Wilberforce Pensions

The Edward Nugee Memorial Lectures

June 2015

Contents

Foreword

These papers, and the lecture series which preceded them, are dedicated to the memory of the late Edward Nugee QC, former head of Wilberforce Chambers and the foremost pensions barrister of his generation.

Ted's expertise in this most technical of legal fields is reflected in the subject matter of these papers. Often when barristers are called upon to give presentations, they concentrate on single cases or on issues which are of particular interest to litigators. The purpose of the Edward Nugee Memorial Lectures is to concentrate instead on issues of technical pensions law aimed at the wider pensions legal community.

Wilberforce Chambers is fortunate to have a number of outstanding practitioners who are able to approach these issues from the perspective of the courtroom as well as the boardroom. I would like to thank the authors of these papers for their hard work and outstanding contributions.

Organising the lectures was a pleasure, and I hope that all those who attended them found them as stimulating and as valuable as I did. The success of them has encouraged us to make this an annual event, so hopefully this collection of papers is the first of many.

Paul Newman QC

The Speakers

Michael Furness QC

Michael is a leading Pensions Silk specialising in occupational pensions, onshore and offshore trust litigation, tax litigation (UK and Hong Kong) and related professional negligence claims. He advises on all aspects of Pensions law and his pensions litigation practice includes regulatory litigation (FSDs and CNs), issues of interpretation of statutes and scheme rules, and claims for rectification of scheme rules. He also advises The Pensions Regulator, The Pension Protection Fund and the FSA on technical pensions issues. Michael is consistently involved in some of the biggest pensions cases, he is ranked as a leading Pensions silk in Chambers & Partners 2015 where is he described as "a highly sought-after silk", "sensationally clever" and praised for the depth of his experience and for his analytical skills. "He impresses both clients and instructing solicitors."

Brian Green QC

Brian is consistently Star Rated in Pensions Law in the Chambers & Partners legal directory and Top Rated in the Legal 500 legal directory. A previous Chambers & Partners Chancery QC of the Year, and STEP Barrister of the Year, he advises and has appeared in many of the major cases in the pensions field. Chambers & Partners describes him as a "powerhouse practitioner" with a "stellar reputation" who provides "pragmatic and often brilliant advice." "Personable and technically superior", he is praised for his "intellect, range of ability and [in the context of contentious litigation] desire to succeed."

Michael Tennet QC

Michael's practice encompasses litigation and advice in the fields of pensions (including professional negligence), financial services and private trusts. In recent years he has appeared in many of the most high profile and complex pensions cases. This has included the litigation concerning – *The Pilots National Pension Fund, The IBM Scheme, The QinetiQ pension scheme, The Merchant Navy Ratings Pensions Fund* and *The Nortel Pensions Scheme*. Michael is also regularly instructed by the Pensions Regulator. He has a particular knowledge of the work of actuaries, both in relation to pension funds and life assurance funds and is described in Chambers & Partners, 2015 as "Very hands-on and good at leading a team of juniors, he's a strong advocate who puts points across forcefully."

Emily Campbell

Emily is a leading pensions junior with a wealth of experience in pensions litigation (including regulatory work, professional negligence and rectification claims) and she regularly advises on complex technical issues including scheme funding, the scope of powers in pension schemes and the effect of mistakes in pension scheme documents. Complementing her pensions practice, Emily has a broad private client practice. She acts in a range of contentious and non-contentious trust and estate litigation, including cases with a foreign element. She advises on a wide range of issues with an emphasis on private wealth planning, tax and the drafting of trust documentation. She is ranked in the legal directories as a Leading Junior where she is described as "extremely bright and experienced." "She has an outstanding grasp of the most obscure technicalities of pensions law." (Chambers & Partners 2015)

Edward Sawyer

Edward Sawyer was called to the Bar in 2001. He has a commercial and chancery practice, with a specialism in pensions. He has extensive experience of pensions litigation and advisory work, having appeared in a number of high-profile recent cases such as IBM (both the rectification and good faith cases), *Nortel, Merchant Navy Ratings* and *Box Clever*. He regularly deals with issues as to scheme funding, section 75 debts, equalisation, rectification, trustee and employer duties, construction, insolvency, regulatory powers, PPF entry and professional liability, amongst other matters. Edward is recommended as a pensions junior in Chambers & Partners and the Legal 500.

Jonathan Hilliard

Jonathan was called in 2003 and is ranked in the top tier for pensions in both principal legal directories. On the litigation front, he regularly acts on his own account, whether by himself or leading a junior junior against QCs, on matters from rectification claims through trustee direction claims to regulatory matters. On the advisory side, he regularly advises on corporate reorganisations, pensions-insolvency, pensions-employment, moral hazard and other issues. Recent examples of his reported cases include *MNRPF, Box Clever, Lehman, Nortel, Pi v The Pensions Regulator, Becker & Fellowes v The Pensions Regulator, Storm Funding, FSS* and *BT*. He studied law at Cambridge and came top in both his undergraduate and masters degrees.

James Walmsley

James Walmsley is a leading pensions junior recommended in both the Legal 500 and Chambers & Partners. He acts in both regulatory and non-regulatory matters. In the regulatory sphere, he has extensive experience acting in relation to trustee appointments (including in relation to the recently reported matter relating to the so-called Barratt and Dalton Schemes), intervention in pensions liberation (including in relation to eg the 5G Futures case), moral hazard investigations and proceedings in related insolvencies (including *Nortel, Lehman, Box Clever, Great Lakes*, amongst others), and Part 3 scheme funding matters (including *Pilots,* as well as e.g. the recently reported DLR matter). In the non-regulatory sphere, he has extensive experience of, amongst other things, rectification claims (eg *MNOPF v Watkins* [2013] EWHC 4741 (Ch), trustee blessings (*MNRPF v Stena Line* [2015] EWHC 448 (Ch)), and professional negligence claims.

Emer Murphy

Emer was called to the Bar in 2009 and quickly established a successful practice; she was named one of Legal Week's 'Stars at the Bar' 2014. Emer has experience in a wide range of pensions matters, acting both on her own account and as a junior. Her recent experience includes acting (as a junior to Robert Ham QC) for the successful employer in *Trustees of the Dresser-Rand UK Limited Pension Scheme v Dresser Rand UK Limited [2014] EWHC 170 (Ch); [2014] Pens. L.R. 153* (a claim concerning the correct interpretation of powers of amendment in the context of an attempted equalisation). Emer was also instructed on the employer side in *British Airways Plc v Trustees of the Airways Pension Scheme* (which concerns a decision to grant discretionary pension increases above CPI).

Scheme funding issues

Michael Tennet QC and James Walmsley

The text of the bulk of this paper is based on the notes used as the basis for delivery on 2 June 2015 and references in the text to a talk are the talk given of that day. A post-script section at the end of the paper updates the analysis in light of comments given on that day and other developments since then.

INTRODUCTION

1. Most of this talk is concerned with an exploration of issues associated with the interrelationship between scheme contribution rules and Part 3 PA04. That will take us into consideration of the position of non-statutory employers and then also non-standard contributions, and in particular asset-backed contributions.

THE INTER-RELATIONSHIP BETWEEN SCHEME CONTRIBUTION RULES AND PART 3 PA04

2. The minimum funding requirement (the MFR) was introduced in 1995; ten years later it was replaced by Part 3 of the Pensions Act 2004. Part 3 has already lasted longer than the MFR. There is no sign of Part 3 being replaced. But some fundamental questions remain open about the interrelationship between Part 3 and Scheme contribution rules, and we look at some of these in this talk.

3. By way of very basic summary of the regimes:
    a. The MFR was introduced by PA 1995. It was a prescribed valuation basis.
    b. S.58 required the trustees to secure that there was a SOC showing the rates payable by employers and members from time to time. Contributions were either those agreed, or, in the absence of agreement, those set by trustees as being sufficient to meet MFR.
    c. The MFR provided a floor but did oust the effect of the scheme contribution rule.
    d. Part 3 PA 04 was passed in 2004 and came into force in December 2005.
    e. It was intended to implement the IORP Directive, the thrust of which was that the scheme should value its liabilities adopting a sufficiently prudent actuarial basis.
    f. Under part 3:

i. Every scheme is subject to a requirement that it must have sufficient and appropriate assets to meet its objectives. The technical provisions (TPs) are the amount required on an actuarial calculation to make provision: s222.

ii. There are triennial valuations.

iii. If there is a deficit, a recovery plan (RP) must be prepared.

iv. In all cases a schedule of contributions (SOC) must be prepared: s.227.

v. If an amount due under an SOC is not paid, it is, to the extent not already a debt, a stat debt on the employer: s.228

vi. The funding documents must be agreed with the employer: s.229. Though there are some important modifications to this which we shall come on to.

vii. Then in s.231 the Regulator (TPR) has powers to step in and impose a SOC (amongst other things) if the relevant documents are not properly concluded within the statutory deadline of 15 months after the valuation date

4. Why is there an issue about the interrelationship between scheme rules and Part 3?

a. In the case of the MFR, it is easy to see that the statutory regime was not intended to oust or displace the scheme rules. The clue is in the name. If it did oust the rules then schemes would (in the absence of employer agreement) only be left being funded on the minimum basis provided for by the MFR. That plainly was not the legislature's intention.

b. In the case of Part 3 the inter-relationship is or was not so easy to identify.

c. The standard set by statute is that the scheme must have sufficient and appropriate assets to cover its TPs. The word minimum is not used, and the TPs are to be calculated in a prudent way under the principles set out in SFR reg.4.

d. On the face of the regime, there is sufficient latitude to calculate liabilities in such a way as to set an appropriate funding target for the scheme. In addition under ss.226-7 and regs 8-10 you can set an RP and SOC that is appropriate for meeting that funding target. If you have a framework in place to do all of that, why would you still need scheme contribution rules too?

e. Further, there are specific elements of the statutory regime which give rise to the question whether the scheme rules are intended still to be operating, or at least operating without modification so that they fall into line with the statutory framework.

f. S.306 of PA 2005 provides :

> *(1) Where any provision mentioned in subsection (2) conflicts with the provisions of an occupational or personal pension scheme-*
>
> *(a) the provision mentioned in subsection (2), to the extent that it conflicts, overrides the provisions of the scheme, and*
>
> *(b) the scheme has effect with such modifications as may be required in consequence of paragraph (a)*

However the existence of s.306 does not answer the question of when the scheme rules are to be regarded as overridden. It is materially the same as s.117 of PA 1995 (which applied when the MFR was in force). As in relation to the MFR it might mean that the scheme rules are overridden only where they provide for less than the SSF minimum.

g. S.227(2) is more interesting. It defines an SOC as a statement showing "the rate of contributions payable". Since Part 3 sets out a process for agreeing that with the employer, it might be said to imply that the statutory framework is a process for setting <u>the</u> contributions payable (i.e. <u>all</u> the contributions, not just some of them).

h. S.231 allows the imposition of SOC by TPR of an SOC specifying "the contributions payable" by the employer in question. Again prima facie this does not mean only *some* of the contributions payable, but *all* of them.

i. Reg 10 of The Occupational Pension Schemes (Scheme Funding) Regulations 2005 ("the Funding Regs") stipulates that a schedule of contributions must show the rates and due dates of <u>all</u> contributions payable towards the scheme on behalf of the employers. This reinforces the impression given by s.231 and 227(2)

j. S.229 requires the agreement of the employer to the scheme, but then para 9 of schedule 2 to the Funding Regs modifies this. It is important to look at that in a bit more detail to understand to what extent it can be said that the funding rule exists independently of the SSF regime. We do this later in this talk.

5. Before exploring the issue further, it can be said that there are at least some stable building blocks on the current authorities:

a. First building block. Part 3 did not automatically oust scheme rules from the outset, so that you could still exercise a scheme contribution power before a Part 3 SOC was in place. That was decided by <u>British Vita</u>. This case related to two demands made by a trustee under a scheme contribution rule in July 2006, after Part 3 was in force, but before any Part 3 schedule was in place. The underlying funding basis supporting the calculation of the demands was a harsh gilts-basis. The validity of the demands was challenged in part on the basis that the scheme contribution rule had fallen away in the light of the coming into force of Part 3. The Judge decided that was not right. The ability to make the demands were not displaced by Part 3. (There was also another issue about whether the construction of the contribution rule allowed the entirety to be put on a single employer, but that need not detain us.) So far as analysis goes, what British Vita emphasised is that if you are relying on s.306 you needed to identify a conflict to cause the scheme rule to be modified.

b. Second building block. If the Part 3 contributions are greater than scheme rules then Part 3 will override scheme rules – in other words the SSF regime has at least the effect of the MFR in setting a minimum standard. The scheme rules cannot put a limit on contributions which prevent the SSF target being met. This was the clear intention of IORP and was implicitly confirmed by the <u>Pilots</u> decision (although much of the reasoning is devoted to the particular position of shared cost schemes (of which the Pilots scheme was one). (The Pilots case concerned an industry wide scheme. The contribution rule was on a shared cost basis which did not really work given the size of the deficit and the maturity of the scheme. Since the first part of the case was about an amendment away of the shared cost structure and the judge said that was fine, the shared cost issues to an extent fell away, but the judge still dealt with it.)

c. Third building block: in the case of a shared cost scheme like the Pilots scheme (where employer/employees in fixed proportions under the rules) the statutory funding standard does not have to reflect that shared cost structure. The statutory framework enabled you to do what you needed to do in practice to achieve the statutory funding objective. If necessary s.306 would operate to oust the effect of the rules restricting your freedom to claim contributions from participants in the scheme. It was not enough to say that in theory you could achieve the statutory funding objective by imposing 200% contributions on employers and 100% on members (under the rules). S.306 wasn't just about identifying a <u>logical</u> conflict between SSF and the rules, it was about identifying conflicts in operation and fact (ie do the rules hamper the Trustees ability to achieve SSF targets in an acceptable time?).

d. Fourth building block. So far as you are concerned with a mix of non-statutory employers and statutory employers, there is nothing in Part 3 that ousts the ability to seek contributions from non-statutory employers. Again that is in Pilots. The argument is that the statutory scheme funding regime simply had no application to non-statutory employers. As we shall see however this ability to seek additional contributions from non-statutory employers is a potential source of tension with other aspects of the Part 3 regime. If there is a mix of statutory and non-statutory employers, the contributions from non-statutory employers can affect the overall level of scheme funding even though they appear to be outside the statutory regime. (We look at this further later in this talk.)

6. But none of the case law has yet decided the impact of the SSF regime on the trustees' ability to seek additional contributions under the scheme rules compared to those that have been set under Part 3? Such case law as there is in this area has had much to say about this topic, but the question has not yet been decided.

7. This will not be a problem in all cases. In practical terms, clashes between the Rules and the statutory regime are less likely to be an issue where the power under the rules is bilateral (as would be the statutory power) because employers will either be:

a. unlikely to consent to an exercise of the power so as to compel contributions in excess of the statutory rate; or
b. willing to pay.

8. A clash between the rules and the statutory scheme is most likely to arise in situations in which trustees have effective unilateral power under the rules but only a bilateral power under Part 3. This is by no means unusual: take a unilateral trustee power subject to a company power to suspend or reduce contributions for instance. Para 9 modification of s.227 is not triggered so that company agreement is still required to the statutory funding documents.

9. Similarly, clashes can also arise in the case of unilateral powers under the rules and under Part 3. Although the trustee can in effect (subject to its duties to take employers interests into account) do what it wishes under both Part 3 and the rules, there may be situations in which a trustee has unilaterally set a Part 3 rate and then wishes to revise this upwards in an

inter-valuation period. Is the trustee obliged to go through the Part 3 mechanics (new valuation, consultation etc) or can it simply impose a new rate under the rules?

10. Nor is it difficult to imagine cases in which Trustees might want to go above and beyond a Part 3 target. For example consider 3 scenarios :

A. Where an SOC at Part 3 levels (perhaps imposed by TPR) is already in place but the trustees decide they want to seek additional contributions under rules to put the scheme on course for a long term solvency funding target.

B. Where there is an SOC at Part 3 levels (perhaps imposed by TPR) already in place but the employer suffers an adverse event / change of circumstances and the trustees want additional contributions to protect the scheme under scheme rules, rather than going through the laborious Part 3 process.

C. Where the Part 3 funding standard has already been reached and the Trustee wants to impose solvency targets under the scheme rules:

11. The key question can be crystallised by reference to a scenario where an SOC is in place and the trustee wants to go further by exercising power under the contribution rule under the scheme rules. Is the contribution rule power unaffected by the extant SOC if the trustee wants to seek more?

12. Policy considerations and statements within Parliament as to the intended effect of the SSF regime can be seen to "cut both ways" in terms of whether it should supplant scheme rules:

a. leaving the scheme rules in place could be useful, and the tendency in this area is to retain flexibility (compare powers of amendment) rather than remove it.

b. IORP tends to be perceived as primarily protecting members / investors. The IORP directive as summarised by Warren J in *British Vita* at paragraph 31, it refers to the scheme as having minimum technical provisions sufficient to cover benefits already in payment and to reflect accrued rights. However:

i. Although IORP does use the word “minimum” in connection with the calculation of technical provisions, all that this may be saying is that it was a requirement of IORP that whatever standard was imposed on schemes under statute, that standard had to be at least good enough to meet liabilities on the prudent basis required by IORP. There is nothing in that language or that policy to suggest that the Trustees should, or should not, be free thereafter to seek funding to a higher standard than was necessary to meet the liabilities. IORP was not drafted for the UK alone and the use of the word minimum in IORP was not intended to have the same connotations as the use of the word minimum in relation to the U.K.’s minimum funding regime.

ii. IORP was not exclusively concerned with guaranteeing a high level of security for benefits. It also talks about helping to promote efficient management of schemes. It is not clear how the efficient management of schemes is promoted by having 2 parallel and inconsistent regimes running at the same time, particularly where the statutory regime already guarantees with a high level of certainty that benefits will be paid (if contributions are paid)

c. Baroness Hollis speaking in the HL about the SSF regime also seemed to accept that what is now s. 229 would override scheme rules:

> *“We are aware that a requirement to seek the agreement of the sponsoring employer raises particular issues for schemes in which the rules of the scheme give the trustees or scheme actuary the responsibility for determining the level of contributions payable to the scheme. Such a requirement would override existing rules in a way that could have an adverse impact on the security of members' benefits”. [emphasis added]*

That said Baroness Hollis then continued

> *“We have concluded that it would not be appropriate to override existing rules of schemes in that situation.“*

However there is an issue which we will consider later in this talk about whether the solution she proposed in fact had the effect of leaving the scheme rules in place and unaffected. She said:

> *"We therefore propose to modify the new provision under the powers in Clause 222 [that is now section 232] [Curiously the British Vita report refers to s.231 here, but that is obviously an error] to provide that when rules of the scheme provide for the trustees or scheme actuary to set the contribution rate, that arrangement may continue."*

That (as we shall see) is not the apparent effect of the modification effected under the regulations put in place pursuant to s.232.

d. TPR's obligations in relation to Part 3 include protecting employers and it is hard to see how this would not involve reducing contributions otherwise payable. If so it begs a question as to whether trustees could simply overrule the TPR's determination of what an appropriate level of funding should be by exercising separate powers under the rules. This does not necessarily mean that <u>before</u> a Part 3 SOC comes into force, the rules are treated as modified (so British Vita may still be correct), but it may alter the position once a Part 3 SOC is in force.

13. The current authorities lean towards the answer "yes" that the trustees' ability to seek additional contributions under the scheme rules is unaffected by the Part 3 regime but just stop short of committing to that conclusion. In both <u>British Vita</u> and <u>Pilots</u>, Warren J explored this question but declined to decide it. The judge said that he inclined to the view that a unilateral power is unaffected but points out that because of a troubling issue about reg.10 of the Funding Regulations in the context of TPR-set contribution schedules, the position is unclear.

14. In <u>Pilots</u> the arguments against having parallel regimes were as follows:

a. It went against the purpose to introduce a consensual approach under Part 3 (para 742)
b. It was a recipe for chaos (744)

c. It went against what is apparently intended by s.229 and para 9 (746-7)

15. Warren J was not persuaded by those submissions:

a. They did not outweigh the apparent thinking behind s.228(3), or
b. They did not outweigh the fact that it would be curious if non-stat employers were unaffected by the introduction of Part 3 but stat employers were.
c. Further he found that there was no conflict for the purposes of s.306 bearing in mind that the purpose (as he had found in BV) was to put in place funding that is sufficient (a floor not a ceiling). It is no part of the Part 3 regime to prevent a scheme being better funded than the SFO being met: para 752.

16. The only thing that appeared to give the judge real doubt about the right conclusion was reg.10 and consideration of how TPR-imposed SOCs work (para 757)

17. As to this, we make 2 observations:

a. First, it does not seem to us that reg.10(1) is the real problem here. If Warren J's analysis is right up to the identification of the reg.10(1) issue, then, we would argue, reg 10 should not present an insuperable problem for his analysis.

b. Second, however, reg 10 is not the only problem for the parallel regime analysis. There are serious reasons other than reg.10(1) for doubting that there can be parallel regimes. The challenge goes beyond addressing the reg.10 puzzle.

18. Turning first to the first of these two points – that reg.10(1) is not an obstacle to their being parallel regimes (with the scheme rules unmodified), if you are otherwise persuaded that there are:

a. What troubled the Judge in particular is how to deal with reg.10 (1)
10 Content and certification of schedules of contributions
(1) A schedule of contributions must show the rates and due dates of <u>*all*</u> *contributions (other than voluntary contributions) payable towards the*

scheme by or on behalf of the employer and the active members during the relevant period.

b. If reg.10(1) applies then it seems that a TPR SOC must show all contributions from stat employers (but not non-stat employers) and if that is right then isn't it the case that greater contributions could only be imposed if the schedule was changed? And a TPR SOC could only be changed by TPR, not by the trustee, given that changing a TPR SOC is tantamount to variation of a Panel determination.

c. There are a number of possible answers to the judge's concerns about reg.10:

   i. The judge's preferred answer is that reg.10(1) does not apply at all in connection with TPR SOCs. While reg.10 does (see.227(10) and 227(4)), obviously not all of reg 10 does (eg 10(5) and 10(6) are not applicable). The basis for saying that reg10(1) does not apply relates to the definition of "relevant period" under reg.10(2) (which looks at the date of certification (not applicable to a TPR SOC) and recovery length (not applicable to a TPR SOC). If reg 10(1) does not apply then one does not need to worry about its apparent scope.

   ii. An alternative answer is to say that even if reg 10(1) does apply it is only concerned with a requirement/constraint about what to include when putting in place an SOC. The effect of an SOC is then dealt with in s.228, and in particular by s.228(3) which provides that an amount in an SOC that is unpaid (and not otherwise a debt) shall be treated as a debt. There is no necessary implication that this limits the ability to seek contributions in future. To take perhaps a silly example to illustrate the point, you might have a rule that on Monday morning you will put in place a to-do list that will show all the things that you will do that week. But in the absence of a rule that you cannot do anything that is not on that list, the putting in place of that list will not prevent you from doing things not originally on that list, or even from doing things not on that list without modifying the list first.

iii. A third answer is to say that, even if reg.10(1) applies to TPR SOCs, TPR SOCs are a special case. And that even if the trustee's unilateral power is constrained by a TPR SOC, such unilateral power need not be constrained by a non-TPR SOC. (Contrast Pilots para 762c.) The justification for this position would be to say that varying a TPR SOC is the ultimate backstop under Part 3. A SOC reached by agreement does not carry with it the authority of one imposed by TPR.

