Share purchase: pensions (The Netherlands)

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Practice notes | **Maintained** | The Netherlands

This practice note provides a summary of the most common pension-related issues in share purchase transactions by companies in the Netherlands. It outlines the Dutch pension system and the most common types of administrators and plans. This note also provides guidance for due diligence reviews of pensions and considers what warranties and indemnities relating to pensions should be included in a share purchase agreement.

Scope of this note

This practice note summarises the pension system in the Netherlands, and the most common types of pension administrators and pension plans.

It provides guidance for due diligence reviews of pensions and specifically describes the most important issues about Dutch target companies' pension plans to consider during share purchase transactions.

This practice note also outlines what warranties and indemnities relating to pensions could be included when drafting and negotiating a share purchase agreement (SPA).

Pension system in the Netherlands

Like many other countries, the Netherlands has a three-pillar pension system:

- The first pillar is a basic state pension for every Dutch resident (known in Dutch as *AOW,* General Old Age Pension).
- The second pillar is a company pension which supplements the basic pension. Employees only accrue this type of pension if their employer has a pension plan in place or falls under a mandatory industry-wide pension plan.
- The third pillar is private arrangements such as annuities.

This practice note only addresses supplementary company pensions.

Company pension plans are not obligatory in the Netherlands; employers are in principle not required to make arrangements with their employees for a pension plan. However, the Ministry of Social Affairs and Employment can, at the request of the social partners (that is, the employers' organisations and trade unions), make participation in a certain pension fund mandatory for all employers in a business industry or profession (see *Mandatory industry-wide pension funds*).

Pension administrators

Employers must outsource management of their supplementary pension plans to one of the following types of pension administrators:

- A mandatory industry-wide pension fund.
- A pension fund (one employer).
- A multi-employer pension fund.
- A premium pension institution.
- An insurance company.

Pension funds: general

A pension fund is a foundation (*stichting*), separate from the sponsoring employers, which is managed by a board made up of representatives of the employer and employees, and generally also of the pension beneficiaries. Pension funds also have a supervisory body and a participation body, composed of (former) employees and pensioners, which has the right to give advice to the board (and sometimes even a right of consent) on specific subjects.

Mandatory industry-wide pension funds

Mandatory industry-wide pension funds are generally mandatory for a particular sector or industry. They are managed by a board comprising of representatives of the industry's employers and employees such as employer organisations and trade unions. As with multi-employer pension funds (see *Pension fund (one employer) and multi-employer pension funds*), they handle the pensions for more than one company. In principle, all the separate employers' pensions are combined into a single pension plan.

If employers fall under the scope of a mandatory pension fund, they must register the relevant employees in this pension fund. If employers fail to do so there is a financial risk as the pension fund can claim unpaid pension premiums, even with retroactive effect.

In some cases, employers can be exempted from mandatory participation. This is however subject to strict requirements which must be met, such as:

- The employer must be part of a group of companies where a pension arrangement for at least 100 employees is in place and social partners have been involved.
- The employer must have its own collective labour agreement for all its employees.

Also, the mandatory pension can have its own specific policy for exemptions.

Even when exemption from the mandatory participation is granted, the employer still has to offer its employees a similar pension scheme, which is at least actuarially and financially equivalent.

Examples of sectors and industries with mandatory pension funds are:

- Metal industry.
- Retail sector.
- Transport sector.
- Construction industry.
- Temp agencies.

Pension fund (one employer) and multi-employer pension funds

Once an employer sets up a pension fund, that pension fund is exclusively responsible for insuring the pension plan that the employer (with its subsidiaries) has agreed with its employees. Virtually all pension funds only administer defined benefit plans (which are almost always average-pay plans, see *Defined benefit plan (DB plan)*).

A multi-employer pension fund is a pension fund, which can be used by multiple employers, with each employer's pension plan kept separate from the others.

