problems with the solution in place, the trustees of the receiving scheme will look to the employer to correct the equalisation position before the merger, which could be costly. Employers should bear in mind that if an equalisation issue is raised, it may be difficult to do nothing about it, even if the merger does not go ahead.

Protection for former public sector employees

Members of the transferring scheme who have previously been transferred from a public sector arrangement could have specific rights or benefits which continue even on merger, i.e. early retirement rights. Employers should check the contract under which those members were previously transferred to the transferring scheme. Whilst such provisions may not stop the merger, they could restrict the way in which benefits can be provided under the receiving scheme.
Complexity

Where schemes already have complex benefit structures, a merger alone will not simplify those structures. The complexities of administering and running a complicated scheme will remain unless the benefit structures themselves are simplified. It may be possible to achieve this during the merger process, but this is a far more involved approach which needs to be recognised by all parties from the outset.

Notice periods

Contracts with third party service providers, such as administrators and investment managers, can have long or fixed notice periods which could incur penalties or delay the merger if they have not been factored into a merger timetable. To avoid this, the transferring scheme trustees should check the contracts of their service providers as soon as merger discussions begin.

To merge or not to merge?

Streamlining pension arrangements may well be attractive to employers in the current economic climate, but they should be well prepared before they start the process. Employers need to ensure trustees are fully committed and understand the reasoning, process and results of merger, whilst recognising that each board of trustees has a duty to its own beneficiaries. Trustees being asked to merge need to fulfil their duties as trustees, achieving merger where that is possible and only where it is appropriate for their own beneficiaries.