19. None of these answers is wholly satisfactory. We consider the best answer is the second, namely that reg. 10(1) is only concerned with what you must put in to the schedule, tested at the time when the schedule is created.

a. If the stat regime did contemplate additional non-statutory contributions from statutory employers, it is slightly curious that the statutory regime would appear to require the inclusion in the SOC of such non statutory contributions from a statutory employer, but not the inclusion of non-statutory contributions from a non-statutory employer.

b. Even if reg. 10 did not exist the problem arises in any event given the language of s.231(2) (and 227(2)). S.231 refers to the TPR <u>specifying</u> "<u>the contributions</u>". There is no question that prima facie this means <u>all</u> (not just some) contributions. Note also that s.227(2) still applies in relation to TPR SOCs, so there is no difference between what contributions are to be included on each.

c. Again, if you locate the problem in s.231(2), a possible answer is that that is concerned with the position when you put in place the schedule. However, this could give the trustees "carte blanche" to rewrite the SOC imposed by the regulator on the basis it specified only the contributions payable until the trustees got round to changing the levels payable.

d. But if the wording of s.231(2) is not a problem for the parallel regime view, then nothing in reg.10 should shift the position.

20. However, there are reasons for thinking that there are problems with the parallel regime approach that have nothing to do with reg.10.

21. First, how compelling are the reasons given for rejecting the submissions in Pilots?

   a. S.228(3). Warren J considered that the words "if not otherwise a debt apart from this section" suggested that the contribution rule is not completely DISPLACED. However :

      i. It is also possible that those drafting had in mind that a schedule of contributions at a level agreed by the employer and signed by the employer might amount to a contractual obligation which would give rise to a debt apart from section 228 (3).

      ii. Even if the draftsman had in mind an obligation arising under the scheme rules, that is still entirely consistent with the contribution rule being modified and constrained by the SOC. Take a contribution rule which requires the employers to pay what is required of them under a statutory SOC. That may not be necessary in the light of s.228(3), but it is an understandable rule, and the precise wording of s.228(3) simply ensures that there is not any inadvertent double liability, because, if you have such a rule, s.228(3) does not add to the liability further.

   b. Warren J also thought it curious that a Trustee who wanted to impose similar contribution obligations on statutory and non-statutory employers would be unable to enforce a right under the rules as against statutory employers but was free to do what it liked against non-statutory employers. But is it that curious? There are a host of situations in which the obligations, of statutory and non-statutory employers differ. Non-stat employers do not have the burdens of the Part 3 regime or the s.75 regime. Why should statutory employers bear the burdens of Part 3 and the rules at the same time (if those obligations would conflict)?

22. Mr Justice Warren's analysis is also difficult to square with the sustainable growth objective that TPR now has, assuming that this objective was always an implicit part of TPR's role. The objective was spelt out by amendment to s.5 PA04 that came into effect two months after the passing of PA14 – ie. in July 2014 (see ss48, 56 of the PA14):

5 Regulator's objectives

<u>(cza)in relation to the exercise of its functions under Part 3 only, to minimise any adverse impact on the sustainable growth of an employer,</u>

23. So if one is concerned simply with the operation of the statutory framework, it would seem clear that TPR is not solely concerned with whether it is good enough for the statutory funding objective, it is concerned that it is appropriate which includes the potential to reject something overly harsh.

24. To illustrate that point, if the trustees have a unilateral power and simply rely on Part 3, and INITIALLY make no separate exercise of its powers under the rules, the way it works is they will first consult for the purposes of Part 3 and then submit their Part 3 documents.

(1) In that case if TPR regards the trustee's proposed SOC as inappropriate to the nature and circumstances of the scheme it has the means to interfere under section 231 on the basis of a failure to comply with the requirement of section 226. (In fact even that is a slight leap since the requirement under s226 relates to RP, but it must carry with it a requirement that the SOC is appropriate to the nature and circumstances of the scheme.)

(2) This ability to intervene works both ways: On the one hand, if the funding target is so weak as to be inappropriate, or the SOC so lengthy as to be inappropriate, TPR can step in. Likewise, if the funding target is so tough as to be inappropriate, or the SOC is so short as to be inappropriate, TPR can step in too, again under s226. And the latter possibility is perhaps all the more pertinent now in the light of the developments of TPR's objectives to involve employers' interests. The assessment of appropriateness must include regard to the sustainable growth of the employer.

25. A further problem with the analysis in <u>Pilots</u> is that it does not really handle or explain away the apparently direct and specific conflicts arising under s.229 (matters requiring the employers agreement) and Para 9 of Schedule 2 to the Funding Regulations.

26. Para 9 is worth looking at in detail. It has 3 parts to it.

i. Paras (1) to (4) deal with the case, in broad terms, where a trustee has unilateral power to set contributions. In that case, Part 3 is modified so that the trustee has merely to consult and does not need to get the agreement of the employer to the funding docs required under Part 3. Otherwise s.229 requires the employers agreement to the SoC.

ii. Paras (5) to (7) deal with the case in broad terms where the actuary sets the contributions without agreement of the employer. In that case, the requirement for the employer agreement to the funding docs is not ousted, but there is an additional requirement that the actuary confirm the contributions under the schedule are not lower than what he would have set.

iii. (Para (8) simply deals with a specific point concerned with schemes related to defence contractors and is not relevant for our purposes.)

One might ask: if the scheme rules were intended to stay in place (or stay in place without modification), what is the point of s.229 and Para 9?

27. The problems trying to reconcile scheme rules and s.229 and Para 9 regime can be illustrated by a few examples of apparent conflicts.

28. Pure unilateral power. First, take a unilateral trustee power without a consultation requirement.

a. Under para 9 there will be (in contrast to the position under the rules) a consultation requirement for agreeing the statutory funding docs. But if the trustee can set the rule-based contributions without consulting, and the SOC must at least include the contributions that have been set under the rules, then isn't the consultation a dead letter? Can't the trustee say that the SOC must include the contributions that it has demanded under the rules, because those contributions have been validly demanded, and the SOC must include all contributions? In that way, the consultation requirement, at least insofar as it relates to contributions, could be rendered ineffective on the parallel regime model.

b. What's the answer to that? One answer may be that this is an example of somewhere where s.306 comes in. The tension is sufficiently stark that it counts as a conflict requiring modification of the effect of the scheme rules.

c. That is, the effect of the scheme contribution rules to be modified to include a consultation requirement, so that then the trustee cannot impose contributions under the rules without first consulting.

d. Consistent with s.228(3), the rule remains in place, but consistent with s.306 it is modified so as to include a consultation requirement.

e. On that approach, the parallel regime model is already being modified.

f. The alternative approach is to say that Part 3 is concerned only with setting a good enough standard, and does not stand in the way of the trustee imposing more if necessary. Indeed there may even be cases where for the purposes of achieving the statutory funding objective it is desirable to impose contributions without consultation.

29. Unilateral power subject to suspension/reduction. Second, take a unilateral power which is subject to a right to suspend/reduce, so that under Part 3 there remains a requirement for agreement.

a. If the trustee does not like an SOC put in place under Part 3 (either by agreement or by Part 3) can it simply impose additional contributions under the rules.

b. Here it might be said that there is not such a direct conflict because the non statutory contributions are subject to suspension/reduction whereas the statutory contributions are not.

c. However until the power to suspend is exercised, the employer will still be required to pay contributions greater than those which TPR has imposed under Part 3. Furthermore the employer's power to suspend the additional contributions may in practice be useless because suspension may have all sorts of unwelcome consequences under the rules for the employer such that the power is not in practice exercisable. Indeed the power may not even be exercisable by the specific employer that is made subject to the additional contributions.

d. There is a question here whether the conflict is sufficient to bring yourself within s.306, but it is clearly arguable that the trustees should not be entitled to act outside the SSF regime in this situation either.

30. Actuarial determination. Third, take a contribution rule under which the actuary determines the contribution rates – attracting the effect of paragraph 9(5). Employer agreement is still required but the actuary needs to certify that the trustee and employer have agreed something at least as good as the actuary would have determined.

a. Suppose the actuary refuses to certify because it's not at least as good, so that there is a failure to comply with the Part 3 requirements and TPR's powers under s.231 are triggered. Or suppose that the trustee and employer fail to reach agreement because the trustee works on the advice of the actuary but the employer is insisting on lower contributions. And then suppose TPR steps in and imposes a s.231 schedule that is lower than what the actuary was recommending.

b. Is it in those circumstances open to the actuary to set contributions under the rule to require the employer to pay more than TPR said was appropriate?

c. That would be very surprising indeed.

d. The 2008 <u>Allied Domecq</u> case looked at para 9(5). It had to do so because there was an argument whether on the proper interpretation of the relevant rules para 9(5) was satisfied.

e. The purpose of 9(5) was explained in Allied Domecq at first instance in the following terms:

> *19 As Mr Furness explained, the thinking behind the whole of paragraph 9 is that the statutory regime set out in the 2004 Act has effectively supplanted the funding mechanism in the scheme rules with the*

result that, in order to comply with the 2004 Act, it is the trustees and the employer who generally will be setting the terms of the recovery plan and the schedule of contributions. In the case of paragraph 9(5), however, the draftsman is acknowledging that the 2004 Act is removing from the scheme something that might be of benefit to the members, namely the fact that the actuary has an unfettered right to set the rate. In those circumstances the overriding provisions of the Act are modified in order to reintroduce an element of actuarial scrutiny on the actual level of contribution setting. Paragraph 9 is therefore an acknowledgment that at some points the terms of the scheme rules ought to influence and modify the overriding statutory regime.

f. And the CA approved this explanation (CA judgment at para 12)

g. True it is that that explanation does not appear to have been the subject of argument, but that stands for at least a degree of authority that the unilateral actuary power is displaced by virtue of Part 3.

h. It really would be a direct conflict if on the one hand an SOC could be put in place without actuary certification (by TPR) but then the actuary could (no doubt at the request of the trustee) seek to impose a higher level of contributions through a purported exercise of the scheme contribution rule.

i. So the idea behind para 9 in this case appears to be that the effect of the contribution rule is displaced.

j. And s.306 provides for that by modifying the effect of the actuarial power so that either the determination power is displaced or is limited by reference to what is agreed in the schedule.

31. These issues are all serious challenges for a “pure parallelism view” on which any unilateral trustee or actuary power under the rules is unaffected by the operation of Part 3.

32. One possible line of argument in answer to these points is that there is only a conflict to the extent that TPR has imposed a schedule of contributions which is less than those which the trustee resolves to impose under the rules. In other words it is only once TPR has exercised its power under 231 that a conflict could arise which would preclude the operation of a contribution power under the rules.

33. However there are difficulties with that answer.

   a. It might be said that the exercise of TPR's powers shouldn't change the nature of the Part 3 regime, that TPR is applying the regime, not altering it. It is difficult to see as a matter of construction or logic why if the rules are overridden/treated as modified once TPR exercised its powers, they should not be treated as modified beforehand.

   b. It might be said that the extent of the employer's funding obligations should not depend upon the happenstance of whether their schedule of contributions has been agreed as an appropriate way of reaching the Part 3 target, or imposed by TPR as an appropriate way of reaching the Part 3 target.

   c. It will be even more odd if trustees in dispute with the employer and sensing that TPR might disagree with their funding preferences, could simply pre-empt TPR decision making powers by imposing their own contribution regime before TPR had a chance to determine the appropriate level of contributions to be paid. Indeed it would beg the question of why a trustee would ever bother with the expense of the regulatory hearing in that situation.

34. Another approach is to say that policy trumps the technical problems, and to say that on a proper interpretation of Part 3 it is only concerned with securing sufficient funding and is not attempting to limit the ability to get more than sufficient, and to explain away paragraph 9 by saying that it reflected the Department's advice in the progress of the Bill about what the effect of the Act would be, and that advice (as reported to the HL by Baroness Hollis) appears to have been wrong:

35. There was a hint of this approach in British Vita.

36. Trustees and employers can agree contractually to a higher level of contributions than is in an SOC – Part 3 doesn't try to preclude that. So why shouldn't trustees be able to do it alone if that's what the scheme contribution rule envisages.

37. But that answer focuses attention on whether Part 3 is there to put in place "appropriate" funding or just to put in place a baseline. The Judge placed heavy reliance on s.228(3) and the policy behind IORP in his answer to that, but for reasons explained already these considerations do not appear to be as clear as the Judge seems to have assumed. And the depth of the problems with paragraph 9 are there for all to see.

38. None of this is to say that the funding rule would be overridden for all purposes.

39. To recap by looking at the scenarios referred to earlier:

   a. SoC at Part 3 levels (perhaps imposed by TPR) already in place but trustees decide they want to seek additional contributions under rules to put scheme on course for a long term solvency funding target.

   b. SoC at Part 3 levels (perhaps imposed by the TPR) already in place. Employer suffers an adverse event / change of circumstances and trustees want additional contributions to protect scheme under scheme rules, rather than going through laborious Part 3 process (which may involve~~s~~ a new valuation and consultation).

   c. Part 3 funding standard already reached. Trustee wants to impose solvency target under scheme rules:

40. Only the third scenario does not seem to us to give rise to any conflict with scheme rules. Plainly if the contributions do not affect what is due during the period that the statutory SOC applies that is not a problem. For example, having contributions going out beyond the recovery period should not be an issue for the statutory regime. It does not affect solvency, nor force employers to fund faster than would be "appropriate" and adequate under the Part 3 regime.

41. The trustees would of course still have duties of care to employers in setting a funding rate and would have to explain why it was appropriate to set a contribution rate against the wishes of the employer which exceeded Part 3: see the 2015 decision in MNRPF. That said they are likely to have a significant margin of discretion under the rules. It may be that as a practical matter, if trustees want to impose solvency targets the circumstances will be such that it makes sense to set that as the statutory funding level point.

42. Furthermore, and for the avoidance of doubt, whatever the role of Part 3 in preventing the exercise of scheme funding powers where a schedule of contributions is already in place, if the employer has already entered into a contract to pay contributions at a higher rate than Part 3 would require (and that contractual rate is not impliedly subject to review at the next triennial valuation), the Part 3 regime should not allow TPR to interfere with the existing arrangements at the next valuation because it is no part of the TPRs regime to rewrite contracts.

43. However, the first and second scenarios above give rise to a real problem and it is quite difficult to see, with all due respect to the reasoning of Mr justice Warren in Pilots, why the trustees would simply be entitled in either situation to rip up the schedule of contributions and impose their own more onerous obligations under the rules.

44. There is naturally far more sympathy for the position of the trustees in the 2nd scenario where there has been a change of circumstances since TPR imposed on the trustees agreed the original schedule of contributions.

45. It is therefore tempting to try to argue that in this situation there is no conflict between the rule and the statutory regime because the trustee is still trying to reach the Part 3 target, but simply taking into account new information.

46. The idea here would be to say the trustee unilateral power is modified but not so as to preclude exercises of the power intended to promote the purpose of the Part 3 regime.

47. However, there are no doubt challenges for this approach. It results in a "slippery slope" insofar as it is would be open to any trustees who disagreed with TPR's assessment of an appropriate level of technical provisions to cite a change of circumstance as a reason for ignoring it and imposing their own schedule under the rules.

48. Furthermore, the mere fact that there has been change of circumstances would not explain why, in this particular situation, the trustee in setting a contribution rate on rules would be free to ignore the formal requirements of the scheme specific funding regime (eg consultation). There is nothing in section 229 and paragraph 9 which suggests that the requirement to consult when exercising funding powers, depend upon whether it is convenient to do so. Either the obligation to consult modifies the scheme funding in all circumstances, or in none.

49. One additional matter that might at first sight cause one to doubt whether the scheme rules are overridden by the SSF regime is the position of non-statutory employers.

50. It is clear that the statutory regime has nothing to do with non-statutory employers. But this means that in practice the trustees can use non-statutory employers to supplement contributions under the Part 3 regime if they so wished. This does not seem wholly consistent with the idea of the Part 3 regime as a complete code.

51. Nevertheless there is no conflict between the rules and the Part 3 regime which requires the rules to be modified because Part 3 simply does not apply to the non-statutory employers.

52. If the Part 3 regime is a complete code, and does not incorporate non-statutory employers, does that mean that the recovery plan must be sufficient on the basis of the stat employer contributions alone?

53. If this was the effect of the Part 3 regime, the policy behind it is hard to discern, since the purpose of the regime is to protect members not simply to increase the burdens on a particular type of employer.

54. It is also noteworthy that in this regard TPR guidance on approach to employer covenant includes as employers the non-statutory employers – and if you can look to them for the purposes of deciding how prudent you need the TPRs to be, it therefore makes sense to be able to take into account their contributions when setting a Part 3-compliant SOC.

55. One way of ensuring that the Part 3 regime does not operate so as to penalise statutory employers in situations in which under the rules there are non-statutory employers who are willing and able to pay, is to approach the preparation of RP and SOC as follows:

a. An RP has to be appropriate to the nature and circumstances of the scheme. By extension an SOC has to be too.

b. Part of the circumstances of the scheme are the sources of funding from non-statutory employers. So you take that into account in setting an RP and SOC. And can make assumptions about that in deciding whether the SOC as imposed on statutory employers is certifiable.

c. There is nothing that requires the SOC to ensure that the funding target is met through statutory employer contributions alone.

d. That still leaves room for making assumptions about other sources of funding, including from non-statutory employers.

e. Clearly at a second valuation, the statutory employers stand to benefit from any contributions that have been made by non-statutory employers since the last valuation.

f. And there is no difficulty in prospectively taking into account that effect when deciding what to impose on the statutory employers

56. An alternative approach is to have a statutory SOC which by itself is sufficient on the basis of stat employer contributions, but back-end load it so that by the time that the non-statutory contributions have come in (assuming they do come in) the back-end loading has been adjusted away.

57. Alternatively, depending on how the non-statutory employer contributions are structured and the application of accounting principles, what are effectively their contributions may be taken into account as assets. An observation that takes us nicely on to the final topic.

RIGHTS TO INCOME IN THEIR VARIOUS FORMS

58. A discussion of the position of non-statutory employers is a convenient point at which to consider rights to income more generally, and how they compare in terms of their accounting treatment and their impact on the perceived solvency of the scheme both under the Occupational Pension Schemes (Scheme Funding) Regulations 2005 and the Occupational Pension Schemes (Employer Debt regs) Regulations 2005.

59. Types of rights to income potentially include:
    a. Statutory Contributions from statutory employers
    b. Non-statutory contributions from non-stat employers
    c. Guarantees of contributions from third parties
    d. Asset-backed "contributions"

60. There is in general good reason to be cautious about including future rights to income from the employer(or others) in scheme accounts because it (i) potentially reduces any section 75 debt (ii) potentially (by its impact on estimated s.75 debts) precludes the regulator from exercising powers such as FSDs to support the scheme.

61. But, aside from the policy considerations, we want to look at bit more deeply into why certain rights to income are considered assets of the scheme for funding purposes and other rights to income are not.

62. Obviously this involves straying into accounting territory, but since the accounting treatment impacts so significantly on the trustees legal rights and remedies against the employer, we think it's important that lawyers too, discuss and try to understand these issues.

Rights to income in general

63. In principle contractual rights to income from third parties may be assets of the scheme. A good example would be an investment in a "bought in" annuity which obviously has a value to the scheme which could and should be reflected in the scheme accounts. Indeed as we understand it its requirement of FRS 102 which is the current accounting standard, that bought in annuities are separately valued.

64. Since a right to the payment of contributions from employers or their associates may also be contractual and therefore legally enforceable, why, one might ask are they not included in scheme accounts too?

65. Looking first at statutory contributions from statutory employers, there is no doubt that contributions the right to which has fallen due, even from an employer prima facie <u>do</u> fall to be included in scheme accounts.

66. This is why reg. 3 of the Funding Regs provides that there is to be <u>excluded</u> from Scheme Accounts for Part 3 purposes sums already due under s.228(3) if they are not considered recoverable without unreasonable expense or within a reasonable time. The Employer Debt Regs have similar provisions. The implication is that otherwise they would be included.

67. However, while future rights to income from an employer are not per se excluded <u>under the regs</u> as assets, this seems to reflect an assumption that they will not be included in the first place.

68. It is not surprising that a future right to income <u>from the employer</u> would not be regarded as an asset of the scheme even if there is a contractual right to such income for a number of reasons.

   a. In the case of statutory contributions the SoC and the employer's obligations will be subject to triennial review and so the payments are not necessarily promised beyond 3 years.

   b. The scheme funding regime is structured in such a way that the contributions to be paid are determined by reference to the deficit already calculated. It therefore makes no sense to treat the same contributions as an input into the calculation of the deficit through inclusion in the value of the scheme assets. Furthermore, factors which would be relevant to the capital value of the future right to contributions, such as the risk of non-payment by the employer have already been factored into the deficit.

   c. This no doubt explains why as a matter of accounting guidance, ordinary employer contributions are only accounted for when they fall due.

69. Contributions designed to meet a Part 3 target from non-statutory employers which fall outside the statutory SOC, are *potentially* different because there isn't the immediate connection with Part 3. However, as one would expect, if the deficit and recovery period has been calculated having regard to the potential support of non- statutory participants It makes no sense to treat the same contributions as an input into the calculation of the deficit through inclusion in the value of the scheme assets.

70. Contractual guarantees of contributions from third parties are also not generally taken account of in the assets we imagine because :

   a. In the case of statutory contributions the SoC will be subject to triennial review so the obligation may not persist and will be difficult to value.

   b. The likelihood is that such guarantees have already been taken account of in determining overall covenant and scheme deficit, to be eliminated by the contributions being guaranteed. So it would again make no sense to include them as assets as well.

71. Asset-backed contributions (ABCs) in contrast, are a special case. Like contributions or guarantees, they may emanate from the employer or the employers group and typically cease when a scheme becomes fully funded. However in contrast to other rights to income they are sometimes treated as investments, with a capital value.

72. If ABCs are treated as assets care is needed in establishing the capital value since that value will impact upon the size of the deficit for both scheme specific and section 75 purposes, and will potentially limit the contributions that can be claimed from both statutory and non-statutory employers (even though in the normal course of events the asset-backed contributions may not be received from many years into the future).

73. A further danger is that may be in the employer's interests to push for the maximum value to be placed on the ABC not least because it will reduce the amount of the PPF levy.

74. The dangers are compounded because there is also scope for a significant amount of disagreement as to the value to be placed on such rights to income even if the basic methodology is agreed.

75. Ideally the ABC would be transferable to a third party, and it will be possible to ascribe to it an open market value in much the same way as bonds issued by the sponsor of the ABC. It this case including that capital value in the accounts would be unobjectionable in theory.

76. However in some cases ABCs will have no obvious open market value because of the peculiar nature of the investment, indeed some may actually be non-assignable. In this situation the only way of describing a capital value will be on a value in use basis by discounting the future value of the income stream it produces.

77. Valuation on this basis may be problematic if the income stream being valued depends on the continuing financial health of the employer or conversely if the right to income cannot be enjoyed if the scheme becomes solvent. The rights to income may also be discretionary, which again ought to affect fair value, but in a way that is inherently difficult to predict.

78. Ideally the ABC would come with security that is bankruptcy remote from the employer covenant. This will not only give a degree of confidence that the contributions will be paid, but it will give the trustees confidence that the asset has a capital value which justifies not claiming contributions from the employer under the schedule of contributions.

79. However the danger with some arrangements is that the income depends in part on the future solvency of the employer and that when the employer gets into difficulties and the asset is needed to pay benefits, it is not there.

