

Done Deal?

When it comes to pension plans in mergers and acquisitions, the handshake is often just the first step to a long, complicated process. What are the options and obligations of sellers and purchasers?

BY ANDREA BOCTOR



While it is rare for pension issues to make or break a corporate deal, every merger or acquisition involving a pension

plan is nonetheless fraught with legal and financial implications for both the purchaser and the seller. More often than not, the pension options available to the parties will depend on the mode of acquisition. In order to minimize the risks associated with acquiring or divesting pension liabilities, both the purchaser and seller need to be aware of their respective options as well as the definite and potential consequences that flow from each.

Below, we'll look at the effect typical deal structures have on the options available to the purchaser and the seller given the nature of the target company's pension arrangements. This article examines pension plans subject to Ontario's *Pension Benefits Act* (PBA). However, the general theme of the article is applicable to plans registered in other Canadian jurisdictions.

1. The Simple Share Deal

The least complex transaction to document is the simple share deal, in which the company being acquired (the Acquiree) sponsors its own pension plan. It is simple because one, all plan assets and liabilities remain with the plan, and all funding obligations remain with the Acquiree. And two, the purchaser cannot pick and choose the pension obligations it assumes. For example, a purchaser cannot leave behind pension obligations in respect of former employees or insulate the Acquiree or the plan from an unresolved partial windup.

As a result, thorough due diligence review of all plan-related documents is essential. A purchaser should request and review the following:

- current and historical plan texts;
- funding and investment management agreements;
- employee booklets describing the plan;
- the most recent actuarial reports, financial statements and asset statements;
- material opinions and memoranda relating to the plan; and
- material correspondence with the Financial Services Commission of Ontario (FSCO), the Canada Revenue Agency (CRA) and other relevant persons relating to the plan.

FSCO's online pension information database is an excellent resource. Generally, plan registration information, head count and recent filing history are available.

A purchaser should also ensure that the

Acquiree has performed all its sponsor and administrator duties in accordance with plan terms and all laws, paying special attention to pension hot spots such as:

- unapproved partial windups and undeclared potential partial windup events (such as large fluctuations in plan membership);
- pending asset transfers and mergers;
- defined benefit (DB) to defined contribution (DC) conversions;
- language in the plan documents relating to contribution holidays, plan expenses and use of surplus; and
- compliance with pension and tax legislation and all filing requirements.

With recent volatility in plan funding, a purchaser will want to ensure it understands fully the Acquiree's funding obligations and the implications of a pension surplus or deficit in the context of the transaction. And it may wish to seek its own actuarial advice on the size of any surplus or deficit so as to ensure the purchase price properly reflects the Acquiree's pension obligations.

When access to full information and thorough review are not feasible, well-crafted representations in a purchase agreement can provide some comfort to the purchaser. While not a substitute for due diligence, at a minimum, a purchase agreement will generally include representations attesting to the plan's:

- general compliance with laws;
- registered status;
- currency of all contributions;
- funded status;
- absence of historical issues (partial windups, asset transfers and plan mergers); and
- absence of pending actions, investigations or other proceedings.

Note, however, in the event that a representation reveals itself to be untrue, recovery of damages is usually time-limited to a few years or less, while many pension issues take several years to surface. That said, a seller must be careful in providing overly broad or potentially untrue representations. The Ontario Court of Appeal decision in *Transamerica (Aegon Canada Inc. and Transamerica Life Canada v. ING Canada Inc.)* provides an example of a deal that was essentially undone due to inaccurate representations regarding the target company's pension obligations.

2. The Classic Asset Deal

In the classic asset deal, a purchaser is buying certain assets, usually a division (the division) of a larger company (the seller), where the seller sponsors a pension plan

for all its employees, including division employees. In contrast to the simple share deal, an asset deal can be the most complex to structure and document because of the many options available to the parties. The principal options and the consequences that stem from each are discussed below.

OPTION 1: No pension plan

Here, pre-sale pension liabilities of division employees remain with the plan; however, where a purchaser offers employees no pension plan, the regulator has discretion to declare the plan partially wound up. Assuming the plan is DB, a partial windup could have several costly implications for the seller. First, whether DB or DC, a partial windup would result in full and immediate vesting of division employees, regardless of age and service; in the absence of a partial windup, unvested employer contributions are forfeited and employee contributions refunded.

The seller could face wrongful dismissal claims from division employees if the terms of employment offered by the purchaser are not substantially similar to those they enjoy with the seller.

Second, division employees having age plus service equal to at least 55 may qualify for potentially expensive "grow-in" benefit enhancements.

Third, the Supreme Court of Canada decision in *Monsanto* established that any surplus assets attributable to employees affected by a partial windup must be dealt with at the time of partial windup, thus potentially leading to a surplus distribution to affected employees, depending on the relevant language in the plan.

Finally, a partial windup is a time-consuming, costly and labour-intensive process. The seller might, therefore, insist that the purchaser establish, at a minimum, a DC plan, thus avoiding a partial windup.

Employment law considerations are also

important. The seller could face wrongful dismissal claims from division employees if the terms of employment offered by the purchaser are not substantially similar to those they enjoy with the seller. Specifically, the seller risks having division employees refuse the purchaser's offer of employment, thus forcing the seller to terminate them. If the other components in the purchaser's compensation package don't adequately compensate for the loss in future pension accruals, the seller could be liable for the costs associated with terminating the refusing employees.

