Pensions Issues in Cross-Border Acquisitions (Germany)

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Practice notes | Law stated as at 12-Feb-2024 | Germany

A Note considering German pension law issues when acquiring a private company or a business in Germany.

This Note explains:

- The mandatory state pension requirements in Germany and any supplementary non-state pension provision.
- Any government supervision or monitoring.
- The consequences for the pensions of employees transferring as a result of a share or asset acquisition.
- The consequences for pensions for any employees working outside Germany.
- What documents a buyer would usually request to see when undertaking retirement benefits due-diligence when acquiring a company or business and provides an example retirement benefit warranty to insert into any share or asset purchase agreement.

Tax reliefs are available for the pension schemes covered in this Note, however, their detailed application to each scheme is out of the scope of this Note.

Mandatory State Pensions

There is a legal requirement for mandatory contributions to be made to the government retirement scheme, which is the first of three pillars of the German retirement system (section 1 et seqq., *Sixth Social Code*) (*Sozialgesetzbuch*, *Sechstes Buch*) (SGB VI). The other two pillars are company pensions and private individual pensions (see *Supplementary (Non-State) Pensions*). First pillar benefits are the most significant source of retirement income in Germany.

The government retirement scheme is a pay-as-you-go scheme providing for (early) retirement, survivor and disability benefits. Contributions to the scheme are deducted from employees' monthly gross salary by the employer, with the employee and the employer each paying half of the total contributions. Contributions paid into the scheme determine the level of the benefits.

Supplementary (Non-State) Pensions

Supplementary (that is, non-state) pension provision such as company pensions and private individual pensions are available but are not legally required in Germany, except for:

- Company pension schemes wholly funded by employees themselves through salary conversion (into a company pension), where an employee makes such a request to the employer.
- Company pension schemes based on collective bargaining agreements, typically for specific industries.

Absent a general legal obligation to provide company pension schemes, most employers provide pension schemes as a vital part of their remuneration strategy to attract and retain talent or responding to works council proposals (while a works council cannot request that an employer establishes a pension scheme). Collective bargaining agreements, on a company or industry level, often provide for company pension schemes.

Supplementary schemes can be defined benefit or defined contribution, with schemes historically having been defined benefit, whereas modern schemes are generally defined contribution.

Company Pension Schemes

Company pension schemes are provided through contractual arrangements between employees and the employer, or, where employee representation exists in a company, based on an agreement between the employer and the works councils or in collective bargaining agreements (as company or industry-wide schemes).

Five types of company pension schemes are possible:

- Employer direct pension commitment.
- Support fund.
- Direct life insurance.
- Pension insurance fund.
- Pension fund.

Defined contribution company pension schemes without a supplementary employer liability for at least the total amount of contributions paid into the scheme (employer guarantee) are not acknowledged under German pensions law. As an exception, since 2018, defined contribution company pension schemes without employer liability are possible, but only on the basis of a collective bargaining agreement and provided certain additional requirements are met (*section 1a, paragraph 2 no. 2a, Company Pension Schemes Improvement Act (Gesetz zur Verbesserung der betrieblichen Altersversorgung) (BetrAVG)*). Such schemes are still rare because small and medium sized businesses are reluctant to engage in collective bargaining solely for the benefit of a defined contribution pension scheme. So far, only two defined contribution schemes have been launched, in October and November 2022 (in the chemical and energy sector).

Company Pension Schemes: Funding

Direct employer commitment schemes do not have to be funded and historically were not funded. Pensions are paid from the company's future cash flow when due for payment. More recently, employers have opted to voluntarily fund such schemes through reinsurance solutions or contractual trust arrangements (plan assets). Support fund schemes are typically funded although full funding is not generally required. Direct life insurance, pension insurance fund and pension fund schemes are funded through contributions paid.

In case of unfunded pension schemes, the employer must record pension book reserves on the company's balance sheet.

Tax Relief

Tax reliefs are available, depending on the type of scheme. For more information on the tax issues to consider on private company acquisitions, see *Practice note, Tax: Private Company Acquisitions (Germany)*.

Private Pensions

Private pensions are provided mainly through contractual arrangements between individuals and product providers (such as insurers). Tax reliefs are available.