80. A further danger with ABC arrangements relates to the difficulty of converting them into cash, even though they may carry a capital value of the accounts. As already indicated, they may well not be transferable to third parties at all, which means they cannot be sold. This calls into question whether they should be described as a capital value at all, given they potentially will operate to reduce the value of a section 75 debt, yet will not be transferable by the trustees for a sum equivalent to the amount of the reduction. It may however be possible to attribute a capital value to the investments based on a terminal value on winding up in the event of employer insolvency, provided the ABC gives access to good quality

security which is bankruptcy remote from the employer. Again however this creates valuation difficulties.

81. Because the terminal/cash value of the ABC arrangements may not be equalled to its "value in use" value, if Trustees do attribute a capital value to an ABC in the scheme accounts, it is critical to keep that value under review in the accounts.

82. This is particularly so to the extent that the value in use value depends to any degree on the continued financial viability of the employer. A value in use valuation is going to be unsatisfactory in a winding up or insolvency situation if the asset cannot be transferred and the terminal value is itself affected by the insolvency of the scheme employer. As already stated putting an unrealistic value on an ABC, even whilst the scheme is ongoing, could prevent the regulator assisting the scheme by seeking FSDs, and may also prevent an accelerated schedule of contributions being required under the scheme specific funding regime.

83. Overall, there are plenty of reasons to question why some ABCs should merit a completely different accounting treatment from ordinary schedules of contributions. This is particularly so when one considers that ordinary schedules of contributions may be backed by third party guarantees or charges over company assets.

84. While it is possible to make a case for different treatment, trustees need to take real care to ensure that the differences between the ABC they are being offered and an ordinary schedule of contributions are sufficiently great that they justify an immediate reduction of the deficit by including the ABC as an asset of the scheme.

POST SCRIPT:

85. During discussion after delivery of the above talk the view was expressed to the authors (in connection with the question of whether Part 3 should be taken to have ousted scheme contribution powers) that any attempt by a trustee to use scheme rules to sidestep the Part 3 framework will simply fall for assessment by reference to trust law principles. On this view, one can maintain the position that the scheme contribution powers are unaffected by the existence of Part 3 but still maintain the potential for the Courts to control abuses where for

example the trustees seek to flagrantly circumvent the apparently intended effect of Part 3. A difficulty with this view, it seems to us, is that it begs the question what the Part 3 regime requires. For instance, if a trustee decides that it wishes to act urgently and impose a contribution liability under the rules of a scheme without prior consultation, how should the trustee take into account the existence of the Part 3 framework (and its requirement for consultation) in order to ensure that it has acted properly?

86. In September 2015 TPR published a s.89 report in connection with the DLR scheme. This merits attention from any practitioner concerned with scheme funding matters. Of particular note is the Regulator's encouragement to trustees to examine carefully the steps that they might take under scheme rules that might solve funding difficulties without the need for powers under s.231 to be exercised. This assumes, of course, that the scheme contribution powers are not displaced by the statutory scheme. Even if that is right, the suggestion referred to in the previous paragraph above may suggest that trustees should carefully consider how the approach to the exercise of their powers under the scheme rules may be affected by the existence terms and effect of Part 3.

South West Trains comes of age

18 years since *South West Trains v Wightman*

Michael Furness QC and Edward Sawyer[1]

This paper uses the following abbreviations for these key cases:

- **"*IMG* (Ch D)" is the first instance decision in *HR Trustees v German, Re IMG Pension Plan* [2009] EWHC 2785 (Ch);**
- **"*IMG* (CA)" is the appeal in *IMG* at [2010] EWCA Civ 1349**
- **"*IBM (No 1)*" is the rectification decision, *IBM United Kingdom Pensions Trust v IBM United Kingdom Holdings* [2012] EWHC 2766 (Ch)**
- **"*IBM (No 2)*" is the decision on breach of good faith, *IBM United Kingdom Holdings v Dalgleish* [2014] EWHC 980 (Ch)**
- **"*IBM (No 3)*" is the decision on remedies for breach of good faith, *IBM United Kingdom Holdings v Dalgleish* [2015] EWHC 389 (Ch)**
- **"*Bradbury (No 1)*" is the decision dealing with s 91 Pensions Act 1995, *Bradbury v BBC* [2012] EWHC 1369 (Ch)**
- **"*Bradbury (No 2)*" is the decision dealing with the employer's duty of good faith, *Bradbury v BBC* [2015] EWHC 1368 (Ch)**

INTRODUCTION

1. This December marks the 18th birthday of the decision in *South West Trains v Wightman* [1997] OPLR 249 ("*SWT*"). In *SWT*, Neuberger J held that a contractual agreement between the employer and active members, by which certain elements of pay would be treated as pensionable and other elements as non-pensionable, was effective to cap pensionable pay for the purposes of the pension scheme. We refer to contracts of this nature as "*SWT* agreements" or "extrinsic contracts".

2. This paper:

   2.1. looks at what *SWT* decided with regard to such extrinsic contracts and how that decision has been developed in subsequent cases;

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[1] The views expressed in this paper are shared by both authors, subject to the following caveat in respect of two ongoing cases in each of which one author is involved. The paragraphs dealing with Warren J's treatment of the section 91 issue in *Bradbury (No 1)* (94 to 98 below) are those of Edward Sawyer alone, Michael Furness (being counsel retained in the case) preferring to express no view; and Edward Sawyer (being junior counsel for the trustees in *IBM*) expresses no view on Michael Furness's critique of Warren J's analysis in *IBM (No 2)* at paragraphs 127-131 and 139 below.

2.2. considers the impact of section 91 of the Pensions Act 1995 ("PA95") on *SWT* agreements;

2.3. considers the impact of the employer's duty of good faith on such agreements.

3. At the outset it is worth making the obvious point that, in its relatively short life, *SWT* has assumed great importance in the modern pensions industry as a tool for the management of DB liabilities by employers. A *SWT* agreement may be the employer's only available option to break or restrict salary linkage. In recent years the Court has consistently treated salary linkage as a part of members' accrued benefits,[2] in line with Millett J's analysis in *Re Courage Group's Pension Schemes* [1987] 1 WLR 495.[3] The result is that in many schemes salary linkage will be incapable of being removed by amendment or scheme closure – unless and until there is a ruling at appellate level which casts doubt on the *Courage* analysis.[4] Absent such ruling, in many schemes it will be essential for an employer to use *SWT* agreements if they wish to sever or restrict salary linkage. We therefore hope that the topics addressed in this paper will be of current interest to practitioners.

4. The law in this paper is stated as at June 2015, the date of our Edward Nugee Memorial Lecture on this subject.

***SWT*: THE CASE-LAW**

The pre-history

5. Before we come to *SWT* itself, we should mention *Tibbals v Port of London Authority* [1937] 2 All ER 413, HL, which might be regarded as the distant ancestor of the *SWT* principle. In *Tibbals*, the question was whether a "war bonus" was part of pensionable pay under a superannuation scheme. The Court of Appeal held that, as a matter of construction of the

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[2] See in particular *Walker Morris v Masterson* [2009] EWHC 1955 (Ch), *IMG* (Ch D), *IBM (No 2)* (where the employer conceded that the provisos to the amendment power protected the final salary link, but Warren J appears to have regarded the concession as rightly made: see [170], [184]), *Briggs v Gleeds* and *Sterling Insurance Trustees v Sterling Insurance Group*, unreported, 3 July 2015.

[3] Attempts to argue that *Courage* was wrongly-decided or could be distinguished were rejected in *Walker Morris* and, more comprehensively, in *Briggs v Gleeds*. We note however that some practitioners take the view that the English Court should adopt the approach taken in several Canadian cases, in which salary linkage was not regarded as part of members' accrued benefits: see Ian Gordon's and Colin Browning's PLC article, "Battling with Courage".

[4] It is understood that permission to appeal has been given on the *Courage* fetter points in both *Briggs v Gleeds* and *Sterling Trustees*. If pursued, these appeals will give the Court of Appeal its first opportunity to review the first instance case-law since *Courage* on the protection of salary linkage. It is possible that the law in this area could be significantly changed if Millett J's approach in *Courage* is disapproved.

rules, the "war bonus" was part of pensionable pay, but that the employee had subsequently agreed to accept the bonus on the basis that it would not be pensionable. The House of Lords agreed that there was:

> "*an agreement by the employers to pay a bonus and by the workmen to receive it, upon the terms that it should not be treated as wages within the meaning of the superannuation deed, be it for purposes of contribution or allowance.*"

The House of Lords therefore concluded that it was unnecessary to decide whether the bonus was part of pensionable pay as a matter of construction, because the parties' above agreement precluded any debate about how the bonus should be treated for pension purposes.

6. Thus, over 60 years before *SWT* was decided, *Tibbals* showed that an employer and employee could agree that remuneration which would or might be treated as pensionable under the rules should be treated as non-pensionable. On the other hand, unlike in *SWT*, *Tibbals* involved only a bipartite relationship: the superannuation scheme appears to have been an unfunded contractual arrangement directly between employer and employee. The decision could simply be explained on the basis that the parties to the contract subsequently clarified an ambiguous term through a compromise agreement.

7. *Tibbals* does not appear to have been referred to in any subsequent cases (including *SWT* itself).

8. Moving closer in time to 1997, we can see other developments which paved the way for Neuberger J's decision in *SWT*:

    8.1. As the concept of pensions as deferred pay was developed, the link between members' rights under an occupational pension scheme and the contract of employment were emphasised. One well-known example (which was cited in *SWT*) is *Mihlenstedt v Barclays Bank International* [1989] IRLR 522 where Nicholls LJ described a pension scheme member's status as springing from the contract of employment, the scheme being part of the member's remuneration package. It was perhaps a small step from the recognition of pensions as deferred pay to the conclusion that an extrinsic contract between employer and employee could affect pension rights.

8.2. Indeed, in *Icarus (Hertford) v Driscoll* [1990] PLR 1 (to which Neuberger J also referred in *SWT*), it was recognised that a consensual arrangement outside the terms of the rules was effective to alter benefits under the scheme (although in *Icarus* Aldous J analysed this in terms of estoppel rather than contract).

The decision in *SWT v Wightman*

The facts of SWT

9. We now come to *SWT* itself. The train drivers employed by SWT were entitled to pension by reference to "Final Average Pay" under the Railways Pension Scheme. Prior to the restructuring at issue, their pensionable Pay was £11,950 p.a. plus average allowances of £11,000 p.a. New terms and conditions were agreed between SWT and the drivers' trade union, ASLEF, which were said to be binding on the drivers via a collective bargaining clause in their contracts of employment. Under the new terms, drivers would be paid £25,000 p.a. (an increase in overall remuneration) but their pensionable Pay would only be £11,950 p.a. (plus any later increases) for years of service up to the restructuring, and £18,000 p.a. (plus any later increases) for future service. The Trustee of the scheme was not a party to the agreement, but it wished to amend the rules of the scheme to reflect the agreement reached between SWT and the drivers. A number of drivers objected to the Trustee executing the proposed deed of amendment.

The issues in SWT[5]

10. SWT issued proceedings seeking:

10.1. a declaration that the drivers were debarred from obtaining pensions at a higher rate than those contained in the new terms;

10.2. authorisation for the Trustee to execute the proposed deed.

11. SWT contended that, as a matter of contract, the drivers (and their dependants) were effectively bound to accept that their pensions would be calculated and paid in accordance with the new terms and on no higher basis. The Trustee supported SWT's claim for a declaration that the rules could be amended to reflect the new terms.

[5] *SWT* concerned a number of other points besides the effect of the extrinsic contracts, such as issues under s 67 PA95, the effect of statutory provisions requiring rights under the Railways Pension Scheme to be "no less favourable" and the effect of collective bargaining. This paper is confined to discussion of the part of the judgment dealing with the effect of the extrinsic non-pensionable pay agreements.

12. The drivers contended that they were entitled to pension based on their total salary of £25,000 p.a. (plus any later increases) which they contended was their pensionable Pay for the purposes of the rules. The argued, inter alia, that the agreed terms were not contractually binding and that, even if they were, they would not prevent a driver claiming a pension by reference to the whole of his pay.

What SWT decided

13. Neuberger J held that:

13.1. The new terms were binding as a matter of contract between SWT and the drivers.

13.2. It was an implied term of the contract between SWT and each driver that the drivers would not claim pensions at a higher level than that agreed.

13.3. SWT could, would and probably should enforce the contract by restraining any driver from claiming a higher pension by way of injunction.

What SWT nearly decided

14. Neuberger J considered that there was a "powerful argument" that SWT was under a duty to restrain the drivers seeking a pension at a higher level (because of its *Imperial* duty to the other members).

15. He also considered that it was "well-arguable" that, as a result of the contract between SWT and the drivers, the Trustee could (without the intervention of SWT) refuse to pay the drivers a pension at a higher rate than that agreed with SWT. Neuberger J said that the possible ways of arriving at this conclusion were:

15.1. the Trustee "might well" be able to argue that any claim against it by a driver for a higher pension would be an abuse of process;

15.2. given the contract between SWT and the drivers, it "may well be" that the Trustee could say there is no basis upon which the drivers could demand a pension from the Trustee on a higher basis (because for there to be a valid trust there must be a beneficiary in whose favour performance of the trust may be decreed); or

15.3. (as suggested by Christopher Nugee, as he then was) in order to decide what pension to pay a driver, the Trustee would have to look at the driver's contract of employment; the level of Pay was a matter of contract between employer and employee; if SWT and a driver had agreed that the level of pay for pension purposes was £X, then that would be the Pay for the purposes of the deed.

SWT: the result

16. Neuberger J then turned to the proposed deed of amendment. He noted that it had not been suggested that its execution would be a breach of any of the terms of the scheme or a breach of fiduciary duty (assuming his above conclusions were correct). He concluded that:

16.1. the Trustee "may, indeed should" execute the deed;

16.2. given that it was well-arguable that the Trustee could refuse to pay a pension at the higher level, it would be "obviously sensible to permit, even to support the execution of the Deed in order to regularise the position". This would "in truth, be no more than an administrative, or tidying up, act, which makes the position clear for the future".

Questions to which SWT v Wightman gives rise

17. The decision in *SWT* poses a number of questions, such as (and this is not an exhaustive list):

(i) Are the trustees *obliged* to give effect to an extrinsic contract of the sort considered in *SWT*?

(ii) Is a *SWT*-type agreement only effective to cap/define pensionable pay (which would be consistent with Christopher Nugee's rationalisation, identified above), or can it be used more generally to vary or override provisions of the scheme?

(iii) Are there any protections for members in relation to entering an extrinsic contract, for example special requirements for offer and acceptance, contractual intention or properly informed consent?

(iv) What is the impact of s 91 PA95?

(v) What is the impact of the employer's duty of good faith?

18. Question (i) did not fall for decision in *SWT*, as the Trustee in that case wanted to give effect to the extrinsic contract if it could. Neuberger J's comment that the Trustee "may, indeed should" execute the deed of amendment arguably suggests that there is an obligation on

trustees to give effect to a *SWT* agreement. Subsequent case-law has not explored question (i) directly.[6] Experience suggests that it is not currently a live question for most schemes since, in an era of deficits, trustees seem generally willing to give effect to consensual arrangements with members that help reduce the deficit and thus improve the security of other members' benefits. We will leave question (i) to be debated another day.

19. Questions (ii) and (iii) have been considered in subsequent case-law, which is summarised below: see paragraphs 21-52 below.

20. Questions (iv) and (v) are the main focus of this paper and are addressed in detail below: see paragraph 53 onwards below.

Key cases subsequent to *SWT*

NUS Superannuation Fund v Pensions Ombudsman [2002] Pens LR 93, Ch D (Lightman J)

21. In *NUS*, the employee received a pay rise for a temporary period of secondment, but on terms that his normal, lower rate of pay would apply for pension purposes. The employee accepted the pay rise but complained that the whole of his pay should be treated as pensionable. Lightman J held at [16]-[17] that the terms offered to the employee contained two integral interdependent elements, namely the increase in pay and the provision about non-pensionability. The two could not be severed: the employee could not accept the pay rise without the non-pensionability term. Lightman J concluded that the employee had accepted both.

22. Lightman J said at [13] that the effect of a *SWT* agreement would be that "the agreement reached overrides the rights of [the employee] under the scheme rules". In terms of question (ii) identified above, this appears to regard an extrinsic contract as having the wide effect of substantively rewriting the members' rights under the scheme (cf. the more limited rationalisation suggested by Christopher Nugee in *SWT*).

HR Trustees v German, Re IMG Pension Plan [2009] EWHC 2785 (Ch) (Arnold J)

23. In *IMG* (Ch D), Arnold J considered the purported conversion of a DB scheme to a DC scheme in 1992. The amendment by which the conversion was purportedly effected contravened the fetters on the amendment power. Relying on *SWT*, the employers argued that the

[6] However, Warren J did observe, obiter, in *IBM (No 3)* at [217] that if the trustees threatened to ignore an extrinsic contract of the *SWT* variety, the employer's remedy would be to seek injunctive relief to restrain payment to the employee, so the "economic effect" of the contract is the same as a valid rule amendment.

members were prevented by an extrinsic contract from claiming benefits otherwise than on the basis that they ceased to be entitled to DB benefits from 1992 and became DC members. The employers relied on the fact that members had filled in application forms to participate in the restructured scheme; this was alleged to amount to consent to the purported changes to the scheme as set out in various explanatory materials.

24. Amongst other matters, Arnold J concluded that:

24.1. In order to establish a *SWT* agreement, it was necessary for the employer to show not merely that the parties intended to create *legal* relations, but specifically an intention to create *contractual* relations, so that the contract would be binding even if its terms differed from the applicable trust documents (see [163]).

24.2. The employer failed to establish an intention to create contractual relations, in circumstances where the changes were presented to members as a "*fait accompli*" not dependent on their agreement, and where the extrinsic documents relied on were not comprehensive and/or were expressed to be subject to the deed and rules (see [164]-[169]).

24.3. Where the alleged extrinsic contract involves overriding contrary provisions in the trust documents (and so would involve a breach of trust if the trustees give effect to it), it is necessary to establish that the members gave informed consent such that they would be precluded from complaining of a breach of trust (see [172]-[174]). The employers failed to establish informed consent, because (*inter alia*) the members were unaware of the specific provisions of the trust documents that were being overridden, they received no advice, and they were not given any real choice about whether to consent (see [174]).

25. Thus Arnold J considered that an extrinsic contract is capable of overriding the provisions of the scheme and is not limited simply to non-pensionability. The extrinsic contracts in *IMG* went far beyond the non-pensionable pay agreements considered in *SWT* and *NUS*. It appears that Arnold J would have accepted that the extrinsic contracts bound members to accept the conversion of their DB benefits to DC benefits, had the employers been able to establish an intention to create contractual relations and informed consent.

26. As will be seen below, Arnold J's views on informed consent have been departed from in subsequent case-law.

Capita ATL Pension Trustees v Gellately [2011] Pens LR 153, Ch D (Henderson J)

27. In *Capita Trustees v Gellately*, Henderson J considered the purported equalisation of a scheme. There was an invalid attempt to equalise in 1995 by the issue of an announcement to members; this did not comply with the requirements under the rules for a valid amendment. However, the members had acknowledged the announcement by signing and returning acknowledgment forms, by which members agreed to the deduction of contributions from their pay at a new level. The employer argued that this made the announcement binding on members by virtue of an extrinsic contract, relying on *SWT*.

28. Henderson J concluded that the issue of the announcement and return of the acknowledgment forms did not amount to an offer and binding acceptance or disclose an intention to create immediate legal relations. The documents were a brief summary and incomplete, and it would have been understood that formal rule amendments would be needed (see [77]-[84]).

29. It is also to be noted that counsel for the employer (Sarah Asplin QC, as she then was) conceded that the mere fact of employees continuing to work after the changes were purportedly made could not amount to sufficient consideration to support a contract,[7] a concession which Henderson J accepted as rightly made (see [69]-[70]).

30. It does appear, however, that Henderson J would have been prepared to accept that an extrinsic contract (had it been made out) would be capable of binding members to accept the equalised NRDs, so overriding the scheme rules.

Bradbury (Nos 1 and 2)

31. The *Bradbury v BBC* litigation arose out of the restructuring of the BBC Pension Scheme in 2010. In the restructuring, DB members were offered three options:

 31.1. to remain in their current DB section of the Scheme but with any future pay awards limited to 1% for pension purposes;

 31.2. to opt out of their current section and join a new career average section in which any future pay awards would not be subject to the 1% cap for pension purposes;

 31.3. to opt out of the Scheme altogether and join a DC arrangement.

[7] See *Jones v Associated Tunnelling* [1981] IRLR 477

32. One of the issues considered by Warren J was whether, if Mr Bradbury had taken the first option and accepted a pay increase subject to the 1% cap for pension purposes, this would have been a binding *SWT* agreement.

33. This gave rise to a number of questions, in particular regarding s 91 PA95 and the employer's duty of good faith, which are considered later in this paper. At this juncture it is sufficient to note that in *Bradbury (No 1)* [2012] EWHC (Ch) 1369 Warren J:

33.1. said that a *SWT* agreement is "effective to override the provisions of a scheme" (see [55]); and

33.2. distinguished *IMG* (Ch D) on the question of informed consent. Warren J noted that Arnold J only considered that informed consent was necessary where the enforcement of the extrinsic contract is contrary to the terms of the trust, and this is not the case where the extrinsic contract is a simple non-pensionable pay agreement (as in both *SWT* and *Bradbury*): see [57]-[63]. Warren J also questioned what "informed consent" might mean in the context of a contract, observing that it is not entirely clear what a contract without consent could be: see [59].

34. As discussed later in this paper, Warren J also concluded (in *Bradbury (No 1)*) that the *SWT* agreement was not contrary to s 91 PA95 and (in *Bradbury (No 2)* [2015] EWHC (Ch) 1368) that the agreement did not involve a breach of the employer's duty of good faith.[8]

IBM UK Pensions Trust v IBM UK Holdings [2012] EWHC 2766 (Ch) (Warren J)

35. In *IBM (No 1)*, Warren J considered a claim to rectify the early retirement provisions of one of IBM's UK DB pension plans. He concluded that the rules were liable to be rectified to confer on active members a right to retire on an unreduced pension from age 60 without employer consent. Relying on *SWT*, the employer counterclaimed that members were subject to an extrinsic contract (as a result of their terms and conditions of employment) which required them to obtain the employer's consent for retirement from age 60.

36. Warren J held that the alleged extrinsic contract was not made out on the facts (see [482]-[489]), but he did accept that, in principle, it was possible for the employer to contract with new joiners on the basis that they would only be entitled to retire from age 60 with employer consent, so overriding the rectified rights under the rules: see [467]. Warren J

[8] See paragraphs 86ff and 132ff below

described the effect of a valid *SWT* agreement as the members "preclude[ing] themselves by contract from asserting their rights under the unamended scheme": see [465]-[466].

37. Thus *IBM (No 1)* reaffirms the view that a *SWT* agreement is not confined to pensionability of pay but can in principle override or restrict rights under the scheme.[9]

38. *IBM (No 1*) also considered s 91 PA95, and this aspect of the case is dealt with below.[10]

IBM (Nos 2 and 3)

39. Warren J considered IBM's restructuring of its UK DB plans in *IBM UK Holdings v Dalgleish*. The key judgments are *IBM (No 2)* [2014] EWHC 980 (Ch) on breach of the duty of good faith, and *IBM (No 3)* [2015] EWHC 389 (Ch) on remedies for breach.

40. The restructuring involved closing the DB plans to future accrual, restricting early retirement on favourable terms and (relevantly for this paper) requiring members to enter *SWT* agreements under which any future pay increases would be wholly non-pensionable for DB purposes. Members who did not accept the *SWT* agreements would not receive any pay increases. The *SWT* agreements were initially expressed to be permanent; this was then revised to a two year duration; but at the end of the two year period all employees were required to enter permanent *SWT* agreements.