As a result, it would be usual for the seller to insist that the purchase agreement require that affected employees be offered a compensation package which, in aggregate, is no less favourable than that received from the seller immediately prior to the sale, or that the purchaser cover any termination costs where such an offer falls short.

Where the plan is DB, it may be difficult for the purchaser to craft a compensation package for long-service employees that provides a comparable level of benefit without actually offering a DB plan. As such, it might be a practical necessity for the purchaser to establish a new DB plan for division employees. However, where the plan is DC, a substantially similar offer may be

achievable without offering a DC plan, given the availability of other similar deferred savings arrangements such as group RRSPs or DPSPs. For the remaining options discussed below, we will assume the plan is DB.

OPTION 2: A pension plan for future service only

Here, the purchaser offers a DB plan to division employees but assumes no pre-sale pension liabilities from the seller. In this case, the seller and the plan retain responsibility for delivering pre-sale pensions accrued to division employees under the plan. In this circumstance, the PBA requires that service recognized under the plan be recognized in the purchaser plan for purposes of determining eligibility for membership in, and benefit entitlement under, the purchaser plan and vice versa.

The foremost advantage of Option 2 is its simplicity: service with the seller remains the seller's responsibility, and service with the purchaser will be the purchaser's responsibility. This option also offers many short-term inducements: there is no need for asset and liability valuation or a pension asset transfer agreement, and a partial windup is avoided.

In the longer term, however, Option 2 loses some of its appeal. First, the pur-

chaser and the seller would be required to exchange member information every time a division employee terminates employment, retires or dies. Second, case law indicates that the plan may still be at risk for a partial windup if the purchaser winds up the purchaser plan. Although the seller could theoretically negotiate an indemnity that deals with the partial windup risk, it would be very uncommon for such an indemnity to last more than a couple of years.

Finally, in some cases, older long-service employees may suffer a loss in pension with years of membership in two plans rather than all years in just one plan. To address this, the purchaser could provide a "wrap" for employees so that their benefits are not adversely affected; however, wraps can be costly and complicated.

OPTION 3: Asset transfer

The purchaser offers a DB plan to division employees and assumes liability for division employees' past service under the plan with a corresponding transfer of a proportionate share of assets from the plan to the purchaser plan.

In all likelihood, the assets transferred from the plan will not equal the liabilities transferred to the purchaser plan. If the plan

is in surplus, surplus will often be transferred. Likewise, if the plan is in deficit, assets less than liabilities will transfer. An additional top-up contribution on the transfer amount or a purchase price adjustment can address this either inside or outside the plan.

The main advantage with Option 3 is the clean break it makes between the purchaser and the seller: after the transfer is complete, no requirement to exchange information exists, and the plan will be unaffected by future windups in the purchaser plan.

One disadvantage is that an asset transfer requires the most upfront time and attention by the purchaser and the seller. The parties must quantify the transferring liabilities and often negotiate the assumptions by which they are to be valued, as well as draft and file a multitude of reports and plan documents with FSCO—all at considerable expense. Advice from actuaries, lawyers and accountants should also be sought. Even with “simple asset transfers,” regulatory approval for the transfer generally takes a year or more.

OPTION 4: No option

Where a collective agreement covers division employees, its terms may require the purchaser to provide certain pension arrangements, thus rendering it a legal and practical necessity for the purchaser to “choose” a particular option. Where the plan is incorporated by reference into the collective agreement and exists only for the division employees, the purchaser may be required to assume the plan in its entirety.

However, where the collective agreement requires a particular level of pension benefit or where groups of employees other than division employees participate in the plan, the purchaser may not be required or able to assume the plan. Instead, the purchaser may be required to establish a new plan providing for identical benefits or even negotiate a new deal with the union. In any case, the terms of any collective agreement must be fully fleshed out to determine the purchaser’s obligations.

3. Variations on the Theme

Not every deal is a “simple share deal” or a “classic asset deal.” Depending on the target company’s structure, from a pension perspective, a share deal may more closely resemble an asset deal. For example, where two subsidiaries (A Co. and B Co.) participate in a pension plan sponsored by A Co., a purchaser buying the shares of B Co. will be faced with the options noted above, but with a twist: the employment law considerations will apply directly to B Co., as it will remain the employer of the affected employees before and after the sale.

Conversely, an asset deal can resemble a share deal. Where, for example, a pension plan exists for the benefit of only the employees of the business unit being purchased, it is possible for the seller to simply assign its pension plan and funding instrument to the purchaser. This will often be the case where a pension plan is for the benefit of a bargaining unit, as discussed above. Assigning a pension plan is a relatively simple process to document, and unlike an asset transfer, prior regulatory approval is not needed. Instead, plan amendments changing the sponsorship of the plan are filed with the FSCO and the CRA.

Note, however, that just as in a share deal, the purchaser must perform adequate due diligence on the relevant pension documents and seek appropriate representations from the seller.

The above discussion is illustrative, but not exhaustive, of the many important issues that can arise for the purchaser and the seller in any transaction involving a pension plan. Early attention in the deal process, adequate due diligence and documentation, and consultation with experts including actuarial, legal and accounting professionals can help both quantify and minimize the associated risks. **BC**

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