Pension funds, unlike premium pension institutions (see *Premium pension institution (PPI)*) and insurance companies, may lower the pension accruals if their solvency drops below a predefined minimum.

Premium pension institution (PPI)

A premium pension institution (PPI) may only administer defined contribution plans (see *Defined contribution plan (DC plan)*). It may not insure risks directly, and therefore always outsources its risks to an insurer. In this respect at least, PPI's resemble collective investment schemes.

Insurance company

In the Netherlands, life insurers can insure pension plans. Most of the pension plans covered by life insurers are defined contribution plans (see *Defined contribution plan (DC plan)*). This differs from pension funds in that insurers cannot lower the pension accruals.

Most common types of pension plan

The most common types of pension plan are:

- Defined benefit plan (DB plan).
- Defined contribution plan (DC plan).
- Collective defined contribution plan (CDC plan).

Defined benefit plan (DB plan)

The most common type of pension plan in the Netherlands is the DB plan, where the members are promised a particular amount of pension benefits. DB plans can be divided into final-pay plans and average-pay plans.

Final-pay plans

Final-pay plans are very uncommon these days but do require careful consideration in some transactions because past pension right accruals can still have major financial implications.

In a final-pay plan, the pension rights are accrued every year of employment so that employees are entitled to a fixed percentage of their most recently established pension base (the pensionable salary less the amount deducted to offset the basic state pension). This means that employees accrue part of their pension every year. Every time employees receive a pay rise, the pension that they accrued with the employer during previous years is raised to the new level of the most recent pension base.

Average-pay plans

In an average-pay plan, employees accrue pension rights according to a fixed percentage of their pension base for every year that they remain with the employer. Generally, the accrual rate is 2 to 2.25%. Unlike with a final-pay plan, pay rises are not automatically taken into account. However, the pension accruals are generally (conditionally) indexed for yearly price increases.

Defined contribution plan (DC plan)

Under a DC plan the employer agrees to contribute a percentage of the employee's pension base every year. This means that the contributions and not the benefits are predefined. This also means that it is not clear beforehand how much pension the employees will ultimately receive. The precise amount depends on several factors such as contributions, costs and returns on investments.

The Dutch legislature is developing a new pension system, in which the DC set-up will be obligated. DB-schemes will have to be converted for future pension accruals and even already accrued pensions under a DB-scheme should be transferred to the DC-environment. However, this new pension system will have some form of solidarity and risk sharing and aims to result in the same retirement benefits as under a DB-system. The new pension system will be implemented by 1 January 2022 and the transition must be completed by 2026.

Collective defined contribution plan (CDC plan)

Besides DB and DC plans, the Netherlands also has CDC plans. Many companies have been forced to modify their pension plans to ensure compliance with domestic (*Dutch Accounting Standard 271*) and international (IFRS) reporting rules that dictate how pension plans must be included on the company's balance sheet. Those rules also apply to Dutch companies, even though the pension fund or insurer is strictly separated from the company, unlike in the USA and the UK, for example. In the Netherlands, it is the pension fund or insurer that owns the assets, not the company. CDC plans have arisen specifically to cover this type of situation, allowing employers to leave their pension liabilities off the balance sheet.

With a CDC plan, the employer's risks are limited to paying a fixed amount, which is determined according to the defined contribution. For example, it could be the employer's intention to contribute to a 2% average-pay plan, but only subject to the contractual maximum costs. If it subsequently emerges that more funds are needed, the employer is not obliged to pay a higher contribution.

Similarly, the employer does not have a claim on any surplus assets. For example, a CDC plan could target a pension of 70% of the employee's average pay. This is called the ambition. However, at a certain point it might be established that the employer's contribution is not enough to fund that ambition. Two solutions are possible in this situation, either:

- The employee pays a higher contribution.
- The future accrual is lowered.