41. The employees argued that the restructuring, including the *SWT* agreements, constituted a breach of IBM's duty of good faith.

42. By way of brief summary:

42.1. Warren J concluded that the restructuring was a breach of IBM's *Imperial* duty and its contractual duty of good faith.

42.2. Specifically as regards the *SWT* agreements, Warren J considered that the employer's contractual duty of good faith (rather than the *Imperial* duty) was engaged: *IBM (No 2)* at [1508] and *IBM (No 3)* at [217].

42.3. IBM's *SWT* agreements conflicted with members' reasonable expectation (based on IBM's previous representations) that, if a salary increase were awarded, it would be

[9] Similarly in *IBM (No 3)* at [217], Warren J said that a *SWT* agreement "overrid[es] the formal provisions of the scheme".
[10] See paragraphs 91ff below

partly pensionable: *IBM (No 2)* at [1511] and *IBM (No 3)* at [6]. IBM was accordingly in breach of its contractual duty of good faith so far as concerns the *SWT* agreements, even the agreements of limited duration: *IBM (No 2)* at [1528] and *IBM (No 3)* at [15], [209]-[211], [216].

42.4. A *SWT* agreement of limited duration may also be a breach of duty if it is part of a wider strategy to make all future pay increases non-pensionable and there is no genuine intention to review the position at the end of the limited period: *IBM (No 3)* at [213], [216].

42.5. Where an employer tells members that a failure to sign a *SWT* agreement will result in there being no pay increases in future, a threat of that sort could well be a breach of good faith; no reasonable employer would make a blanket decision refusing for all time not to grant any pay increases unless the member enters a *SWT* agreement: *IBM (No 2)* at [1521], [1535](ii) and *IBM (No 3)* at [19], [213], [219].

42.6. However, Warren J considered that, on the counter-factual hypothesis that there were no reasonable expectations and viewed "in isolation" from the other objectionable features of the pensions restructuring, a *SWT* agreement of limited duration would not be a breach of duty: *IBM (No 3)* at [13], [18].

42.7. Turning to remedies, Warren J held that a contract (such as a *SWT* agreement) entered into as a result of a breach of the employer's duty of good faith is voidable by the member: *IBM (No 3)* at [86]. However, if a member avoids a *SWT* agreement, he is not entitled to any salary increases and would possibly be under an obligation to pay back the increases he has already received: *IBM (No 3)* at [123].

42.8. Nevertheless, even if the *SWT* agreement is not avoided, the effect of the breach of the duty of good faith is that the employer cannot enforce the non-pensionability term and any attempt to enforce it should be restrained; the non-pensionability term is invalid and severable from the rest of the employment contract pursuant to which the pay increase was granted; and accordingly the member is entitled to keep past and future pay increases and have them treated as pensionable: see *IBM (No 3)* at [88], [107], [117]-[118], [121]-[123]. A member would in principle be entitled to damages for the breach of the duty of good faith, based on what the employer would have been likely to do so far as concerns pay increases in a way that did not involve a breach of good faith: see *IBM (No 3)* at [139], [166].

43. It is interesting to compare the result in *IBM* (members were entitled to keep their pay rises on terms that they were pensionable) with the result in *NUS* (where the member was not entitled to sever the pay rise from the non-pensionability term). The existence of the breach of the duty of good faith enabled the Court to sever the pensionability term in *IBM*; there was no question of any breach of duty in *NUS*.

44. Warren J's analysis of the test for breach of the duty of good faith is considered later in this paper.[11]

Briggs v Gleeds (Head Office) [2014] EWHC 1178 (Ch) (Newey J)

45. In *Briggs v Gleeds*, Newey J found that a series of amending deeds had been invalidly executed. Relying on *SWT*, the employers argued that if the amendments were otherwise ineffective, the members had contractually bound themselves to accept pension benefits on the basis of the invalid documents.

46. The relevant invalid documents were a 1997 deed to create a new DC section to which some DB members transferred and which new members joined; a 2003 resolution to introduce member contributions, reduce the accrual rate and remove minimum pension increases; and a 2006 deed to close the DB section to future accrual and create a new DC section which 103 ex-DB members joined.

47. In support of their *SWT* argument, the employers relied on application forms and election forms signed by the members, authorisations to deduct contributions, and, in the case of the 2006 deed, a one-off salary increase awarded to the 103 ex-DB members in exchange for their agreement to join the new DC section.

48. Newey J concluded that, except for the 103 ex-DB members in 2006, the *SWT* arguments failed. In summary:

48.1. Agreeing with Arnold J in *IMG* (Ch D), Newey J considered that it was necessary for the employers to show that there was an intention to create *contractual* relations, not merely legal relations (see [147]-[148]).

48.2. Conduct which was equally referable to pre-existing rights and obligations did not disclose an intention to make a contractual offer. In particular, members had been asked to exercise options and rights which it was thought they had under the

[11] See paragraph 127ff below

scheme, not to agree to vary such rights or agree to changes being made. Therefore there was no intention to create contractual relations (see [148]-[150], [158]-[159]).

48.3. However, the conduct of the 103 members who accepted the one-off salary increase in 2006 was not wholly explicable by reference to pre-existing rights and showed that they bound themselves to accept the 2006 changes to the scheme (see [167]).

48.4. There was therefore a valid *SWT* agreement in respect of the 103 members. En route to this conclusion, Newey J disagreed with Arnold J's decision that informed consent was necessary. In Newey J's judgment this wrongly conflated contract law and trust law principles (see [170]). Newey J also rejected a challenge to the *SWT* agreement based on s 91 PA95, considered later in this paper.[12]

49. Thus *Briggs v Gleeds* is the first case where *SWT* was successfully invoked in a context other than pensionability of pay, and resulted in an invalid scheme restructuring (closure to accrual and joining a DC section) being treated as effective, albeit only for a relatively small number of members.

Conclusions to be drawn from the post-SWT cases

50. It seems clear from the post-*SWT* cases that (subject to any contrary ruling at appellate level) *SWT* agreements are not simply confined to pensionability of pay but may be used more generally to override the scheme rules or give effect to changes that would otherwise be invalid, subject to the points on s 91 PA95 and the duty of good faith considered later in this paper. In this sense, the post-*SWT* cases have gone far beyond the actual decision in *SWT* and the rationalisation suggested by Christopher Nugee in that case.

51. Most of the post-*SWT* cases do not deal with deliberate, planned *SWT* exercises, but instead deal with after-the-event attempts by employers to salvage invalid amendments by spelling an extrinsic contract out of announcements and other such materials. The cases therefore do not provide direct guidance on how to carry out a *SWT* exercise. However, it is apparent from the cases that for a *SWT* agreement to be effective, it is important to make clear to members that they are being asked to enter a binding contract with potentially significant consequences which (if applicable) overrides their rights under the scheme. An unequivocal and clearly expressed offer, unequivocal acceptance and consideration must be identified. Unless and until the conflicting rulings on the necessity of "informed consent" are reconciled,

[12] See paragraphs 103-104 below

it would seem prudent to ensure that members are given information about the effect of the proposed contract.

52. We now turn to the main topics addressed by this paper, namely the impact on *SWT* agreements of:

52.1. s 91 PA95; and

52.2. the employer's duty of good faith.

<u>SECTION 91 OF THE PENSIONS ACT 1995 AND *SWT*</u>

Introduction

53. This section of the paper addresses the question whether s 91 PA95 can catch a *SWT* agreement and render it unenforceable. We will address this question by reference to a *SWT* agreement of the traditional type, i.e. one that caps or limits pensionable pay. We understand that there are currently three pending appeals to the Court of Appeal in which this question might arise. At the heart of the question is whether s 91 PA95 protects future salary linkage for past service benefits.

54. As we will see, the current case-law indicates that s 91 will not catch a *SWT* agreement which breaks or limits future salary linkage (so long as the employee does not have a right to pay increase), but it is suggested below that these cases are potentially open to question.

55. Section 91 PA95 came into force on 6 April 1997. In its current form, s 91(1) provides:

"*Inalienability of occupational pension*

(1) Subject to subsection (5), [where a person is entitled to a pension under an occupational pension scheme or has a right to a future pension under such a scheme] –

(a) the entitlement or right cannot be assigned, commuted or surrendered,

(b) the entitlement or right cannot be charged or a lien exercised in respect of it, and

(c) no set-off can be exercised in respect of it,

and an agreement to effect any of those things is unenforceable."

56. The words in square brackets were substituted by the Welfare Reform and Pensions Act 1999 with effect from 1 December 2000. Prior to that amendment, s 91(1) applied "where a person is entitled, or has an accrued right, to a pension under an occupational scheme".

57. For the purposes of s 91, "pension" is defined as including "any benefit under the scheme and any part of a pension and any payment by way of pension": see s 94(2) PA95.

58. Section 91(5) sets out a list of permitted transactions which are excepted from s 91(1). These are not of obvious relevance to a *SWT* agreement, except potentially s 91 (5)(b)(ii) (a surrender for the purpose of "acquiring for the [member] entitlement to further benefits under the scheme"). This exception is discussed below.

Is s 91 engaged at all?

59. Section 91(1) PA95 applies to an agreement to "surrender" an entitlement to a pension or a right to a future pension.

60. It might be argued that a *SWT* agreement is not an agreement to "surrender" such an entitlement or right at all. The argument would be that the relevant entitlement or right arises between the member and the trustees, but the trustees are not party to the agreement and the member is not directly giving up anything vis-à-vis the trustees.

61. However, this is clearly not the view that the Court has taken. In *Bradbury (No 1)*, *IBM (No 1)* and *Briggs v Gleeds*, the Court proceeded on the basis that a *SWT* agreement is capable of being an agreement to "surrender" within s 91(1). This appears to be the settled view at first instance.

62. This view is supported by s 91(2) PA95. This subsection provides that, where by virtue of s 91 a person's entitlement to a pension or right to a future pension cannot be assigned, "no order can be made by any court the effect of which would be that he would be restrained from receiving that pension". The effect of s 91(1) is that in general such an entitlement or right is non-assignable. It follows that a Court cannot enjoin a member from receiving a pension protected by s 91. Since the fundamental basis of a *SWT* agreement, as explained by Neuberger J in *SWT* itself, is the ability of the Court to restrain a member from claiming his pension, it follows that s 91(2) would prevent a *SWT* agreement from being effective insofar as it relates to entitlements or rights protected by s 91(1).

63. Thus the key question is whether a *SWT* agreement bites on an "entitle[ment] to a pension" or a "right to a future pension" within the meaning of s 91(1) PA95. In the context of a traditional *SWT* agreement that breaks or limits salary linkage, the essential issue is whether the right to have future salary increases treated as pensionable is part of the member's "entitle[ment] to a pension" or "right to a future pension". If so, it is protected by s 91 and the *SWT* agreement will be unenforceable in relation to such entitlement or right.

Is salary linkage part of an "entitlement to a pension" or a "right to a future pension"?

64. It is clear from consistent case-law that an "entitlement to a pension" means entitlement to a pension already in payment: see *Barclays Bank v Holmes* [2000] Pens LR 339 at [129]-[130], *Aon Trust Corporation v KPMG* [2006] 1 WLR 97 at [181][13] and *Bradbury (No 1)* at [75]; cf. *Alexander Forbes Trustees v Clarke* [2008] Pens LR 145.

65. Therefore salary linkage does not fall within the "entitlement to a pension" limb of s 91(1).

66. Does salary linkage fall within the concept of a "right to a future pension"? It might be thought these wide words are apt to include the right to have pay rises treated as pensionable, particularly in respect of service already accrued.

67. In order to understand what s 91(1) means by a "right to a future pension", it is necessary to look at the legislative history. As noted above, the reference to a "right to a future pension" was added to s 91(1) in 2000 in substitution for another concept, "an accrued right to a pension". It may therefore be helpful to begin with consideration of whether salary linkage was included within "an accrued right to a pension" as referred to in the original version of s 91(1).

Do "accrued rights" include salary linkage?

68. Section 124(2) PA95 defines the "accrued rights" of a member at any time as "the rights which have accrued to or in respect of him at that time to future benefits under the scheme", and where pensionable service of the member is continuing, "his accrued rights are to be determined as if he had opted, immediately before that time, to terminate that service".

69. This definition of accrued rights applied for the purposes of the pre-2000 version of s 91.

[13] A case on s 67 PA95 which has been treated as relevant to the meaning of the same term in s 91: see *Re LPA Umbrella Trust* [2014] Pens LR 319 at [27].

70. It also applied to the original version of s 67 PA95, which was concerned with modifications of the scheme which would or might affect "any entitlement, or accrued right".

71. There are *Hansard* materials on the meaning of "accrued right" in the s 67 context. In answer to a question about whether "accrued rights" meant only early leaver rights, the relevant minister (William Hague MP) confirmed that they did. He said it would be unreasonable "to protect members and impose costs on employers in respect of rights that have not yet been earned. Early-leaver rights are those which have accrued. That is in line with the recommendations of the Goode committee."[14] The minister noted that the "future expectations" of members could be reduced by such amendments.[15]

72. This would appear to indicate that salary linkage was not intended by Parliament to be included within "accrued rights".

73. However, the minister's reference to the Goode Report arguably muddies the waters. Whilst the Goode Report certainly recommended that accrued rights (but not future accruals) should be protected against detrimental amendments,[16] the Report potentially creates a degree of confusion by defining "accrued benefits" as "benefits for service up to a given point in time … They may be calculated in relation to current earnings or projected earnings".

74. In addition, the parts of the Goode Report dealing with the inalienability of pensions (which led to s 91 PA95) did not suggest that salary linkage might fall outside the scope of the protection of what became s 91.[17] Instead the Goode Report specifically stated that inalienability should *not* be confined to short service benefits, i.e. early leaver benefits[18] – which had been protected by the predecessor inalienability provisions.[19] This recommendation was specifically accepted in the ministerial speech in *Hansard* dealing with what became s 91;[20] and far from suggesting that salary linkage should be excepted from the protection of s 91, the minister in the House of Lords described the legislative intention as

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[14] House of Commons, Pensions Bill, Standing Committee D, 13th sitting, 8 June 1995
[15] Ibid
[16] Goode Report, 1993, para 4.6.13 and 4.6.16 and Recommendations 55-57
[17] These parts of the Goode Report are relevant to construing the scope of s 91: see *Re LPA Umbrella Trust* [2014] Pens LR 319.
[18] Goode Report, para 4.14.3 and 4.14.4
[19] See s 77 Pension Schemes Act 1993 and its forerunners. There were also provisions making GMPs and protected rights inalienable (see e.g. s 159 Pension Schemes Act 1993, derived from s 48 Social Security Pensions Act 1975, and s 2(7)-(8) Social Security Act 1986).
[20] House of Commons, Pensions Bill, Standing Committee D, 15th sitting, 13 June 1995

being that "all occupational pension rights should be inalienable".[21] Indeed, it would be peculiar if members were able to alienate in advance that part of their pension which is attributable to future salary increases.

75. Thus the picture that emerges from *Hansard* and the Goode Report is not particularly clear.

76. However, clarity was provided by the decision of Neuberger J in *Barclays Bank v Holmes* [2000] Pens LR 339, to which reference has been made above. Neuberger J concluded that an "accrued right" does not include salary linkage and that the definition of "accrued rights" in s 124(2) PA95 showed that Parliament had not adopted the approach to salary linkage taken by Millett J in *Courage*: see *Barclays Bank* at [126]-[128]. In Neuberger J's view, "accrued rights" are "to be based on the pensionable salary of the employee at the date that his accrued rights are assessed": see [126]. Although this was a decision on s 67 PA95, Neuberger J specifically referred to ss 91-93 PA95 and he clearly considered that the same terms had the same meaning in those sections: see [129]. The Court of Appeal appears to have accepted Neuberger J's analysis of "accrued rights" in *Aon Trust Corporation v KPMG* [2006] 1 WLR 97 at [125], [181].

77. Thus it appears that s 91(1) as originally enacted did not protect salary linkage.

78. The next question is whether this changed when s 91(1) was amended by the Welfare Reform and Pensions Act 1999 to replace "accrued right" with "a right to a future pension".

"Right to a future pension" – what Parliament intended

79. It is very unclear what Parliament actually intended by making this change. As demonstrated by Jonathan Moody in a lecture to the Association of Pension Lawyers, the explanatory notes to the 1999 Act and the preceding Bill simply say that the amendments to s 91 were consequential amendments to include pension credit rights within s 91.[22] He suggested that a "right to a future pension" was only intended to mean "accrued rights" plus pension credit rights, and did not cover future service rights at all.

80. There is no discussion in *Hansard* of the reason for the amendment, which suggests that Parliament did not think it was making a significant change. That supports Jonathan Moody's

[21] House of Lords, Pensions Bill, Committee Stage, 4th day, 20 February 1995

[22] "Inalienability of pension: section 91 Pensions Act 1995", June 2013. See the Explanatory Notes to the Bill for clause 69 and Sch 9 para 51, 55-57 and the Explanatory Notes to the 1999 Act for s 84 and Sch 12 para 53, 57-59.

view. It is also notable that the post-amendment form of s 91(6) PA95 still refers to "accrued rights" which suggests that it is still a relevant concept for s 91 purposes. It is possible that the draftsman took the view that pension credits do not "accrue", so a different form of words was needed to capture both "accrued rights" and pension credits, namely a "right to a future pension".

81. However, this thesis is difficult to maintain in the face of the fact that the 1999 Act amended s 67 PA95 to refer to an "accrued right or pension credit right". This suggests that a "right to a future pension" must mean something different from accrued rights plus pension credits – but it is not clear what.

Case-law on the meaning of "right to a future pension"

IMG (CA)

82. The meaning of "right to a future pension" and "entitle[ment] to a pension" for s 91 purposes was considered by the Court of Appeal in *IMG* (CA) [2010] EWCA Civ 1349.

83. The facts of *IMG* have been briefly summarised at paragraph 23 above. One of the issues considered in *IMG* was whether s 91 affected a number of compromise agreements that had previously been entered into with members regarding disputed rights and whether s 91 would prevent a compromise of the litigation itself.[23]

84. In *IMG* (CA), the Court of Appeal concluded that s 91 is "directed to cases of the deliberate giving up of an actual existing entitlement or an actual existing right" and does not apply to "cases in which a putative entitlement or right to a pension is claimed, but its existence is doubted or disputed"; thus s 91 did not render unenforceable "the compromise of a bona fide dispute about the existence of the entitlement or right": see [27]-[32], [37].

85. *IMG* (CA) did not consider *SWT* agreements or directly cast light on whether salary linkage is included within a "right to a future pension", but the exclusion from s 91 of "doubted or disputed" rights has proved important in later cases on *SWT* agreements: see below.

[23] Although the first instance decision in *IMG* addressed *SWT* agreements, those agreements had been entered into before s 91 came into force, so the *IMG* decisions do not deal with the effect of s 91 on a *SWT* agreement.

Bradbury (No 1)

86. Warren J's judgment in *Bradbury (No 1)* [2012] EWHC 1369 (Ch) was the first to consider the impact of s 91 on a *SWT* agreement. The facts have been summarised at paragraph 31 above.

87. Warren J held at [76]:[24]

> "*In my judgment, section 91, in referring to 'the right to future pension' is focusing on <u>all benefits payable in the future which arise as a result of both past service and future service</u>. An active member does not, of course, have an entitlement to an immediate pension at all. It cannot even be said that he has a present right to a pension based on a salary in excess of his current salary since he might leave service (eg to move to another job) before any pay increase has been awarded. What can be said is that the Scheme provides him with certain benefits depending on his own circumstances. <u>An active member thus has a right to receive a pension in the future, the amount of which will depend on a number of factors including not only pay increases but the period of future service</u>. In my judgment, in referring to 'the right to a future pension', section 91 is focusing on <u>the pension to which a member will become entitled in future depending on the events which actually occur</u>*" (emphasis added).

88. This sounds very similar to the approach taken by Millett J in *Courage*, i.e. recognising that a member's bundle of rights includes an emerging pension which takes account of future pay rises, if any are granted. In particular, Warren J's reference to "the pension to which a member will become entitled depending on the events which actually occur" would appear to embrace salary linkage. If so, then s 91 would protect salary linkage as part of the "right to a future pension".

89. However, applying *IMG* (CA), Warren J concluded that the BBC's *SWT* agreement did not fall foul of s 91. There appear to have been two separate limbs to Warren J's reasoning:

89.1. The first limb is specific to the facts of the case. Warren J considered that it was arguable that the BBC had power under the rules to determine that part of a member's salary should be non-pensionable. Therefore a member's putative right to

[24] It might be questioned whether this is actually part of the ratio of the decision, since Mr Bradbury did not enter the *SWT* agreement in question: see [8](b) of *Bradbury (No 1)*.

have pay rises count for pension purposes was doubtful or disputed, and could have been compromised by agreement without contravention of s 91: see [83] and the first half of [84]. This seems to be a fairly straightforward application of the "doubted or disputed rights" exception discussed in *IMG* (CA).

89.2. The second limb is of general application. Warren J considered that the member had no right to a salary increase, so he would have realised that, by refusing the *SWT* agreement, he would end up with no pay rise and no increase in pensionable salary either. Therefore his right to a future pension based on the full amount of an anticipated pay rise was no right at all, so accepting a salary increase on terms that part only is pensionable does not involve a surrender of anything: see the second half of [84] and [85]. This limb of the analysis does not focus on the existence of a dispute but rather on the fact that there is no right to a pay rise at all.

90. Except in highly exceptional cases where the member has a *right* to a pay increase, the second limb of Warren J's reasoning would appear to take all *SWT* agreements which limit pensionability of pay outside the scope of s 91.

IBM (No 1)

91. Warren J applied the second limb of the *Bradbury* analysis in *IBM (No 1)* [2012] EWHC 2766 (Ch), the facts of which have been summarised at paragraph 35 above.

92. He considered that new joiners to the scheme could agree by an extrinsic contract to restrict their pension benefits, because at the time of the contract they had accrued no service: "they had no right of any sort at all" in relation to the scheme (see [470]-[472]). In Warren J's view, a new joiner who agrees by contract at the outset that his pension benefits should be restricted does not surrender any right, nor does he agree to surrender any rights in future: "Rather, the agreement defines what the future pension rights will be" (see [471]).

93. This illustrates that the second limb of Warren J's analysis is not based on the existence of a dispute (cf. *IMG* (CA) but on the lack of an underlying right.

The *Bradbury* analysis of a "right to a future pension": discussion

94. How confident can one be, based on the second limb of the *Bradbury (No 1)* analysis, that a *SWT* agreement that restricts pensionability of pay is compliant with s 91?

95. It is respectfully suggested that the second limb of the *Bradbury* analysis poses some potential problems:

95.1. The second limb is dependent on the fact that the member has no right to a pay increase.

95.2. However, as noted above, in [76] of *Bradbury (No 1)* Warren J accepted that the "right to a future pension" referred to in s 91(1) means the pension to which a member will become entitled depending on the events which actually occur, including pay increases.

95.3. Viewed in this way, it could be said that the member's "right" is to have such pay increases as are awarded count for pension purposes under the rules of the scheme.

95.4. The fact that the member does not have a right to a pay increase is irrelevant. The point is that *if* an increase is awarded, the member has a right to a pension calculated by reference to it. This distinction was recognised by Neuberger J in *SWT* itself.[25]

95.5. It is this latter "right" which falls within Warren J's definition of a "right to a future pension" in [76] of *Bradbury (No 1)*. By the *SWT* agreement, the member agrees in advance not to enforce this right.