Employees Working Outside of Their Home Jurisdiction

Employees that are working outside of their home jurisdiction, and employees of a subsidiary company in a different jurisdiction, can participate in a pension scheme established by a "home" parent company in limited scenarios, but they rarely do. Social security and tax reliefs are generally not available in these circumstances.

Government Supervision

No specific government supervision for supplementary pension schemes exists. However, where such schemes are insurance or insurance-type schemes (for example, private life insurance policies, company pension direct insurance or pension fund schemes) they are subject to supervision by the Federal Financial Supervisory Authority (BaFin).

BaFin may issue instructions that are to prevent or eliminate undesirable developments against the interests of policyholders. BaFin may appoint a special commissioner to replace the board of management, supervisory board or other governing bodies of an insurance company and can revoke the authority to carry on business. BaFin can also conduct ad hoc stress tests or scenario analyses.

Employer direct pension commitment schemes and support fund schemes are not subject to government supervision.

Consequences for Retirement Benefits Resulting from a Business Acquisition

In a business acquisition (asset deal), the transferee must assume the pension liabilities of transferring employees "as they find them", including past service pension liabilities.

The general rule is that existing pension rights need to be honoured except where they are substituted (at least at equal level) by the transferees' existing pensions schemes. Where existing pension schemes cannot be continued by the transferee, for example for regulatory reasons where the scheme is exclusive to the transferor legal entity, the transferee must provide equivalent rights and translate the transferring employees' past service pension rights into the equivalent scheme. Assuming and continuing insurance-type pension schemes is straightforward in most cases; the transferee simply succeeds the transferor as policy holder or member of the respective scheme. If employer direct pension schemes are transferred, the transferee will have to build up balance sheet book reserves reflecting the transferring pension liability.

Pension scheme transfers in asset acquisitions may cause problems where schemes are based on works agreements at the transferor with the transferee having conflicting pension schemes also based on works agreements. Much depends on the specific structure of the acquisition but, as a rule of thumb, the largest scheme (by members) will typically survive the acquisition and apply for the future service of employees.

Benefits Acquired Before Transfer of Business

Accrued pre-transfer pension liabilities transfer to the transferee for all transferring employees, that is, the active employees of the transferor (but not for inactive employees, former employees or retirees of the transferor). As of the transfer date and vis-à-vis the transferring employees, the transferring liabilities become the responsibility of the transferee alone, irrespective of any commercial agreement of the acquisition parties to the contrary (which is standard, that is, the transferor compensates the transferee for the pre-transfer pension liabilities by way of lump sum payment, transfer of funding assets (if any) or purchase price reduction).

Due Diligence: Retirement Benefits

A buyer would usually request (and the seller commonly provide) the following information about pensions and other retirement benefits in a due diligence exercise relating to a private company or an asset acquisition:

- Overview of pension schemes and whether open/closed.
- Scheme membership details (number of active employees, inactive (former) employees with vested benefits, retirees).
- Pension scheme plan documentation including external scheme documents, for example, insurance policies.
- Basis for pension schemes (collective bargaining agreements, works agreements, employment contract or other).
- Amount of pension scheme liabilities (evidenced by actuarial opinions).
- Scheme funding: funding level and funding mechanics (and documentation).
- Amount of contributions to Pension Protection Fund (insolvency protection).
- Pension indexation: indexation reviewed and undertaken.
- History of scheme reorganisations (for example, closing, freezing, substitution).
- Pension scheme related litigation (including conciliation boards with works councils).
- (Asset acquisitions only) carve-out issues where only a part of a business is acquired.

Example Retirement Benefit Warranty in Share or Asset Purchase Agreement

Specific warranties relating to pensions and other retirement benefits would commonly be incorporated in a share purchase or asset purchase agreement, depending on the review of the due diligence information, that is, providing for an accurate description of the pension scheme landscape and related liabilities (see *Due Diligence: Retirement Benefits*).

Disclosure schedules would list the transferring pension schemes as well as scheme related claims and litigation. Any scheme funding as well as contributions paid (contribution history) would be warranted. Legal compliance of scheme reorganisations and pension indexation would be warranted (with sellers often being reluctant to warrant).

The amount of transferring pension scheme liabilities and any transferring funding (assets) would be agreed, as well as how the buyer will be compensated by the seller for the transfer of unfunded pension liabilities, for example, through lump sum payment of cash or reduction of the purchase price where the purchase price clause does not already reflect any pension book reserves as liabilities on the balance sheet.

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