An external auditor must decide whether the CDC plan satisfies the criteria defined by that auditor for omitting the liabilities from the company's balance sheet. However, this does not automatically mean that the plan satisfies the legal criteria as set out in Dutch pension law. For example, a key factor is how the plan is communicated in any of the communication channels used (for example, the pension plan rules, websites, brochures, collective bargaining agreement and terms of employment).

Advising on pensions in connection with share purchase transactions

Pensions are sometimes not addressed in transactions until the process is nearing its end. Significant issues can then arise as pensions potentially involve large sums of money.

In a typical share purchase transaction, the terms of employment, and in particular the pension plan, essentially remain unchanged. Nevertheless, any information relevant to pensions needs to be considered carefully.

Most important pension issues during due diligence

The due diligence process gives the buyer the opportunity to review the target company's pension plans, not only so that the buyer can consider what those pension plans are, but also to identify potential risks attached to the current and past pension plans.

Important questions to bear in mind during the due diligence process include:

- Are any pension plans in place?
- Will the transaction include other entities? Do those other entities also have pension plans for any of their employees?
- What type of pension plan does the target have: a DB, DC or CDC plan, or a combination of two or more of these types?
- Does the target have multiple pension plans? For example, for salaries above and below a particular amount? If so, what are their features?
- Are there any individual arrangements for specific employees in place?
- Are there any other pension-related arrangements (like arrangements for early retirement that are no longer allowed or conditional pension arrangements (*Wet afschaffing Vut en Prepensioen en introductie Levensloopregeling*)). Have all these arrangements been fully paid?
- Have past amendments to the pension plan been accepted by all employees? Has this been documented in writing? For example, have the employees signed to signal their agreement?
- Is the pension plan mandatory? Is it possible that the target should have been registered with a mandatory industry-wide pension fund (see *Mandatory pension funds*), but is not?
- Does the buyer want to continue the pension plan, or should preparations be made to review possibilities to terminate it? How will the pension plan change after the transaction closes?
- Will the employees stay with the target company, or will they be transferred to other parts of the seller's organisation or the buyer's organisation? How will this affect the pensions?
- Will the risks attached to survivor's pensions and disability pensions still be covered after the transaction, or will new insurance have to be taken out (if necessary)?
- How much does the target pay in pension contributions? Have all those contributions been fully paid?
- Are there any pending requests from former employees for value transfer to another pension administrator?
- Have all the employees been registered with the pension administrator? If not, what is the reason for this and is this compliant with the pension plan?
- Are any pension-related disputes pending or foreseen with employees, former employees or pension beneficiaries?
- Are the pension plans legally compliant, including with tax law? Have they always been compliant in the past?
- What is the materiality of any findings during the due diligence process?

Must-have documents

To properly address the listed issues (see *Most important pension issues during due diligence*) it is important to obtain the following documents during a due diligence review:

- The pension agreement or the employment contracts showing what pension arrangements have been agreed with the employees; this may also be a collective bargaining agreement or a standard set of employment terms.
- The applicable pension plan rules.
- The contract with the pension administrator (if the pension plan is administered by a life insurer) or the contract with the appropriate pension fund, including any change of control clauses.
- Waivers of the employees who are not participating.

Nice to have documents

In addition to the must-have documents to properly assess the target's pension arrangements, it is advisable to obtain the following documents:

- Letters and newsletters for members of the pension plans.
- Presentations about pensions.
- Statements from employees accepting changes to their pension plans (if applicable).
- Invoices for contributions.
- Confirmation of exemption from participation in a mandatory industry-wide pension fund (if applicable).
- An audit report by a specialist pension consultancy firm on whether or not participation in an industry-wide pension fund is mandatory.
- Communications with the pension administrator.
- Evidence that indexation has been granted, including for previous years (if applicable).
- The pension fund's annual reports and other documents regarding the pension fund, such as its articles of association.

Specific issues

Indexation and employees' part of nominal contributions

The indexation forecast, that is the promises that were made regarding the level of indexation of the accrued pensions, should be reviewed. The proportion of the nominal contributions the employees are supposed to pay should also be noted, as this would minimise the exposure of the employer.