95.6. Therefore arguably the *SWT* agreement does involve an agreement to surrender a "right to a future pension".

95.7. A further problem may be that on Warren J's analysis in *IBM (No 1)*, it would appear that rights yet to be earned by future service are not protected by s 91. And according to *Bradbury (No 1)*, salary linkage is not protected either (except in the highly unusual case where the member has a right to a pay rise). The combined effect is that s 91 only protects accrued rights calculated on a leaving service basis. This would appear to give a "right to a future pension" the same scope as "accrued rights" in the pre-2000 version of s 91 (as interpreted in *Barclays Bank v Holmes*), thus depriving the 2000 amendment of any effect.[26]

[25] Per Neuberger J, rejecting one of Mr Etherton QC's arguments: "It confuses two concepts. While the drivers have no right to an increase in salary generally or under the pension schemes in particular, this does not alter the fact that, if and to the extent that an increase in salary is agreed and given, the drivers have a right [under the schemes] to have that increase in salary reflected in their pension."

[26] Unless of course the only change made in 2000 was to include pension credits within the protection of s 91.

96. Thus there are grounds for challenging the correctness of the second limb of the *Bradbury (No 1)* analysis.

97. However, it can well be imagined that any future Court would not be attracted to arguments that *SWT* agreements that restrict pensionability are unenforceable under s 91. Such agreements have been widely used in the 18 years since *SWT* was decided and they continued to be widely used after the amendment to s 91 in 2000. It can be expected that the Court would be reluctant to reach a conclusion that would upset past transactions or impede future consensual restructurings. The Court could avoid that conclusion by, for example:

97.1. following the second limb analysis in *Bradbury (No 1)*;

97.2. deciding that the amendment to s 91 in 2000 simply included pension credits and did not extend to salary linkage;

97.3. holding that the exception in s 91(5)(b)(ii) applies to a *SWT* agreement that restricts pensionable pay. As mentioned earlier in this paper, the exception applies to an agreement to surrender an entitlement or right if it is made for the "purpose" of "acquiring for the [member] entitlement to further benefits under the scheme". In *Bradbury (No 1)*, the employer advanced an alternative argument that this exception took the *SWT* agreement outside the prohibition in s 91(1), because the purpose of the agreement was to obtain a limited increase in pensionable salary (i.e. a further benefit under the scheme) which would not otherwise be achieved. Warren J rejected this argument on the basis that the purpose was to achieve a pay increase; the increased benefit under the scheme was merely the effect: see *Bradbury (No 1)* at [86]-[87]. An appellate court might take a different view;[27]

97.4. regarding the *SWT* agreement as wholly extrinsic to the "rights" under the scheme. As Christopher Nugee argued in *SWT*, the *SWT* agreement could be rationalised as the employer and employee agreeing what "pay" is. The employee's right under the scheme to have pay rises treated as pensionable remains intact, so there is no

[27] This argument gives rise to further complexities. The policy background to s 91(5)(b) (discussed in *Re LPA Umbrella Trust* [2014] Pens LR 319 at [45]-[46]) suggests that the "further benefits" would have to be of at least the same value as those surrendered. If so, it could be argued that giving up full salary linkage in return for a small pensionable pay increase is not permissible (a similar argument was raised in *Briggs v Gleeds* at [172] but not determined). On the other hand, it might be said that full salary linkage is not of itself worth anything if there is no entitlement to a pay rise.

surrender of any rights under the scheme (indeed the trustees are not party to the agreement and nothing is surrendered to them). But the trustees have to look at the extrinsic contractual arrangements between the employer and employee to work out what "pay" is, and the latter are free to agree what shall be treated as pay for this purpose.

98. It is suggested that, in the case of a traditional *SWT* agreement that restricts pensionability of pay, the last point above is perhaps the most straightforward justification of why the agreement does not involve the surrender of any "right to a future pension" within s 91(1).

The "doubted or disputed rights" exception

99. The final topic dealt with in this section of the paper is how the "doubted or disputed rights" exception identified in *IMG* (CA) has been developed in subsequent cases.

100. The exception has been deployed (it is suggested, somewhat ingeniously) to take *SWT* agreements outside the scope of s 91.

101. As explained above, in *Bradbury (No 1)*, the first limb of Warren J's analysis was that the employer arguably had a power to treat pay rises as non-pensionable, so members' right to salary linkage was doubted or disputed and therefore outside the protection of s 91. In reaching this conclusion, Warren J did not suggest that the putative right had to be *consciously* subject to dispute at the time of the agreement. The *SWT* agreements in *Bradbury* do not appear to have been presented as compromise agreements at all. Nevertheless at [83], Warren J concluded: "There would have been, at the very least, a serious doubt about whether the BBC was wrong in the view it took. If a member had disputed the BBC's position, that dispute could then have been compromised … and such a compromise would not have engaged section 91" (emphasis added).

102. So it appears that the disputed rights exception can be invoked even though there may not be a crystallised dispute or a conscious compromise.

103. This was taken a step further in *Briggs v Gleeds* where the *SWT* agreements (which in effect validated an invalid change to the scheme) were entered into several years before any form of dispute arose. Applying the disputed rights exception, Newey J rejected a s 91 challenge to the *SWT* agreements. Newey J concluded that, even though the relevant change to the scheme was invalid, "that would not mean that [the employers] had not had a respectable argument to the contrary. The members' "rights" would not have been clear-cut by any

means and so would not have represented an "entitlement or right" for the purposes of section 91 of the 1995 Act": see [175]-[176] (emphasis added).

104. In other words, even though there was in fact no dispute at the time of the *SWT* agreement, if the matter had been investigated there could have been a dispute and members' rights would then have been doubtful, and so fell outside s 91.

105. This is perhaps a surprising development from the decision in *IMG* (CA) which was concerned with a bona fide compromise of an existing dispute. It suggests that an employer can validly procure a surrender which would otherwise be prohibited by s 91, so long as, *ex post facto*, it is able to point to some arguable reason to cast doubt on the surrendered right, even if the argument is wrong (as was the case in both *Bradbury (No 1)* and *Briggs v Gleeds*). This potentially erodes the protection offered by s 91. It seems curious that the Court is willing to assume, hypothetically, that members' rights would have been disputed if anyone had thought about it, but does not go on to assume, hypothetically, that the dispute would have been resolved by the Court ascertaining the members' true rights before the *SWT* agreement is signed.

106. It remains to be seen how this extension of the "doubted or disputed rights" exception will be applied in later case.[28]

Conclusion on *SWT* agreements and s 91

107. For now, *Bradbury (No 1)* gives considerable comfort that a *SWT* agreement that restricts pensionability of pay does not contravene s 91 PA95, so long as the employee does not have a right to a pay rise. However, the prospect of a successful challenge on appeal cannot be ruled out.

***SWT* AGREEMENTS AND THE DUTY OF GOOD FAITH**

Introduction

108. As the foregoing discussion has shown, the use of contractual agreements with members to reduce the value of their scheme benefits may be significantly constrained by s 91. Such agreements are, however, potentially available to limit future increases in pensionable salary, in circumstances in which it is not possible to achieve this through the scheme rules

[28] In the recent Pensions Ombudsman determination, *White v Thames Water*, PO-5304, 20 May 2015, it was argued that there needed to be a "pre-existing dispute" before the exception could apply, but the ombudsman did not have to rule on this point because in any event there was a dispute at the time of the agreement.

(either because the trustees are reluctant to agree to an amendment, or the amendment power is subject to a *Courage* type restriction which guarantees members' benefits computed by reference to their salary at leaving service).

109. The duty of good faith in the employment context was summarized by Lord Nicholls in *Mahmud v BCCI* [1998] AC 20, 35:

> "*The conduct must, of course, impinge on the relationship in the sense that, looked at objectively, it is likely to destroy or seriously damage the degree of trust and confidence the employee is reasonably entitled to have in his employer. That requires one to look at all the circumstances.*"

110. This test was referred to by Sedley LJ in *Buckland v Bournemouth University* [2011] QB 323 as "the unvarnished Mahmud test". This duty has been recognized in employment law ever since *Woods v W M Car services (Peterborough) Ltd* [1981] ICR 666, and was imported into pensions law by Sir Nicholas Browne Wilkinson V-C in *Imperial Group Trust v Imperial Tobacco Ltd* [1991] 1 WLR 589. *Imperial* held that an employer could be found to be in breach of the duty of good faith by reason of the manner in which he exercised a power vested in it under the terms of the pension scheme. The so-called *Imperial* duty of good faith, ought, in the writers' view, to be used to refer to the duty of good faith as it applies to the exercise of powers and discretions under a pension scheme, but not to the exercise of discretions under the employment contract which have an effect on the level of pension payable. Although subsequent cases have sought to preserve the possibility of the *Imperial* duty having a different <u>content</u> to the wider employment law duty of good faith,[29] it is submitted that the *Imperial* duty is simply an application of the wider duty, as laid down in *Mahmud* to a particular <u>context</u>.[30]

111. As *SWT* itself shows, an agreement between a freely consenting employer and employee, whereby, for example, the employee receives a higher salary than before, but on the basis that only part of it is pensionable, will be enforceable (subject to any s 91 issues). It is hard to see how the duty of good faith could be invoked in such a situation. But where an employer seeks an agreement to limit future pensionable salary increases there is usually an element of compulsion involved. Typically the employee will be told that if he does not forego the pensionable nature of his salary increase he will get no increase at all. He may be told that if

[29] See e.g. *IBM (No 2)* at [358].

[30] Although the duty may be wider than the implied contractual term in the sense that it appears to be owed to pension scheme beneficiaries who are not parties to the employment contract (see *IBM (No 2)* at [353]).

he wants a salary increase he must agree that that increase, and all future increases will be non-pensionable. Sometimes, where the employer has the right to exclude a member from the benefit of a final salary pension scheme, the member will be told that his continued membership will only be allowed on condition that future salary increases will be non-pensionable, or only partly pensionable. In many cases the attempt to impose a cap on future pensionable salary increases will be accompanied by an offer of an alternative pension arrangement to the final salary scheme, under which the less generous accrual of benefits in future is offset by the ability to claim all future salary increases as pensionable. In some circumstances the threat of the imposition of a cap on pensionable salary for final salary scheme members may effectively force them, in their own interests, to elect to leave the final salary scheme.

112. In situations of the sort outlined in the previous paragraph an employee may seek to argue that the exercise, or the threat to exercise, the employer's discretion over salary increases and, in some cases, its discretion to exclude the employee from the pension scheme completely, amount to a breach of the duty of good faith. It may be said that the very act of seeking to change the status quo is destructive of the relationship of trust and confidence. In support of that allegation the employee may cite previous assurances from the employer that the status quo would be preserved, and may also cite detrimental reliance on those assurances by the employee concerned.

113. The starting point for an examination of the legality of *SWT* agreements which seek to limit pensionable earnings has to be the case-law on the employer's general duties with respect of pay increases. An employer's decision whether or not to award an annual pay rise is a matter of discretion for the employer. In some employment contracts there is an express duty on the employer to consider whether to award an annual increase. Even absent such a clause there is likely to be a regular custom of annual salary reviews. There is a certain amount of employment case-law on the nature and extent of an employer's duties when exercising a discretion over remuneration (whether in relation to an annual bonus or an annual salary review). The case-law shows that the fundamental duty of the employer, when exercising a discretion over remuneration, is to be rational. Whatever the employer decides to do must be capable of rational justification. As long as an employer reaches a conclusion which a rational employer could have reached in the circumstances, the employee cannot (absent other employer misconduct) have any complaint, even though another rational employer could have reached a result which would have been more favourable to the employee.

However, if the employer reaches a perverse result – one which no rational employer could have reached – then it will be in breach of the implied duty to act rationally. At that point the Court can assess damages by reference to what it considers a rational employer would most likely have done.

The employment case-law on discretion over remuneration

114. It is important to say a little about this case-law, because of the importance which it has since achieved in the context of the duty of good faith as it applies to pension schemes. In chronological order the cases are as follows:

Clark v BET Plc [1997] IRLR 348 (Dyson J)

115. This was a case about an executive who had been wrongfully dismissed without notice. It was solely about quantum, and concerned the level of salary and bonus increases which the Court was to assume would have been granted to the employee during his three year notice period. The employer's argument that it should be assumed that it would have performed the contract in the manner most favourable to it (and therefore awarded nil increases and nil bonuses) was rejected. That would have been tantamount to a rejection of its duty to give proper consideration to question of salary increases and bonuses. The Court assessed damages by reference to the levels of increases and bonuses that the employer would probably have awarded had the contract continued.

Clark v Nomura International [2000] IRLR 766 (Burton J)

116. Again, a case in which an executive was dismissed, but during his notice period his annual bonus fell to be awarded. The employer awarded him nothing. The Court held that the test to be applied was one of "irrationality or perversity ie no reasonable employer would have exercised his discretion this way" (see [40]). If the employer's conduct could be so described, there was a breach of contract and the Court could assess damages by substituting its own view of what should have been awarded. The Court held the employer had behaved irrationally, and awarded damages accordingly.

Horkulak v Cantor Fitzgerald [2005] ICR 402 (CA)

117. This case concerned an employee who resigned after a campaign of harassment against him and alleged breach of the duty of good faith. This case succeeded at first instance. The Court of Appeal were concerned only with quantum. The Court considered what if any term should be implied into an obligation to consider awarding a discretionary bonus. Again it was held

that the bonus discretion had to be exercised rationally. It was not to be construed simply as a statement in the contract that the employer could award a bonus if it chose to, but was under no obligations in respect of it.

Keen v Commerzbank AG [2007] ICR 623

118. This was a case where the employee had been made redundant and was suing for damages on the basis that his employer had failed to exercise its discretion properly in relation to the last three annual bonuses that had fallen for consideration before his contract ended. The claim failed on the basis that the bank had a wide discretion and it could not be shown that it had acted irrationally.

Discussion

119. What is important to note about all of these cases is that in none of them was it alleged that the failure to award a bonus or a salary increase was, of itself, a breach of the duty of good faith. The cases were all concerned with the narrower question of what duties were imposed on an employer by virtue of the existence of a contractual discretion over remuneration. The answer was that the employer had to be rational. But it is important to appreciate that the fact that an employer's decision is rational, or reasonable, is not a decisive answer to an allegation that the employer's behaviour is in breach of the implied duty of good faith. This was made very clear by the Court of Appeal in *Buckland v Bournemouth University* [2011] QB 323. In that case the employer argued that it was not in breach of the duty because its conduct fell within a range of reasonable responses to the situation it was faced with. The Court rejected that as a test for whether the duty of good faith had been complied with (see [25]). Sedley LJ had this to say about the role of reasonableness in the context of the duty of good faith.

> "*It is nevertheless arguable, I would accept, that reasonableness is one of the tools in the employment tribunal's factual analysis kit for deciding whether there has been a fundamental breach. There are likely to be cases in which it is useful. But it cannot be a legal requirement. Take the simplest and commonest of fundamental breaches on an employer's part, a failure to pay wages. If the failure is due, as it not infrequently is, to a major customer defaulting on payment, not paying the staff's wages is arguably the most, indeed the only, reasonable response to the situation. But to hold that it is not a fundamental breach would drive a coach and four through the law of contract, of which this aspect of employment law is an integral part.*"

120. The point is obvious – a course of action which is reasonable or rational for an employer to undertake may nonetheless constitute a fundamental breach of contract. The Court said that the "unvarnished *Mahmud* test" (see above) should be applied instead (see [25]).

121. In principle (and without regard at this stage to recent authority, which is discussed below), the relationship between the duty to exercise a contractual discretion rationally and the duty of good faith appears, therefore, to be this. Even absent any suggestion of a breach of duty of good faith, there may be a breach of the implied term to exercise a discretion rationally which may give rise to a claim for damages. But if a case is made out that the exercise of a discretion in a particular way constitutes an element in conduct which taken overall constitutes a breach of the duty of good faith, the fact that the discretion has been exercised rationally will not necessarily be an answer to that claim. Of course, if a breach of the duty of good faith claim is to be mounted against an exercise of discretion which can be rationally justified, there must be aggravating conduct over and above the mere exercise of discretion which the employee can rely on. If the only complaint is about the result of the exercise of discretion, and the exercise is rational, that must be the end of the matter. Aggravating conduct in these circumstances might relate to the manner in which the exercise was undertaken (e.g. no consultation) or might be a complaint that the exercise went back on a previous assurance given by the employer to the employee.

122. The other point to bear in mind when discussing reasonableness is that the existence of the duty of good faith does not mean that the employer has to act in a manner which the Court thinks reasonable, or fair. This point has been emphasised in several cases, for example in *Imperial* itself, where Browne-Wilkinson V-C pointed out that while an irrational action might well constitute a breach of the duty, there was no basis for engrafting on to the employer an implied obligation to act in a way the Court considered reasonable (*Imperial* at page 597[31]).

Content of the employer's duty as considered in *Prudential*

123. Although the existence of the *Imperial* duty was alluded to in several cases in the intervening years, the first decided case to rule on the content of the duty where the exercise of a discretion is concerned was *Prudential Staff Pensions Ltd v Prudential Assurance Company Ltd* [2011] PLR 239. This was not a case involving an *SWT* type contract. Instead it concerned the exercise by the employer of a discretion as to pension increases conferred on it by the scheme rules. It was, in that sense, a classic application of *Imperial*. The employer changed

[31] See also *IBM (No 2)* at [362].

its practice on granting pension increases on favourable terms, to the discontent of various members.

124. The contest in *Prudential* was between the members of the pension scheme, arguing that by changing its policy the employer had breached a high level duty to treat members fairly, and the employer, who argued for the transposition of the duty to take a rational decision from contractual discretions to pension scheme powers, and he argued that it had acted rationally. The Court rightly rejected the members' attempt to convert the duty of good faith into a duty of fairness or reasonableness, pointing out that the authorities had always made it clear that this was not to happen. The Court then went on to accept the employer's submission that the duty to exercise a discretion rationally applied to the exercise of powers in a pension scheme.[32]

125. The employer's case seems to have been that the test being rationality, it was under no obligation to consider the interests of members or to take account of their expectations. The court, however, did not go that far. The court's view was that

> "*… members' interests and expectations may be of relevance when considering whether an employer has acted irrationally or perversely. There could potentially be cases in which say a decision to override expectations which an employer had engendered would be irrational or perverse.*"

126. Taken out of context, this passage appears to come dangerously close to converting the duty of good faith into a "range of reasonable outcomes" test. By feeding the disappointment of an employee's expectations into the question whether the employer has acted rationally, the employer can win if it can show that its response to the disappointment of the expectation was a rational one. But that runs quite counter to the approach of the Court of Appeal in *Buckland*. In fact, Newey J did not combine the two duties in this way – he was careful to distinguish between the duty to be rational and the duty of good faith, and did not elide the two (see for example [178] and [187]).

Content of the employer's duty as considered in *IBM (No 2)*

127. The elision of the two tests did, however, occur in Warren J's decision in *IBM UK Holdings v Dalgleish* [2014] EWHC 980 (Ch) (*IBM (No 2)*). That case involved both the exercise of a scheme power, and the imposition of an SWT contract which sought to cap pensionable

[32] The reasoning behind this decision is not entirely clear, but it lies beyond the scope of this talk to explore it.

salary for members who continued to accrue benefits in the final salary scheme. The case is therefore highly significant for SWT agreements, and the circumstances in which they might fall foul of the duty of good faith.

128. In *IBM (No 2)*, as in *Prudential*, the employer argued that the question whether its decision to make pay increases conditional on the acceptance of a non-pensionability agreement breached the duty of good faith turned on whether it had acted rationally. Reliance was, of course, placed on the employment law cases referred to above. The argument was in essence that a decision whether or not to grant a pay rise was a discretion of the employer which needed to be exercised rationally. A decision to grant an increase, but only on a condition (such as it not being pensionable) likewise fell to be assessed by reference to its rationality. This the judge accepted, reasonably enough. However, the employer went further and argued, contrary to the thesis advanced above, that where the exercise of a discretion was concerned the test for whether the duty of good faith had been breached was also one of rationality. The members argued that the duty of good faith test was wider than that (in effect "unvarnished *Mahmud*"). The judge purportedly followed Newey J in *Prudential* by saying that the passage quoted in paragraph 125 above had been adopted by Newey J as the test for whether the duty of good faith had been breached. This is, with respect, a misreading of Newey J's judgment.

129. In both *Prudential* and *IBM (No 2)* the members alleged that the employer had engendered expectations on their part which it had then departed from. In *Prudential* this claim was rejected, because all of the employer statements relied on by the members had been carefully qualified to make it clear, in effect, that the employer reserved the right to change its mind. Thus, when Newey J referred to taking account of members' expectations when considering whether the employer had acted rationally, he was dealing with a case where there were no relevant expectations to consider. By contrast, in *IBM (No 2)* the Court found that members had been given clear expectations by the employer, on which they had placed reliance, and the employer was now seeking to go back on those expectations. The Court coined the phrase "Reasonable Expectations" to describe expectations generated by the employer itself. One might therefore have thought that the disappointment of those expectations would be an important element in the application of the "unvarnished *Mahmud*" test. Instead, the Court said that they fell to be fed into the question whether the employer's decision was irrational, on the basis that a rational employer would not disappoint such expectations, at least not without a very good justification.

130. While this approach enabled the Court to find a breach of the duty of good faith (because the court concluded that no rational employer would have acted in the way that IBM did) it is submitted that it is contrary to principle and creates problems in its application. It is contrary to principle because by asking the question "is this a rational decision" it converts the test of whether the duty of good faith has been breached into a "range of reasonable options" test (cf. *Buckland* and the cases there relied on). It is difficult to apply because it is hard to feed in member expectations into a rationality test. It simply may be rational for the employer to disappoint them, even though to do so would on any view destroy the relationship of trust and confidence. Warren J's test can only be made to work if you assume that no rational employer would contravene the duty of good faith. But then it ceases to be a rationality test and becomes a question of whether the duty of good faith has been breached, at which point the *Mahmud* test must be applied.

131. It is interesting that there was a distinct issue in *IBM (No 2)* about the lack of proper consultation. The judge dealt with this separately from his consideration of the merits of what the employer did (at [1538] onwards), and held that, applying the *Mahmud* test, the defects in the consultation process of themselves breached the duty of good faith. This aspect of the decision points up the oddity of subsuming one important aspect of the duty of good faith case (disappointing Reasonable Expectations) into the rationality question, while leaving another one (defective consultation) outside it.

The employer's duty revisited: *Bradbury (No 2)*

132. Warren J returned to the issue of the duty of good faith and SWT agreements in *Bradbury v BBC (No 2)* [2015] EWHC 1368 (Ch). This case was an appeal from the Pensions Ombudsman in connection with a reorganization of the BBC's pension arrangements. The facts of the case have been briefly summarised in paragraph 31 above. By way of recap, the BBC's proposal to members of the final salary section of its pension scheme had been:

132.1. An employee could remain in his DB section and agree that all future salary increases would only be pensionable on the first 1% increase.

132.2. He could opt out of his DB section and join a new career average section (in which case all salary increases would be pensionable).

132.3. He could leave the Scheme and join a defined contribution arrangement.

133. As noted above, there was a first hearing of this appeal in 2012 (*Bradbury (No 1)*), at which Mr Bradbury's contention that the proposed *SWT* agreement (which he did not in fact accept, thus receiving no pay increase at all) was contrary to s 91 PA95. At the 2012 hearing the judge decided that there was a further aspect to Mr Bradbury's complaint, namely that the imposition by the BBC of the choices set out above was a breach of the duty of good faith. As this had not been considered by the ombudsman, the matter was remitted for a further determination. The ombudsman found that the duty had not been breached, and Mr Bradbury appealed that finding, which was the subject of the 2015 hearing. In giving judgment on the first hearing, the judge said this about the legal test for breach of the duty of good faith (*Bradbury (No 1)* at [103]):

> "*… a decision by an employer which was irrational or perverse might offend the obligation of good faith, and in that context, Member's interests and expectations might be of relevance when considering whether an employer had acted irrationally or perversely.*"

In other words a statement of the position he was later to reach in *IBM (No 2)*.

134. On the appeal in *Bradbury (No 2)*, Mr Bradbury mounted a wide-ranging attack on the way the BBC had implemented the proposals, alleging that there had been a breach of the duty of good faith. The judge summarised his case as follows:

> "*His complaint has always been about the mechanism used by the BBC and not about the offer of a pay increase or the exercise of a discretion which was the issue in the Prudential case. He is concerned with the wider question (i.e. was the BBC's conduct calculated or likely to destroy or seriously damage the bond of mutual trust and confidence?) taken as a whole, viewed objectively and accepting that the test is severe*" (see [6]).

135. The BBC, on the other hand, argued for the rationality test adopted in *IBM (No 2)*.

136. The ombudsman found for the BBC on both of the rival approaches to the relevant test. Warren J referred to his judgment in *IBM (No 2)* and the employment law cases on which it was founded, and then said, at [15]:

> "*Absent some special factor, the exercise of a discretion in a way which was neither irrational nor perverse in that sense would not give rise to a breach of the implied duty of trust and confidence; there would be no conduct which would on an objective*

> *assessment be likely to destroy or undermine the relationship of trust and confidence. If there are special factors (as there were in IBM) then the exercise of the discretion in a particular way may give rise to a breach of duty. It does not matter much whether the analysis, where there is a breach, is that the special factors lead to the exercise of the discretion being irrational and/or perverse; or whether the conduct in question becomes such as to destroy or undermine the relationship of trust and confidence without reasonable and proper cause.*"

137. That is an interesting passage. In *IBM (No 2)* a lot of argument and many paragraphs of the judgment were devoted to the question of the correct test to apply when an employer exercised a discretion which was said to breach the duty of good faith. The rationality test prevailed, but here is the judge saying that it does not matter much if you apply the unvarnished *Mahmud* test instead. As explained above, on one view it does matter because the two tests are conceptually distinct – the question whether the employer's actions are within a range of reasonable outcomes (which is the question posed by the rationality test) is not the same as the *Mahmud* test, as *Buckland* demonstrates. The judge was, however, undoubtedly correct to say that absent some special factor, if all the member is complaining about is the outcome of the exercise of a discretion by the employer, all he is entitled to expect is a rational decision.

138. In the following paragraph [16] the judge points out that "Not all conduct leading to a breach of the Implied Duties necessarily involves the exercise of a discretion or the making of a decision which should be treated in the same way as the exercise of a discretion." In that case, the judge says you should apply what has been described above as the "unvarnished *Mahmud*" test.

139. Then, in [18] to [23] of the judgment, the judge seeks to reconcile *Buckland* with the approach he adopted in *IBM (No 2)* of asking whether the employer's decision was rational. The passage is, with respect, hard to follow, but the judge seems to come out (at [23]) at the position that the range of reasonable outcomes test may provide the answer to the question whether the implied duty has been breached where an employer decision is under attack, but not otherwise – outside the scope of the challenge to a decision the unvarnished *Mahmud* test must be applied. It is submitted that this approach is hard to reconcile with *Buckland*. The true position is that where the employee is alleging a breach of the duty of good faith arising out of an employer decision (such as to impose non-pensionabilty terms on a pay rise) the first question to ask is whether the employer's decision is rational. If it is then

the employer has satisfied his contractual duty to exercise his discretion rationally and the employee can have no complaint about the decision unless he can point to other factors which together mean that the decision breaches the duty of good faith, even though it is rational. At this point issues such as reneging on Reasonable Expectations or inadequate consultation may be relied upon. And in evaluating whether those factors, when added to the outcome of the decision, amount to a breach of the duty of good faith, one applies the unvarnished *Mahmud* test.

140. One potentially important argument advanced by Mr Bradbury in *Bradbury (No 2)* was that it was in principle a breach of the duty of good faith for the BBC to have sought to cap the pensionability of future pay rises by means of an *SWT* agreement instead of seeking to persuade the trustees of the pension scheme to agree a rule amendment to the same effect. This argument was dismissed by the judge in [44] of the judgment. The judge pointed out that capping pensionable salary by means of a contractual arrangement was not contrary to the provisions of the scheme deed and rules. He also made the point that Mr Bradbury was not entitled to any given level of pay increase, and that in theory the BBC could decide to offer no pay increase at all. Such a decision could not, thought the judge, be attacked as a breach of the duty of good faith absent some other factor (such as a "Reasonable Expectation").

141. The problem for the appellant in *Bradbury (No 2)* was that, as the judge pointed out (at [41] and [42]), the ombudsman made no findings (and was not asked to make findings) about the existence of "Reasonable Expectations". Furthermore, the ombudsman was justified in concluding that the consultation procedure did not breach the duty of good faith (see [74]). Two other lines of attack (age discrimination and the employer's alleged collateral purpose in effecting the changes) were not established before the ombudsman and were dismissed by the judge. So Mr Bradbury was really left complaining simply about the outcome of the employer decision to restrict pensionable pay increases to 1% for members who remained in the final salary section of the scheme. In view of the alternative options which were made available to members, and the pressing need for the BBC to reduce its pension costs, it was clear that the actual decision was rational.

Conclusion on the employer's duty of good faith and *SWT* agreements

142. What, then, can we learn from *Bradbury (No 2)*? One point which emerges is that the "rationality" test in *IBM (No 2)* may not be quite as it appears to be. Any confusion over this

is likely to be resolved by the Court of Appeal in the pending appeals in either *IBM* or *Bradbury*, but for the moment careful attention needs to be paid to the passages in *Bradbury (No 2)* which appear to qualify the approach in *IBM (No 2)*. The other main point which emerges is that *SWT* agreements capping the pensionability of pay rises will, in appropriate cases, be upheld by the Court. *IBM (No 2)* was a case where the employer was burdened by a long history of involvement with the scheme which effectively restricted its freedom for manoeuvre when it came to implementing "Project Waltz". *Bradbury*, by contrast, shows that an employer who has not engendered Reasonable Expectations in the members, who conducts a proper consultation and who has not given any other hostages to fortune, will only have to satisfy the Court that its *SWT* agreement is a rational response to a real problem. All the authorities, *IBM (No 2)* included, stress that showing that an employer has breached the duty of good faith is a hard task for the employee to succeed in. *Bradbury (No 2)* shows that in an appropriate case the employer should have no difficulty in defending its position.

The transfer of pensions rights under TUPE

Brian Green QC and Jonathan Hilliard

1. Pension scheme rights cause particular difficulty for the law governing the transfer of undertakings because:
   (1) they are elements of pay that can be delivered in a number of different ways, including being funded through a trust that stands separately from the employer's own assets and under which the employee has rights against persons other than the employer;
   (2) they comprise a wide universe of potential rights, such as income and lump sum rights, and rights that could easily be delivered outside a retirement arrangement, like redundancy rights; and
   (3) many of the rights that are triggered by something other than retirement are nevertheless effectively accelerated retirement rights.

2. The easiest way to deal with such rights is simply for them not to transfer and this is a solution that has appealed to at least some of the legislators who have considered the problem down the year.

3. However, this is an uneasy answer to the question of how to deal with an important component of employee's pay, because it creates a disconnect between the treatment of the different components of their pay packet, and chafes against the idea that an employee should take his employment rights with him on a transfer of an undertaking.

4. The pragmatic decision of Hildyard J in *Procter & Gamble* [2012] PLR 257, which provides an English law path through some of this thicket, was the inspiration for this talk. We shall start by looking at where the problems begun in the history of this area of the law, namely at the European level, and work towards considering how these problems may be dealt with if and when they find their way back to the European level in the shape of the ECJ to have the questions left over by *Beckmann* and *Martin* resolved.

The problematic early history of the matter

5. With hindsight, the difficulties that the topic gives rise to can be traced back to the moment of its inception, and the compromises that were made at the time.

6. The history begins with the Acquired Rights Directive 1977, whose purpose was to safeguard employee rights on a change of employer. This it did by way of a statutory novation of the contract of employment (art.3(1)).

7. The original Commission proposal appeared to suggest that there should be an automatic transfer of rights under pension schemes (art.9(3) of the draft proposed directive), [33] [34] presumably on the basis that occupational pension rights are part of pay and therefore they should be treated in the same way as other parts of the employment deal struck between the employer and employee.

8. However, the Council was concerned that the then present wording might allow a transferee who was in service at the time of the transfer of undertaking to make a claim against both the transferring employer and the receiving employer.[35] Moreover, they were concerned that the transferee might, depending on how the receiving employer's scheme was structured, receive as a result of the original draft art.9(3) greater benefits under the receiving employer's scheme than under the transferring employer's scheme. Therefore, they suggested that art.9(3) be made more complex to make clear that this would not happen.

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[33] Available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:JOC_1974_104_R_0001_01&from=EN - see draft art.9, particularly art.9(3).
[34] See http://eur-lex.europa.eu/legal-content/EN/HIS/?uri=CELEX:31977L0187 for a fuller legislative history.

[35] http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:51975AC0489&from=EN at paras.2.9.4-2.9.5:

> *"2.9.4. The Committee fears that the wording of Article 9 (3) could lead to a plurality of claims by employees. It is right that a transferred employee should retain the claims and entitlements he has already acquired, but the present text makes it possible for him to make additional claims under arrangements in force in the transferee's business. The Committee considers that the possibility of such double claims being made should be precluded by making the text clearer.*
>
> *2.9.5. Preferential treatment of transferred workers which does not seem justifiable could also occur if the transferor's business has been in existence longer than the transferee's and a pensions scheme geared to the number of years of service is operated by the transferee but was not by the transferor. If, for example, the transferee has a scheme under which employees are to receive supplementary benefits after 20 year's service, and his business has been in existence for only five years; whereas the business which has been taken over had been operating for 20 years, the transferred employees could immediately make claims against the transferee which they did not have, vis-a-vis the transferor, and would not have had, vis-a-vis the transferee, if they had been working in his business from the start."*

9. By the time of the final version of the 1977 Directive, the position had evolved further, art.3(3) providing:

   " Paragraphs 1 and 2 shall not cover employees' rights to old-age, invalidity or survivors' benefits under supplementary company or inter-company pension schemes outside the statutory social security schemes in Member States.

   Member States shall adopt the measures necessary to protect the interests of employees and of persons no longer employed in the transferor's business at the time of the transfer within the meaning of Article 1 (1) in respect of rights conferring on them immediate or prospective entitlement to old-age benefits, including survivors' benefits, under supplementary schemes referred to in the first subparagraph."

10. As to what had happened in the interim, the Commission provided a helpful explanation in *Beckmann* itself, which is recorded at para.23 of the ECJ judgment:

    "*The Commission argues that the exception provided for by Article 3(3) of the Directive is explained by the characteristics of the supplementary company and inter-company pension schemes to which it relates, as is clear from the preparatory work for the Directive. The structure and, at the same time, the diversity of those schemes was such that it was impossible to require transferees generally to assume obligations under schemes with their own equilibrium, in which the transferees often do not participate.*"

    Similar light is shone on the background in *Adams v Lancashire CC* [1997] 3 CMLR 79 at paras 17-20.

11. Therefore, right from the outset, there was an uneasy tension. The European legislature started from the position that pensions should be treated like other elements of pay, but were stymied by the peculiar issues that funded pension schemes give rise to. The drafting became more complex when the problems were realized, and the revised drafting appears still not to have been considered adequate to cope with all situations, so instead pensions were carved out as too difficult to deal with.

The wording of the 1977 Directive

12. The directive provided by art.3(1) for the automatic transfer of rights arising from a contract of employment or employment relationship, but per art.3(3):

"*Paragraphs 1 and 2 shall not cover employee's rights to old-age invalidity or survivors' benefits under supplementary company or inter-company pension schemes outside the statutory social security schemes in Member States.*"

13. Art.3(3) goes on to require Member States to adopt measures necessary to protect the old-age benefits and survivors' benefits of those who were no longer in employment at the time of the transfer.

14. The language of the first paragraph of art.3(3) is difficult. One explanation, which is how the UK draftsmen initially understood it (see below), is that it is simply a carve-out for rights under occupational pension schemes given the difficulties that had arisen in the lead up to the passing of the Directive in including pensions within its scope. On this view, the reference to old-age, invalidity and survivors' benefits in art.3(3) is just attempting to describe the sort of benefits that pension schemes provide. There is nothing in these difficulties that suggests that there was an intention to differentiate between some rights under pension schemes (which should transfer) and other rights (which should not).

15. That explanation makes a good deal of sense but it is not quite what art.3(3) says. Art.3(3) could have just said that rights under company or inter-company pension schemes were excluded, but it does not. Instead, the draftsmen appears to have been keen to make sure that he specified what rights under occupational pension schemes should not pass. A possible explanation of this is that in light of the diversity of arrangements that seems to have been uncovered during the legislative process since the Commission's original proposal and which seems to have led to the pensions exclusion from the directive in the first place, the draftsmen was keen to ensure that there were limits on the exclusion, in case there were "non-old age" benefits that were being supplied by these schemes. For example, the draftsmen may have thought that it could be possible to route other types of benefits, like redundancy benefits, through pension schemes, and did not wish the fact that they were being delivered as a matter of form by the pension scheme rather than direct by the employer to prevent them transferring.

The wording of the 2001 directive

16. The 1977 directive was replaced in 2001 by a successor directive, which contains slightly different wording in some respects but contains the same core provisions.

17. Among its differences are that it provides that Member States *may* provide that the transferor employer and receiving employer shall be jointly and severally liable for obligations that arose before the date of the transfer (art.3(1)), an invitation that the UK has not taken up under TUPE. Art.3(4) states that *unless Member States provide otherwise,* the ordinary statutory novation shall not apply to employees' rights to old-age benefits and so forth, and again there is an obligation to provide suitable protection for the old-age and survivors' benefits of those who have left service pre-transfer.

The TUPE Regulations 1981 and 2006

18. The 1981 Regulations was the UK's attempt to incorporate the 1977 directive.

19. The important feature of the 1981 regulations in their original form is that reg.7(1) provides a simple occupational pension scheme carve out- the statutory transfer does not apply to:

    "…*so much of a contract of employment… as relates to an occupational scheme*" (reg.7(1))

20. However, the Commission clamped down on the UK in the early 1990s, in respect of a number of areas in which it felt that the UK had not fully transposed the requirements of EU law.

21. The upshot in relation to the pensions exclusion was that the Trade Union Reform and Employment Rights Act 1993 made the following addition to reg.7:

    "*For the purposes of paragraph (1) above any provisions of an occupational pension scheme which do not relate to benefits for old age, invalidity or survivors shall be treated as not being part of the scheme.*"

    The 1981 Regulations have since been superseded by a 2006 iteration, but the same wording is retained (reg.10).

22. Therefore, whatever the Commission's view at the time of the 1977 directive as to the scope of the pensions exception, by the early 1990s it was adhering to the second of the two views of art.3(3) set out earlier on in this paper. This sets the scene for the decision in *Beckmann.*

Beckmann and *Martin*

23. The result of the two cases is that:

    (1) 'Benefits for old age' are benefits payable by reason of having reached the end of working life as defined in the given employer/employee relationship.

(2) 'Benefits for old age' do not include benefits payable on

    (i) Beckmann – earlier redundancy a *special benefit* which ceased to be payable on normal retirement date ("NRD") or

    (ii) Martin – agreed early retirement in the interests of efficiency, likewise a *special benefit* which ceased to be payable on NRD

24. However, what is interesting is understanding how we reached this position, because this tells us something about how far the decisions reach.

25. Before *Beckmann* and *Martin*, the Employment Appeal Tribunal had held in *Frankling v BCS Public Sector Ltd* [1999] ICR 347 that although the provisions of the scheme in question in relation to redundant employees were triggered by the redundancy dismissal and not the age of the employee, the benefits retained their character as retirement benefits, albeit accelerated and enhanced, and therefore did not transfer under TUPE. *Frankling* concerned the same pension scheme provisions considered in *Beckmann.* However, the UK Government regarded the decision as wrong, no doubt in light of the forceful view that the Commission had expressed in the early 1990s leading to the change in the wording of the TUPE pensions exception.

26. Therefore, when *Beckmann* was referred to the ECJ, the Government provided helpful support for Mrs Beckmann's position that a redundancy benefit was not an old-age benefit.

27. When one looks into *Beckmann* and *Martin* a little more, one sees other reasons that could have made the case an appealing one for the ECJ to find that the benefits were not old-age benefits:

    (1) they did not continue past NRD; and

    (2) they had a clear trigger that is not related to old-age.

28. Therefore, given the above and the reluctance of the Court to (as it would see it) eat into the directive's general objective of safeguarding employee rights on transfer of undertakings, it is in retrospect perhaps understandable that the ECJ found what it did.

29. Finally and interestingly, the Commission put forward a more complex position, which required one to look at the method of financing, nature and purpose of the benefits, conditions for the grant of benefits and the method of calculation of the benefits (para.37 of Advocate-General's opinion; paras.22-25 of the ECJ judgment). What the Commission appears to have been trying

to get at is whether the benefit was a classic funded pension benefit. It concluded that it was and therefore said it should fall within the exception in art.3(3) and not pass. Therefore, the Commission's approach looks very much like saying that there is an exclusion for occupational pension scheme rights, as long as they are genuine pension scheme benefits rather than a device for routing through the scheme a different sort of benefit. However, this reasoning was not engaged with directly by the ECJ.

30. So in summary, *Beckmann* was a case where a number of different factors pulled together in the same direction to bring about the result. This means that a little care is needed in extending it.

<u>The effect of *Beckmann* in practice</u>

31. In order to see what *Beckmann* really means for UK occupational pension schemes, a detour is necessary into English law practice. A seller and purchaser of an undertaking will generally include provision for the provision of pension benefits (not limited 'old age benefits') by the purchaser, previously available from the seller, and so far as regards past service rights taken on by the purchaser, a purchase price adjustment to deal with the same. To the extent that there is doubt as to what the value/cost of assumed rights may turn out to be (future rate and distribution of employer consents to conferment of early retirement or redundancy cases) the parties may negotiate and put in place a *Beckmann* Indemnity.

32. Beckmann Indemnities generally indemnify in respect of the cost of provision of early retirement or redundancy benefits *and any other benefits* accrued by reason of employee participation in the seller's pension scheme, for which the purchaser becomes liable by virtue of TUPE, subject to –
    (a) possible time limits;
    (b) possible liability caps;
    (c) machinery for resolution of any question of whether a benefit has so transferred by a court or employment tribunal (consultation and costs); and
    (d) assurances that the purchaser will act reasonably in limiting the provision of any consents having the effect of bringing home such liabilities.

33. Therefore, the useful route to deal with the uncertainty is through an indemnity. However, this is necessarily a pragmatic rather than a comprehensive solution, because it leaves open the question of what *Beckmann* rights the transferring employees have.

<u>The road to *Procter & Gamble*</u>

34. The limits of the *Beckmann* Indemnity solution raise the possibility of a different way of dealing with the problem, which is adjusting the price in the way in *Procter & Gamble*:
    (1) The more uncertain the purchaser's exposure, the more significant the Beckmann Indemnity, and specifically the more significant the quality of the covenant underpinning it.
    (2) The more likely the Beckmann Indemnity is to be called, the less satisfactory it is liable to be.
    (3) Correspondingly, the greater the incentive in such a case for the purchaser to secure an upfront payment
    (4) The seller may not be un-amenable to such an approach.

<u>*Procter & Gamble*- introduction and outline of facts</u>

35. P&G (seller) and SCA (purchaser) used a price adjustment clause to cover all the transferred benefits – there was deliberately no *Beckmann* Indemnity. SCA sought a reduction of the purchase price payable by it in respect of prospective benefits that it might be obliged to provide in practice.

36. Therefore strictly the issue that arises in *Procter* is one of interpretation of the contract rather than of TUPE. However, the Court proceeded on the basis that the interpretation of the contract would be materially identical to the relevant parts of TUPE.

37. The practical effect of the decision, as we shall see, is to limit the seller's exposure under *Beckmann* indemnities past and future.

38. The relevant scheme rules of the P&G scheme were as follows:
    (1) NRD 65 – final salary scheme (state pension offset);
    (2) Early retirement pension ("ERP") with employer consent 55-65
        i. 4% p.a. 55-60 early retirement factor ("ERF") if 15+ years service (maximum 20%);

ii. larger ERF 55-65 if <15 years service (maximum 60%);

iii. bridging pension to 65.

(3) Early deferred pension ("EDP") with employer consent 55-60,

i. 4% p.a. 55-60 ERF if 15+ years service (maximum 20%);

ii. larger ERF 55-65 if <15 years service (maximum 60%);

iii. no bridging pension.

39. Therefore, the substance of the benefits were as follows:

(1) ERP with employer consent ceases – members become deferreds on TUPE transfer out.

(2) Deferred pension – continues to be provided under P&G Scheme – if taken ('employer' consent to taking early 55-60) then with statutory revaluation

i. no final salary link;, and

ii. no bridging pension.

40. The route map through the Judge's reasoning is that

i. P&G Scheme provided early retirement benefits i.e. benefits that are not "old age benefits" (para 7), which throws up the question of whether such benefits transfer under TUPE;

ii. The early retirement benefits can be regarded as a standard pension plus two "Enhancements"(para 97);

iii. Therefore, the question was whether the whole early retirement benefits pass to SCA or just the Enhancements (to the early retirement benefits) (para 89);

iv. Early retirement benefits and deferred pensions ("DPs") are mutually exclusive (paras 97 & 104) - there is no question of the DPs transferring, only the early retirement benefits.

41. Given this way of proceeding, it becomes important to understand what the "Enhancements" were. There were two enhancements raised by the parties and recognized by the Court:

(a) Preferential ERFs if continuing to 15+ years service

(b) Bridging pension on early retirement from active SCA service.

42. However:

(c) It was not recognized that there was a further, third, Enhancement, namely the final salary link on accrued service at the date of transfer insofar as that exceeded statutory revaluation.

(d) It is also important to recognise that in other cases if EDPs will suffer more substantial ERFs than ERPs, that would be a further "Enhancement" on the logic of P&G.

<u>The decision</u>

43. The decision in P&G is that:

(1) Only the Enhancements transfer.

(2) The DP remains where it is under the transferor scheme and

(3) the DP under the transferor scheme discharges the obligation of SCA to provide the "standard pension" component of the ERP (para 104).

(4) The Enhancements only transfer insofar as they are payable up to 65- this part of the Enhancements is a non-old age benefit but the part payable from 65 is an old-age benefit like a normal retirement pension.

44. Critically, findings (1)-(3) were heavily influenced by a desire to avoid the possibility of double recovery by a transferring member, whereby such a member is able to receive both his DP from the transferor scheme and an ERP from the transferee scheme.

<u>The pragmatism of P&G</u>

45. The solution in P&G is undoubtedly pragmatic and elegant:

(1) It takes into account the English law fact that employees have inalienable rights enforceable against trustees (not their employer) under their transferor scheme, by treating the DPs and EDPs as remaining where they were.

(2) It treats the seller's retained obligations as if provision made by purchaser.

(3) It avoids double recovery issues, by allowing the EDP to count towards the ERB.