Disputes

It is also important to establish whether any pension-related disputes are pending or expected, such as with the pension administrator, for example, about exemption from participation in a mandatory industry-wide pension fund. More importantly, it should be established if any disputes with employees are pending or expected about changes to the pension plan entitlement or the target's pension arrangement in general.

Mandatory pension funds

A further factor in many transactions is whether the target company falls under a mandatory industry-wide pension fund (see *Mandatory industry-wide pension funds*). Whether an employer falls within the scope of a mandatory pension fund depends on the company's actual business activities and is mainly a factual matter. Unfortunately, the scope of a mandatory pension fund is not always clear. It regularly leads to legal discussions or even to court proceedings.

Problems will arise if it emerges that the target company should have joined a mandatory industry-wide pension fund previously. In principle, the target company will then need to join the pension fund retroactively, which can be costly. The target company can try to negotiate with the pension fund to limit the duration of the retroactive membership. In general, mandatory pension funds are keen to register all relevant employers and employees, especially as non-registered employees can claim a pension from their mandatory pension fund even though no pension premiums have been paid for that employee.

Another possible consequence of a transaction is that the target company becomes part of another group that falls (in whole or in part) under a(nother) mandatory industry-wide pension fund. Alternatively, the acquisition of the target company may result in one or more of the acquiring group's entities participating in an industry-wide pension fund. It is therefore important for a buyer to establish at the start of the process what the structure and the business activities will be post-closing.

Group pension plan

If the target company is part of a group of companies and participates in a pension plan of that group, the pension administrator should be contacted to discuss continuance of the participation after the transaction is closed. Obviously, post-closing the target company will no longer form part of that former group and the pension contracts with external parties should be rearranged. By law, if the pension plan is administered by a pension fund, this may be continued for a limited time. For employees this would be a maximum of three years (*article 54, Dutch Pensions Law Act* and *article 10a, Implementing Decree Wage Tax Act*). This, however, requires the pension fund's consent.

If the pension plan is administered by a life insurer, the existing arrangement could also be continued for a maximum period of three years. However, in practice this will rarely happen since the seller usually does not want the target company's employees to continue participation under the seller's insurance contract. An own pension plan (perhaps on the same terms and conditions) or even an alternative pension administrator, will need to be considered in good time before the transaction is closed.

The only exception to this rule is where the pension plan is administered by a mandatory industry-wide pension fund and the target company will continue to operate in the same industry (see also *Mandatory industry-wide pension funds*).

As a general rule, the employees (and the works council if the company has one) must agree to change their pension agreement and to the new pension administrator's pension plan rules. In practice, it is generally (if not entirely) impossible to continue an existing pension plan with a new pension administrator without any changes. The approval process will need to be conducted with due care and can take a great deal of time. In practice, however, changes can be successfully achieved with careful and thorough preparation.

Pensions warranties and indemnities in a SPA

Unfortunately, it is often impossible to uncover all the necessary information about pensions in a due diligence investigation. In some cases, it will be fragmented and out-of-date. In those situations, a useful course of action is to include specific pensions warranties in the SPA, such as:

- That all the necessary information has been provided.
- That the pension plans are legally compliant, including with tax laws and regulations.
- That all contributions and other financial obligations have been paid in full and on time. This warranty could be important if the contract with the pension fund contains an obligation to make additional payments into the pension fund if its solvency drops below a predefined minimum value.
- That all employees have been registered with the pension administrator.
- That no mandatory pension fund is applicable.

The SPA may also often include specific indemnities about pensions to address situations when:

- It is unclear whether the individual employees have accepted past changes to the pension plans.
- Any discrepancies exist between the pension agreement under the employment contracts and the pension plan rules.
- Any claims may exist relating to a mandatory pension fund (see *Mandatory pension funds*).

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