(4) Treating the non-old age benefit as stopping at NRD avoids oddities that a pension from 64 is a non-old age benefit whereas pension from 65 is old age benefit. It therefore may be said to respect the logic of the old age benefit carve-out: benefits that you receive after NRD do not pass.

The curiosities of P&G

46. However, the more one pokes beneath the surface, the more curious the points that emerge.

47. The starting point is that pension scheme benefits are just employee pay rights that happen to have been provided through a trust, and TUPE mandates that the employee's rights transfer across to the purchaser insofar as they are not old age benefits. However, P&G proceeds on the basis that the employee's rights (namely the DP and EDP) are satisfied by there being retained with the seller's pension scheme. The odd net result of this is that what passed across to SCA under TUPE were emasculated obligations in respect of pension benefits.

48. Further, when one adds these transferred obligations to the rights under the P&G Scheme, one is left with very strange results:
   (a) If SCA consents to early retirement, how can SCA's consent to an employee taking an ERP between 55 and 60 generate a right to the payment of an EDP under the P&G Scheme, which depends on P&G consent? SCA is not an "employer" under the P&G Scheme. One possible answer to this is that P&G's right to decide whether to consent transfers under TUPE to SCA, so that SCA can decide whether to exercise it, but this would be a very odd answer, involving as it does SCA being able to exercise rights under the P&G Scheme.
   (b) Even if one ignores this, such benefit would be provided as follows:
      i. pre-65: gets EDP with ungenerous ERFs under P&G scheme and from the SCA scheme gets difference between ungenerous and generous ERFs;
      ii. when member attains 65: just gets the EDP with *ungenerous* ERFs from the P&G Scheme;
      iii. and that benefit would not have the benefit of final salary linkage as regards P&G service.

Possible criticisms of P&G

49. These curiosities lead one to ask the following questions of P&G:
   (1) Why should an old age benefit (DP payable at 65) discharge liability for a non-old age benefit (ERP payable from say 55)? Does it?
   (2) And if the reference to a DP encompassed an EDP payable before 65, why was this EDP element an old-age benefit that stayed behind in the P&G Scheme? Should it have?

(3) Similarly, as regards the missed "Enhancement" - what about salary increases after the transfer - doesn't this differentiate a DP from the ERP (so that the former doesn't to that extent discharge the latter)?

(4) More broadly, why doesn't the whole non-old age benefit transfer (including the EDP), rather than just the so-called enhancements? Why should the transferor scheme continue to meet this non-old age benefit?

(5) Is this "discharging / satisfying" really what TUPE intends and how does this work in an ordinary *Beckmann* case where there are no "enhancements"?

(6) What happens if the transferor scheme can't provide the EDP? And how does the purchaser deal with this? Does it need to fund or otherwise provide for (insure) these benefits in case it needs to pay them?

(7) A benefit that starts before NRD changing its nature for TUPE purposes at NRD does not seem to fit comfortably with the underlying principle of TUPE that the purchaser assumes responsibility in respect of employees who transfer.

(8) How can transferee schemes discharge the odd benefits that Procter & Gamble can produce, which only last up to NRD?

<u>A simple alternative?- transferring *more* of the benefit across</u>

50. The complexities that the middle-ground solution of allowing the Enhancements to transfer across up to 65 can be addressed in one of two ways. The first alternative is that *more* of the benefits should transfer across.

51. One of the puzzles of P&G is why the entitlement to an EDP does not pass across. If what marks out a non-old age benefit is the benefit being triggered before NRD, then why doesn't an EDP fall into this category and simply transfer across?

52. Transferring the EDP takes care of the double-recovery point that troubled the Judge and led him to find that one franks the EDP against the ERP so that only the Enhancements passed. His concern was the risk of the member getting both the EDP (from the transferor scheme) and the ERP (from the transferee scheme), but transferring across the ERP deals with this because both benefits are housed in one scheme, the receiving scheme, and so the member only receives one of them.

53. On a purer variant of this approach, the purchaser is obliged to provide the benefit up to and past NRD – such benefit being a fraction of an old age benefit otherwise payable at NRD if it had been taken as such. In this way, the uneven pension before and after NRD issue (para 0(b)) falls away.

54. However, despite its attractions, this solution has problems of its own. They stem from the fact that while this alternative solution transfers more of the pension benefits across, it cannot transfer all of the benefits across because old age benefits must stay where they are in the transferor scheme. Therefore, one still ends up with a split of benefits between the two schemes.

55. This means:
    (1) You won't know in advance when a member will retire, so the transferor scheme will need to fund the old age benefit (e.g. NRP) and the transferee scheme will need to fund the non-old age benefit (e.g. ERP). (But this is an issue with P&G also).
    (2) Which scheme ends up paying for the benefit depends, where the benefit depends on employer consent, on unilateral act of the purchaser. (Not clear whether this is an issue with P& G also).
    (3) On what basis does the transfer of early retirement obligations to a transferee scheme discharge the transferor scheme from the obligation to provide an *ordinary* DP at 65?
    (4) What happens if the transferor scheme goes into the PPF before a member takes his pension under the transferee scheme? How does one stop the member getting his pension twice over? Similar issues arise where the transferor scheme buys out. (Issue under P&G also).

What would Europe make of it?

56. There are four reasons for thinking that the European Courts might prefer a simpler solution to that provided by P&G:
    (1) The concern over potentially inalienable nature of benefits under a trust that underlies P&G is an English law concern, not a Europe-wide one.
    (2) The domestic structure of using a trust is a means simply of delivering an employment benefit: see e.g. Barber v GRE (1990). If the seller has conferred such a benefit on its employees that endures after they cease to be employed by it, that is no reason why the purchaser should be absolved from providing such a benefit under the Directive.

(3) The public policy underpin here is that the employee's new employer should be responsible for the employee's pay (including vested rights to pay) from the undertaking.
(4) P&G is a complex solution for the reasons explained above and the CJEU likes direct and simple solutions.

<u>A second alternative solution: transfer *fewer* benefits across</u>

57. If one is looking for a simpler solution, the other alternative is to go to the other end of the spectrum from the first alternative and transfer *fewer* benefits across than P&G did rather than more.

58. Going back to the original debate over the form of the 1977 directive with which we started this paper, one might be able to understand the reluctance to allow lump sum redundancy benefits payable before NRD to remain with the transferor simply because they are routed through a pension scheme when they would otherwise transfer across.

59. However, it is a further step to hold that benefits that are paid periodically until death are not old age benefits, when they look very much like a normal retirement pension taken early, and the vast majority of the benefit may be paid after NRD just like a normal retirement pension. This is not a step that the law need take here. Therefore, ERPs (and EDPs) need not transfer across.

60. This solution has the following benefits:
(1) It avoids many of the problems mentioned earlier about the transferor scheme remaining responsible to pay certain periodic pensions (e.g. NRPs) and transferee schemes being responsible to pay other periodic pensions (e.g. ERPs).
(2) Further, as it was conceded in P&G that an ERP was not an old-age benefit, the point was not determined (para 137) and the Judge's comments at para 150 lend some support to this alternative.
(3) Both <u>Beckmann</u> and <u>Martin</u> were bridging pension cases (see e.g. AG reasoning in <u>Beckmann</u> at para 79), so they can be reconciled with this approach.
(4) And underlying all of above is the proposition that the ARD (and original TUPE) just provided for a simple pensions carve out from the transfer provisions, whether for the

reasons set out by the Commission in Beckmann at paras 22-23 or otherwise, with the ARD instead giving alternative protection for ex-employee's pension rights.

61. However, this solution is not perfect. Unless one takes the purist view canvassed at the start of this paper that the 1977 ARD just provided for a simple pensions carve out for *all* rights under occupational pension schemes, then one is still left with a situation where some pension rights, such as redundancy rights, do transfer across and therefore there is a split of rights between the two schemes, with the problems to which that gives rise, albeit to a lesser extent than under the P&G solution. This problem could be contained further if one was prepared to regard *periodic* redundancy pensions that *continue past NRD* as old age benefits, so that only lump sum benefits or bridging pensions transferred.

62. It also requires at the very least the reconsideration /or tempering of the desire in *Beckmann* and *Martin* to construe the pensions exclusion narrowly, and while there has been some recent indication of the European Court construing the ARD in a more balanced way, this will not be an easy sell.

Conclusion

63. Absent radical recasting of art.3 ARD to transfer *all* pension rights across, the only pure solution to the problem is the one that was floating around at the inception of the ARD, namely to exclude pension scheme rights from transfer.

64. While the UK draftsmen of the original TUPE appears to have thought that this is what the ARD did, that ship sailed long ago in the early 1990s when TUPE was changed under pressure from the Commission to narrow the UK domestic legislation carve-out, and Beckmann merely put the nail in the coffin.

65. The next best solution would be to only allow lump sum (and possibly bridging pensions) to transfer, recognising that they are different from pensions that continue periodically past NRD.

66. Taking the step of allowing some periodic pensions that continue past NRD to transfer is what causes the problem, because one ends up with a split of similar periodic pensions between the two schemes. It may be that matters have gone too far to draw the line there and that English law has to live with that, but it is to be hoped that this is not the case and that the European

Court will canvass simpler solutions if and when the problems that P&G pragmatically grapples with come before it. The troubled delivery of the baby and the problems the resultant compromise that emerged have caused should not be allowed to hinder the adult life of the ARD.

War and Peace: The story of pensions liberation

Emily Campbell and Emer Murphy

Introduction: Policy for favourable treatment of pensions

1. Traditionally, pensions have enjoyed the possibility of numerous tax advantages. The justification is said to be that it is for the benefit of society that people save for their retirement. In the first instance, it is assumed that there is likely to be an additional cost to society when those who are of state pension age have no private pension. Further, it is self-evident that a society where fewer older people live in or close to poverty is a better society. And it must not be forgotten that it is good for the economy that as wide a range of adults as possible are spending money.

2. Of course, entitlement to working age benefits ceases upon state pension age. However, for those of state pension age on a low income, the state may provide means-tested support in the form of pension credit, housing benefit and council tax reduction. And it must be remembered that many charities provide financial support to the elderly.

3. The introduction of auto-enrolment sits comfortably with the policy of encouraging pensions saving, as does the aggressive "Scorpion" campaign to counter pensions liberation and the increase in the minimum pension age from 50 to 55. Indeed, it was reported today on Perspective that (according to Aviva) 48% of advisers believe that the government's top financial priority should be encouraging people to save more into their pension.

4. However, in recent years, a contradictory policy has emerged of making pensions saving less attractive in tax terms and making the retention of accrued pension rights less necessary. You will all be aware I am sure of the new pension freedoms introduced with effect from 6 April 2015 by the Taxation of Pensions Act 2014. It is a central theme of this talk to look at how these two competing policies sit together and to make some predictions as to the likely outcome in the longer term.

5. In April 2015, the Pensions Policy Institute published a report entitled "*Transitions to Retirement – how might the UK pensions landscape evolve to support more flexible retirements?*" This report drew comparisons with four countries, Australia, Ireland, New

Zealand and the United States. The report concluded that, compared to Australia in particular, the UK appeared to be moving in the opposite direction in terms of the evolution of the regulatory landscape. The report states:-

> "Prior to April 2015, the decumulation phase was strictly regulated relative to the US and Australia, with the majority of DC savers effectively required to purchase an annuity. However, the absence of minimum withdrawals and rules around governance of and defaults during the decumulation phase from April 2015 means that the position has reversed so that the decumulation phase is regulated to a lesser extent than in both Australia and the US. Similarly, in the UK, the decumulation phase is moving in the opposite direction to the accumulation phase, which has become more regulated due to the introduction of automatic enrolment".

6. In other words, just as the use of pension assets is becoming less regulated, by reason of auto-enrolment the making of pension savings is becoming more regulated.

7. How can we make sense of policies which pull in different directions? The gradual reduction in the lifetime and annual allowances may be said to be principally concerned with the taxation of higher earners. As such, it is unlikely to have anything to do with a policy of avoiding poverty in old age, although it has to be said that the current level of lifetime allowance may hit middle-earners such as nurses and policemen.

8. But what of the new pensions flexibilities which came into force on 6 April this year? It is very hard to square these with auto-enrolment. Someone suggested to me the other day that pension flexibility would have the effect of a short term cash injection for the government, and the cynic in me did start to wonder. Also, certain policies appeal to certain types of voter – particularly in the run up to a general election.

9. Pensions savings in a registered pension scheme are held in the environment of a type of tax wrapper. In a broad sense, liberation is the removal of the savings from that wrapper during the lifetime of the member other than by means of the payment of a pension. In the past, almost all liberation has been "bad" liberation. An obvious exception is the pension commencement lump sum. But, as from 6 April this year, a date which has been labelled "Pension Freedoms Day", there is an extensive new possibility of "good" liberation and it is known by the euphemism "pensions flexibility"!

Rise of pensions flexibility

10. In this next section, I am going to look at the rise in pensions flexibility generally.

Position prior to 2010 General Election

11. Looking back historically, the groundwork was laid for the concept of a pension as a "pot" to which the member was entitled by the rise of contributory pension schemes and the introduction of preservation legislation, so that the receipt of an occupational pension was no longer dependent on the continuation until retirement of service with the sponsoring employer.

12. The first important step towards pensions flexibility was, of course, the introduction of the statutory right to a cash equivalent with effect from January 1986 by the Social Security Act 1985. This step, together with the introduction of personal pension schemes with effect from July 1988 so as to replace retirement annuity contracts, gave rise to the possibility of the removal of assets from occupational pension schemes into an environment in which the member had a measure of control over investment policy. Unfortunately, this step was not accompanied by sufficiently tight controls on those providing financial services, and this led to the huge scandal of pensions mis-selling, which Emer will be talking about shortly.

Requirement for annuity purchase

13. Now, it is not possible to look further at the question of pensions flexibility without considering the so-called requirement to purchase an annuity by the age of 75, which applied to schemes which were not permitted to or which could not in practice provide a scheme pension, i.e. personal pension schemes and some occupational money purchase schemes (in particular small self-administered schemes).

14. It is useful to consider the question, "where is the source of the requirement to buy an annuity from an insurance company by the age of 75"? The notion of annuitisation by the age of 75 can be traced back to the retirement annuity contract legislation: The Finance Act 1956[36] required the annuity to commence between the ages of 60 and 70 and the Finance Act 1976

[36] Section 22(2)(b).

raised the age of 70 to the age of 75[37]. But in the context of occupational and personal pension schemes, the requirement as a positive injunction to purchase an annuity was not as explicit a part of IR12/76, and latterly Finance Act 2004 as introduced from A-day, as one might have thought[38].

15. It is probably truer to say that, with the introduction of income drawdown in 1995, the ability to receive an income from a scheme other than by means of a permitted permanent arrangement, most notably the purchase of an annuity and the securing of a scheme pension, ceased at the age of 75. Following that, in practice a member would often be required to purchase an annuity if he or she wished to continue to receive an income. Further, failure to receive an income would lead to the funds being trapped within the pensions wrapper, with limited opportunities to extract them on death by means of a lump sum without incurring penal tax charges. In any event, the rules of most schemes were not sufficiently flexible to permit the acquisition of an annuity by the age of 75 to be avoided.

16. The position whereby income drawdown would not be permitted after the age of 75 survived A-day in 2006[39]. However, by this stage this inflexibility had already become deeply unpopular with savers. One reason was poor annuity rates. Perhaps an even more important reason politically was the fact that the purchase of an annuity excluded the possibility of the use of a pension fund as a vehicle for passing on assets to children.

Coalition Government reforms

17. Following the General Election in 2010 and the associated change of government, the upper age limit for income drawdown was raised from 75 to 77[40]. As has subsequently transpired, this measure was only a temporary sticking plaster in the context of a much more ambitious project.

18. The Finance Act 2011 permitted members to continue in drawdown after the age of 77 - and indeed indefinitely[41]. It also introduced a new form of income drawdown, namely flexible drawdown to supplement the existing capped drawdown facility, whereby (provided the

[37] Section 30.
[38] For an example of a reference to a positive requirement, see IR12 (2001), Appendix XII, paragraph A12.109: "*The purchase of an annuity … cannot be delayed beyond the Member's 75th birthday*".
[39] Finance Act 2004, Schedule 28, paragraph 7 (as originally enacted).
[40] Finance (No 2) Act 2010, Schedule 3, paragraph 3.
[41] See in particular the amendments made to the Finance Act 2004, Schedule 28, paragraph 7 by the Finance Act 2011.

member had a guaranteed income of £20k pa) there was no limit on the amount which the member could receive by way of an instalment of pension. Indeed, HMRC accepted that the entire fund could be withdrawn under flexible drawdown, which is perhaps surprising because it looks very much like a lump sum rather than a pension instalment.

19. Therefore, it would be accurate to say that such requirement as there might have been previously to purchase an annuity by the age of 75 was abolished by the Finance Act 2011. One would, however, have been forgiven for thinking that the requirement was abolished more recently. There was widespread confusion in the national media, including I notice in the Times leader article only last Thursday, which included the sentence: "*Under the previous arrangements, savers were forced to buy an annuity from an insurer*". This confusion was no doubt fuelled by the Chancellor of the Exchequer George Osborne's own statement in his Budget speech on 19 March last year: "*Let me be clear: no one will have to buy an annuity*". The full text of the relevant part of the Budget speech is as follows:-

> *"We've introduced flexibilities.*
> *But most people still have little option but to take out an annuity, even though annuity rates have fallen by a half over the last 15 years.*
> *The tax rules around these pensions are a manifestation of a patronising view that pensioners can't be trusted with their own pension pots.*
> *I reject that.*
> *People who have worked hard and saved hard all their lives, and done the right thing, should be trusted with their own finances.*
> *And that's precisely what we will now do. Trust the people.*
> *Some changes will take effect from next week.*
> *We will:*
> - *cut the income requirement for flexible drawdown from £20,000 to £12,000*
> - *raise the capped drawdown limit from 120% to 150%*
> - *increase the size of the lump sum small pot five-fold to £10,000*
> - *and almost double the total pension savings you can take as a lump sum to £30,000*
>
> *All of these changes will come into effect on 27 March.*
> *These measures alone would amount to a radical change.*
> *But they are only a step in the fundamental reform of the taxation of defined contribution pensions I want to see.*
> *I am announcing today that we will legislate to remove all remaining tax restrictions on how pensioners have access to their pension pots.*
> *Pensioners will have complete freedom to draw down as much or as little of their pension pot as they want, anytime they want.*
> *No caps. No drawdown limits.*

Let me be clear. No one will have to buy an annuity.
And we're going to introduce a new guarantee, enforced by law, that everyone who retires on these defined contribution pensions will be offered free, impartial, face-to-face advice on how to get the most from the choices they will now have.
Those who still want the certainty of an annuity, as many will, will be able to shop around for the best deal.
I am providing £20 million over the next two years to work with consumer groups and industry to develop this new right to advice.
When it comes to tax charges, it will still be possible to take a quarter of your pension pot tax free on retirement, as today.
But instead of the punitive 55% tax that exists now if you try to take the rest, anything else you take out of your pension will simply be taxed at normal marginal tax rates – as with any other income. So not a 55% tax but a 20% tax for most pensioners.
The OBR confirm that in the next fifteen years, as some people use these new freedoms to draw down their pensions, this tax cut will lead to an increase in tax receipts.
These major changes to the tax regime require a separate Act of Parliament – and we will have them in place for April next year.
Mr Deputy Speaker, what I am proposing is the most far-reaching reform to the taxation of pensions since the regime was introduced in 1921."

20. Now, I found the premise of this statement surprising. It is unclear why – given the portability of pensions and the terms of the Finance Act 2011 already described – there was anyone who had "*little option but to take out an annuity*".

21. Turning the clock back again for a moment, the seeds of the Coalition government's reforms, were sown by the Finance Act 2004 itself with effect from A day in the form of alternatively secured pensions. Subject to strict requirements, this allowed the requirement for the purchase of an annuity by the age of 75 to be circumvented. Some of you will recall that all this was thanks to campaigning by a small religious group known as the Plymouth Brethren, who believe that it is wrong to bet on the date of your death as that is a decision for God alone. The New Labour government appears to have been wrong-footed by the scope of this reform, which attracted wide-ranging interest. By 4 July 2006, Ed Balls (then economic secretary to the Treasury) explained in the House of Commons[42]:-

"*It was always our intention that the rules would apply in the specific and narrow case of individuals with such principled religious objections, such as the Christian Brethren. It has always been our intention to replicate the lifelong income*

[42] Hansard, 4 July 2006, Columns 728-729.

obtainable from an annuity through those measures, but not to allow that to become a way in which a small and wealthy minority could benefit from tax advantages to taxpayers overall. We have always made it clear that we shall not allow those concessions to be taken up more broadly to get round the annuity rules. This is not a mainstream product, and it must not become a tax avoidance measure. We shall not be going down that road."

22. You can see from this passage how the political battle-lines were being drawn!

Budget 2014

23. Turning back to the Budget speech of 19 March 2014, two distinct phases of reform were announced. The reforms which were announced with almost immediate effect (i.e. taking effect from 27 March 2014) may be summarised as follows:-

    23.1. An increase in the amount which could be taken as a lump sum trivial commutation of <u>the whole</u> of a person's pension rights from £18k to £30k;

    23.2. An increase in the small pension pots lump sum exemption from £2k to £10k, and an increase in the number of small pots which can be taken irrespective of total pension wealth from two to three;

    23.3. A reduction of the guaranteed income needed in retirement to access flexible drawdown from £20k per year to £12k per year; and

    23.4. An increase in the maximum amount which could be taken out each year from a capped drawdown arrangement from 120% to 150% of an equivalent annuity.

24. However, alongside the Budget, the government published a consultation paper on the proposal that, from April 2015, from the age of 55 and whatever the size of a person's defined contribution pension pot, he or she would be able to take it how they wanted, subject to their marginal rate of income tax in that year.

25. In the context of the Budget, it was said[43] that the changes coming into effect on 27 March 2014 would mean around 400,000 more people would have the option to access their savings more flexibly in the financial year 2014-15; and that from April 2015, the 320,000 people who would retire each year with defined contribution pensions would have complete choice over how they access their pension.

26. The consultation paper was entitled "*Freedom and choice in pensions*". The government's response was published on 21 July 2014. At this time, the Chancellor of the Exchequer explained that "*This Government believes that individuals should be trusted to make their own decisions with their pension savings.*" No doubt mindful of the risk of another pensions mis-selling scandal, he confirmed: "*The right to free and impartial guidance I announced at the Budget will empower savers and ensure that they are clear on their retirement income options before they make any decisions about what to do with their savings*". The advisory body which in the event was created is known as "Pensions Wise".

27. Many of you will advise primarily in the context of occupational pension schemes. The Chancellor has rejected any moves to prevent altogether transfers from defined benefit occupational pension schemes by members who wish to take advantage of the new flexibilities. He promised, however, that there would be a statutory requirement[44] for independent advice from a person authorised by the FCA in relation to any individual considering transferring out of a defined benefit scheme.

28. The tax reforms which came into force on 6 April 2015 are now found on the statute book in the form of the Taxation of Pensions Act 2014, which makes numerous amendments to the Finance Act 2004.

29. In due course I will return to the tricky question of who it was that the government intended to benefit from the April 2015 formulation of the rules, but who were unable to benefit from the March 2014 formulation.

30. Now, however, I am going to hand over to Emer, who is going to look at some of the bad things which have happened in the past so that we can assess what the likely risks are for clients going forward.

[43] HM Treasury document: Budget 2014: greater choice in pensions explained.
[44] See Pension Schemes Act 2015, section 48.

Mis-selling

History

31. Having gone through the history of pensions flexibility, I am going to look at some of the negative consequences of these changes, in particular mis-selling and liberation.

32. As Emily touched upon earlier, legislation in the 1980s passed by the Thatcher Government permitted people for the first time to save for retirement themselves in personal pensions, instead of joining either an occupational scheme or the government scheme.

33. A House of Commons Research Paper 99/68 commented that personal pensions were:

> *"designed to be particularly suitable for the self-employed and those who moved jobs frequently, thus reflecting the Conservative Government's policy of encouraging mobility of labour"*[45]

34. Between 1988 and 1994, more than five million personal pensions were sold.

35. By this time, it had become clear that many people had bought a personal pension when this was likely to have been to their disadvantage. Employers did not contribute to personal schemes, and in the early 1990s many occupational schemes were still final salary schemes, whereas the size of a personal pension is dependent on the growth of the relevant investments.

36. So why did so many people opt out of their employer's scheme and buy a personal pension when this would leave them worse off? There were a whole host of reasons:

    36.1. Failure to educate. Personal pensions were trumpeted by the Thatcher government. There were advertisements run by the then Department of Social Security telling people they could "*break the chains*" of their occupational pension scheme[46].

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[45] http://researchbriefings.parliament.uk/ResearchBriefing/Summary/RP99-68#fullreport (accessed 14 June 2015)

[46] *"How the Thatcher governments changed occupational pensions in the 1980s"*, Jonathan Stapleton, Professional Pensions, http://www.professionalpensions.com/professional-pensions/feature/2261768/how-thatchers-governments-changed-pensions 16 April 2013 (accessed 14 June 2015)

However, there was a real failure to communicate that personal pensions were only suitable for certain categories of people, for example the self-employed[47].

36.2. Commission. Those advising people on their pensions were frequently on commission and thus gave personal pensions the 'hard sell', usually in breach of the relevant professional rules in force at the time. Investment firms employed tactics such as requiring their sales force to reach certain targets in order to even qualify for their own salary[48]. Ultimately though, as Lord Hoffman put it in *Lloyds TSB General Insurance Holdings v Lloyds Bank Group Insurance Co Ltd* [2003] UKHL 48:

> *"The underlying reasons for mis-selling were partly the method by which salesmen were paid but largely the inadequacy of the training and monitoring of their performance provided by the companies employing them."*[49]

36.3. Ineffective regulation. In a Treasury Committee report on mis-selling, the Committee commented that the regulatory system failed to prevent, or deal more swiftly with, mis-selling *"because firms simply did not abide by the regulatory rules*"[50], and the then regulators simply did not catch this non-compliance.

Response – claims against advisers

37. One perhaps predictable response to the pensions mis-selling scandal was a wave of claims against investment advisers for breach of statutory duty under section 62 of the Financial Services Act 1986. This section gave a direct right of action to persons who suffered loss as a result of contravention of the rules and regulations then governing investment business[51].

38. There are not lots of reported cases – in all likelihood because they settled – but one example is *Walker v Scottish Equitable* [2007] EWHC 1858 (Ch); [2007] Pens. L.R. 347. A Scottish

[47] See the Ninth Report of the Select Committee on the Treasury, 12 November 1998 at [42], http://www.publications.parliament.uk/pa/cm199798/cmselect/cmtreasy/712/71203.htm (accessed 14 June 2015)
[48] See House of Commons Research Paper 99/68 at p. 11 http://researchbriefings.parliament.uk/ResearchBriefing/Summary/RP99-68#fullreport (accessed 14 June 2015)
[49] At [5]
[50] At [20] http://www.publications.parliament.uk/pa/cm199798/cmselect/cmtreasy/712/71203.htm (accessed 14 June 2016)
[51] S. 62A Financial Services Act 1986 (in force 15 March 1990) restricted s. 62 to claims by "private investors" save in specified circumstances.

Equitable broker was found to have breached his professional rules by recommending a personal pension to Mr Walker. As a representative of a product provider the broker should not have given advice at all: it breached the so-called ‘principle of polarisation’ then in force. Mr Walker was found to have relied upon the broker’s advice in addition to that of his independent financial adviser (who had subsequently gone into administration). Scottish Equitable plc had to pay out over £700,000 in compensation.

Response – Pensions Review

39. Another related response to the pensions mis-selling scandal was a pensions review which was set up by the then regulators (the Securities and Investment Board (“SIB”), later the Financial Services Authority (“FSA”), and the Personal Investment Authority). The review was set up to pro-actively identify cases where the wrong advice had been given and to provide compensation to restore the investor to the financial position that he or she would have been in but for the bad advice. In practical terms this usually involved topping up the personal pension, using financial assumptions laid down by regulators.

40. During the course of the review the incidence of and cost of compensation rose dramatically, because:

40.1. The outlook for long term investment returns fell; and

40.2. Annuity rates fell[52].

41. The estimates are that around £11.8bn in compensation was paid out.

42. Even with that eye-watering level of compensation, it is still likely that people who were persuaded to opt out or leave their occupational pension scheme during the pension mis-selling scandal were left worse off. There is a thread on a forum on the Money Saving Expert website where one gentleman explains what happened to him: his company made an appointment for him to see Sedgewick on company premises and they persuaded him to transfer his pension. As part of the Pensions Review, Sedgewick eventually paid compensation using the assumptions laid down by the regulators. However, 16 years later:

[52] Ibid at [13]

> *"my final salary pension would have paid me £23,000 annually and the pension I transferred to is going to pay me £6,900 annually....One thing a (sympathetic) lady said at the Ombudsman office was that "there are several thousand others in the same position"*[53]

Financial Services and Markets Act 2000

43. The pensions mis-selling scandal was one of the major precursors to the Financial Services and Markets Act 2000.

44. The big change introduced by FSMA was its scope. The Financial Services Act 1986 covered investment business. FSMA extended this to all financial services, including eventually banking and general insurance business.

45. From a pensions perspective, the establishment, operation and winding up of stakeholder and personal pension schemes must now be carried out by a person either authorised or exempt under FMSA, who holds the relevant permission. Therefore, not just investment advisers, but the very operators of personal pension plans came to be regulated under the FSA (now the FCA).

46. The other big changed implemented by FSMA was statutory regulation, as opposed to self-regulation. Self-regulatory organisations were abolished by FSMA and the role taken up by the FSA (as it was). This was a fulfilment of the Labour Party's 1997 Business Manifesto, which stated:

> *"as the guardians of other people's money, there needs to be effective supervision and regulation of the industry"*.

Fee and commission structures

47. A final sea-change that has occurred following the mis-selling scandal is a complete overhaul of the way in which financial advisers can charge consumers for financial advice.

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[53] http://forums.moneysavingexpert.com/showthread.php?t=4405667 (accessed 14 June 2015)

48. The so-called "commission bias" was one of the reasons why the FSA carried out a "retail distribution review" from June 2006, resulting in a swathe of new rules restricting the types of fees a financial adviser can charge for his advice. The end result is that the payment of commission for advised sales of retail investment products (including personal pensions) were banned in their various forms from 31 December 2012[54]. The idea is to encourage providers to compete on price and quality of products, and for advisers to pick the product most suited to the client without having their heads turned by the commissions payable.

New mis-selling scandals

49. The Treasury Committee report on mis-selling commented in 1998:

> *"A pension is often a person's biggest asset and this large-scale series of errors must not be allowed to happen again"*[55]

50. Since the pensions mis-selling scandal, the regulatory environment has been strengthened, the commission bias eliminated and the financial services industry forced to pay billions in compensation. With all these changes, is pension mis-selling a thing of the past?

51. Sadly not. Certain drivers of the mis-selling scandal remain constant, such as the desire of product providers and investment advisers to make a profit. Thus, some recent press articles have reported a so-called annuity mis-selling scandal[56]. Accounts have surfaced indicating that millions of pensioners who purchased an annuity have been short-changed because of failures by annuity providers. First, providers failed to ask relevant questions (such as those relating to ill-health) which could have enabled the pensioners to access higher annuity rates. Second, providers allegedly failed to advise existing customers of their option to buy an annuity on the open market[57].

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[54] FCA Conduct of Business Sourcebook, 6.1A

[55] http://www.publications.parliament.uk/pa/cm199798/cmselect/cmtreasy/712/71203.htm (accessed 14 June 2016), at [42]

[56] http://www.telegraph.co.uk/finance/personalfinance/pensions/11246773/Pension-mis-selling-scandal-hits-100000-retired-savers-a-year.html; http://www.telegraph.co.uk/finance/personalfinance/pensions/11471372/Mis-sold-annuities-savers-to-get-thousands-in-official-compensation-plan.html (accessed 17 June 2015).

[57] As a result, the FCA carried out a thematic review into the sale of annuities: http://www.fca.org.uk/news/fca-publishes-the-findings-of-its-work-into-annuities-sales-practices-and-retirement-income-market (accessed 23 June 2015)

52. Further, as the cost of defined benefit provision becomes a bigger and bigger burden on employers, the temptation to find ways of encouraging members to leave the employer scheme and transfer to a personal pension instead can be overwhelming. A Telegraph article in March 2012[58] warned of a potential £20bn pension mis-selling scandal, as adviser firms carried out large scale exercises for employers whereby members were given very generous transfer values and offered cash incentives to transfer out. The report comments that there was evidence of up to 55% of workers who received such advice transferring out.

53. As these examples demonstrate, the mis-selling of pension products is certainly not a historical relic, but rather a stark reminder of the potential for abuse in the pensions product market.

Pensions liberation

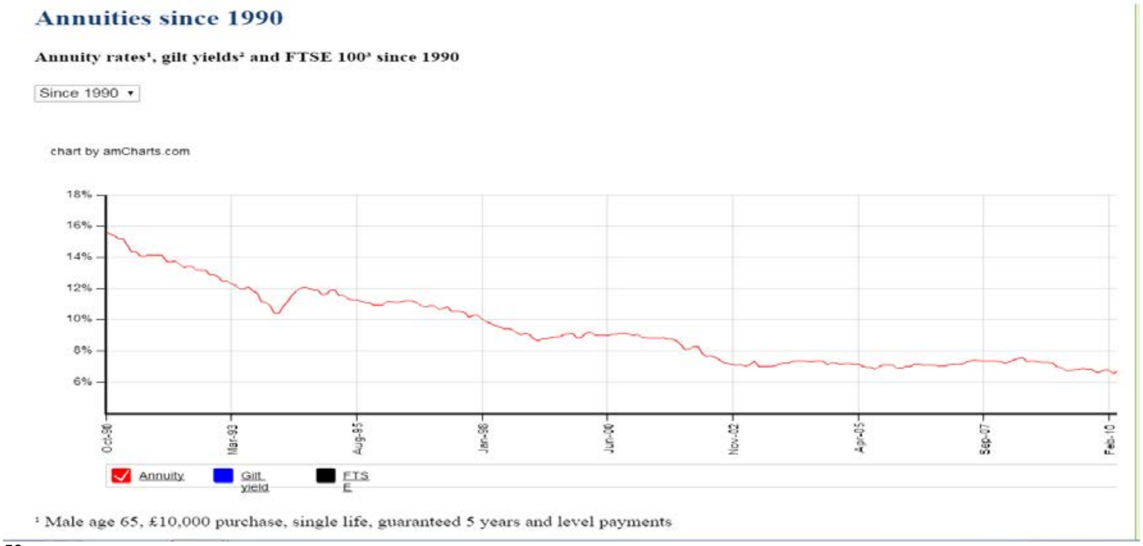
54. Pensions liberation is a hot topic at the moment, but it has been around in various guises for decades.

R v IRC ex p Roux [1997] PLR 123

55. Prior to the legislative changes in 2004, "pensions liberation" cases often concerned people trying to avoid the so-called 'annuity trap'. One example of this is given in the case of *R v IRC ex p Roux.*

56. In the 1990s, annuity rates fell dramatically.

[58] http://www.telegraph.co.uk/finance/personalfinance/pensions/9120476/A-20bn-pension-mis-selling-scandal.html (accessed 17 June 2015)



[59]

57. Mr Roux perceived the requirement to purchase an annuity to be unfair and a waste of money. However, if his pension money was otherwise applied, his scheme would lose its revenue approval and under s. 591C Income and Corporation Taxes Act 1988, a tax charge of 40% would apply to the value of assets of the scheme.

58. So Mr Roux with his advisers came up with an ingenious plan:

58.1. A new scheme would be set up. The Inland Revenue had indicated it would approve that new scheme.

58.2. Mr Roux requested a transfer out of the old scheme to the new scheme.

58.3. On the day of the transfer, the new scheme took steps to ensure that it would not become an approved scheme.

58.4. As there were no assets in the new scheme on the day before its cessation of approval, there were no assets to which the tax charge could apply.

59. The Inland Revenue sought to get around this by removing approval of the old scheme and the trustees sought judicial review of that decision.

60. The judicial review application failed. Mr Justice Tucker determined that:

[59] http://www.retirement-intel.co.uk/rates-charts/annuities-since-1990.aspx (accessed 19 June 2015)

60.1. The Revenue were entitled to look at the broad facts concerning the scheme and purpose for which it was to be used [8]. The Revenue was not limited to considering the genuineness of each individual step but could consider the scheme as a whole [20].

60.2. The Trustees of the old scheme knew the purpose was to transfer the funds to a non-approved scheme. Such transfer was not permitted without the loss of approval [19].

61. Thus, the old scheme lost its tax-approved status and was subject to a hefty 40% tax charge on its assets. Mr Roux lost substantially more than he would have done had he just purchased an annuity.

Brand New Carpet Company

62. Another type of early "pension liberation" case involved people, usually in financial dire straits, trying to access their pension pots as lump sums. The Brand New Carpet Company Scheme targeted people in Liverpool who had recently been made redundant[60]. People were promised access to their pension cash less a hefty 30% handling fee. A fake employer and a bogus scheme were set up, and managed to get tax approval and a contracting out certificate. Transfers duly took place and the members received around 70% of their pots as cash. However, once the scheme was discovered, the cash payments were subject to a hefty tax charge payable by the members under the Income and Corporation Tax Act 1988 Part XIV.

63. So it was double whammy for these vulnerable members – they lost 25-30% of their pension in 'fees', and then paid a substantial tax charge on the money they had 'liberated'. The press reports at the time indicated that as a result people were losing up to 70% of their pensions[61]. Also, and perhaps most significantly, they were left without any pension in later life.

64. The Brand New Carpet Company Scheme was eventually wound up by OPRA.

[60] http://www.telegraph.co.uk/finance/personalfinance/2762267/Opra-carpets-the-trust-busters.html
[61] http://www.mirror.co.uk/money/personal-finance/pension-rip-off-535822

Modern-day pensions liberation

65. That was in the early noughties. With the Finance Act 2004, out went the prescriptive system for the approval of pension schemes by HMRC and in came the regime of authorised and unauthorised payments.

66. The Pensions Act 2004 s. 18(2) provides that money is to be taken to have been "liberated" from a pensions scheme where:

> *"(b) the trustees or managers of the scheme transferred the amount out of the scheme on the basis that a third party ("the liberator") would secure that the amount was used in an authorised way,*
> *(c) the amount has not been used in an authorised way, and*
> *(d) the liberator has not secured, and is not likely to secure, that the amount will be used in an authorised way."*

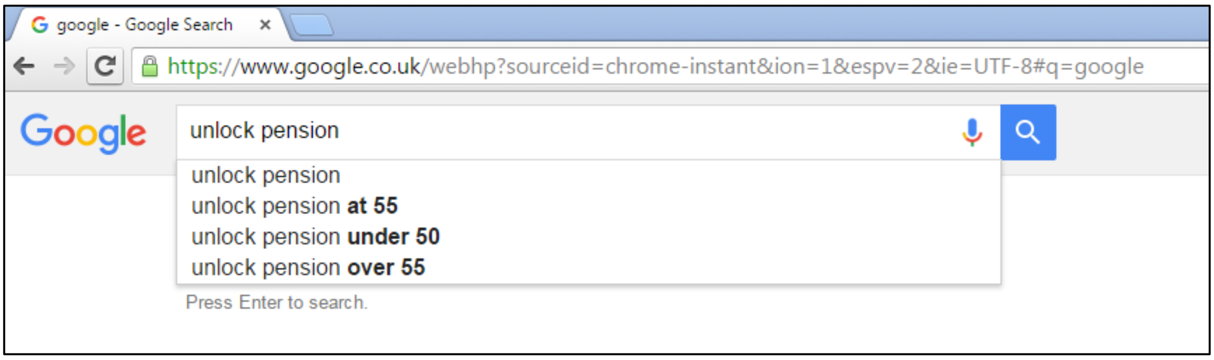
67. Liberation was defined in the 2004 Act partly to give the Pensions Regulator powers to freeze and repatriate liberated funds, but substantial concerns have been voiced as to (i) the restrictive scope of those powers; and (ii) the Regulator's willingness to use them[62].

68. This definition of liberation covers all unauthorised payments, but the main target for modern-day "pension liberators" are those under 55 seeking to "unlock" their pension. Payment of any pension benefit under the normal minimum retirement age (which is now 55), save in the circumstances of ill health, constitutes an unauthorised payment. Payments can attract a punishing 55% rate of tax[63], and a scheme sanction charge may also be applied[64].

[62] Sections 19- 21, Pensions Act 2004
[63] Finance Act 2004 ss. 165, 279, 208, 209, 210
[64] Ibid, ss.239-240

Extent of the problem

69. To give you an idea of just how serious this problem is, if you put 'unlock pension' into Google, the first suggested entry you get is 'under 55'.



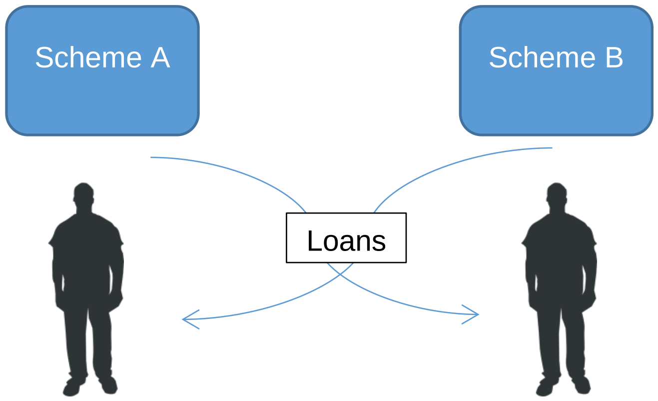
70. Lots of those in the audience will also have received the dodgy emails, texts and cold calls that pension liberators sent out in droves. In March 2013, the Information Commissioner's office recorded that in that month one in eight spam texts sent were thought to relate to pensions[65]. Amusingly, the previous Pensions Minister Steve Webb was himself bombarded with text messages pushing him to liberate his pension[66].

Examples of pension liberation schemes

71. Some pension liberation schemes, like the Brand New Carpet Company scheme, are simply scams. There is no attempt by the operators thereof to avoid members incurring tax penalties, and the operators frequently abscond with a large proportion of the funds. Some are more sophisticated, and their operators insist that their method of pensions liberation does not result in unauthorised payments. A number of these more sophisticated examples have been considered by the Courts.

72. In *Dalriada Trustees Limited v Faults & Ors* [2011] EWHC 3391, [2012] Pens. LR 15, Mr Justice Bean considered the Ark Pension Schemes, a series of schemes operating a 'Pensions Reciprocation Plan', whereby scheme A would loan funds to a member scheme B, and scheme B would loan the same amount to a member of scheme A.

[65] https://ico.org.uk/about-the-ico/news-and-events/news-and-blogs/2013/05/ico-helps-prompt-fraud-arrests-as-reports-of-pension-spam-texts-triple/ (accessed 18 June 2015)
[66] http://www.dailymail.co.uk/news/article-2276286/Steve-Webb-Pensions-Minister-reveals-target-cold-calling-pension-pot-raiders.html (accessed 19 June 2015)



73. The operators of the schemes maintained that the Pensions Reciprocation Plan allowed members access to their pension capital prior to retirement without breaching HMRC rules.

74. However, they lost that argument. Mr Justice Bean concluded that the payments were unauthorised payments under the Finance Act 2004. The Finance Act 2004 s. 173 provides:

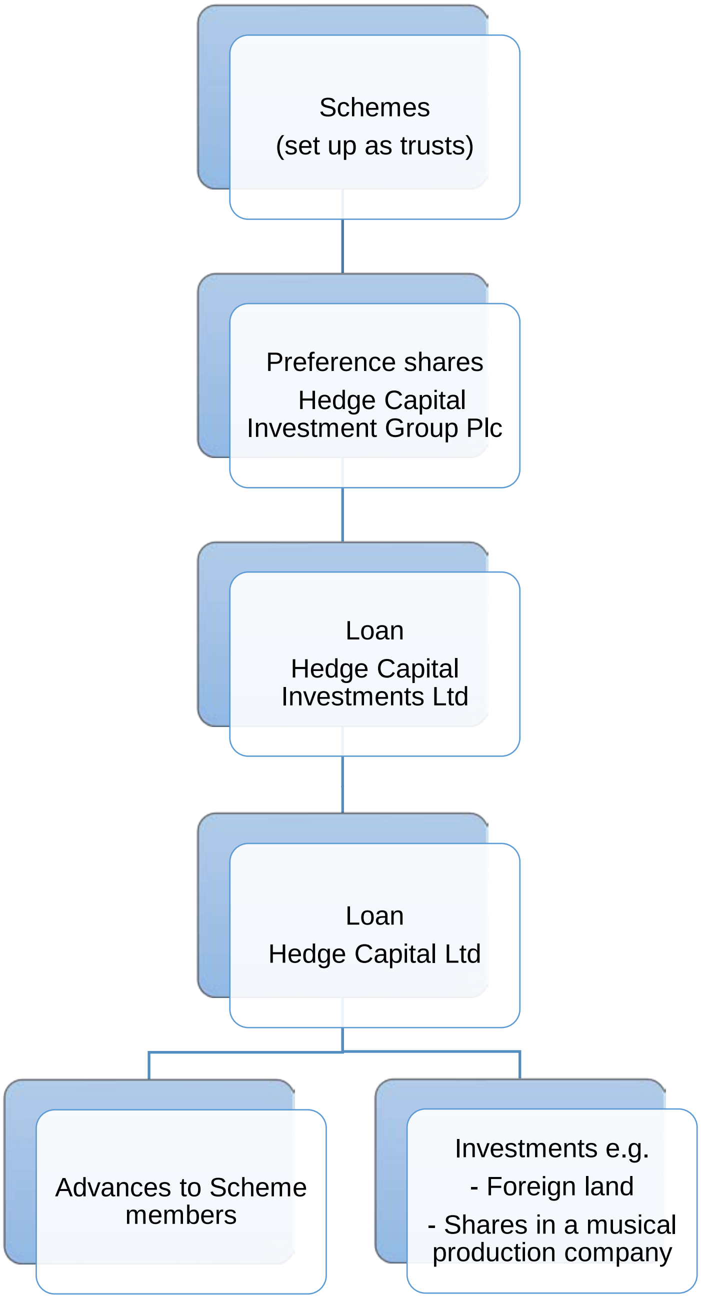
> *"A registered pension scheme is to be treated as having made an unauthorised payment to a person who is or has been a member of the pension scheme if an asset held for the purposes of the pension scheme is used to provide a benefit (other than a payment) to—*
>
> *(a) the person, or*
>
> *(b) a member of the person's family or household."*

75. In relation to scheme A, the loans to scheme B members were assets, and these loans were made to provide a benefit to the members of scheme A, i.e. the reciprocal payments[67]. The recipients of these loans were thus liable for the penal tax charges applicable to unauthorised payments. The judge also concluded that, had the loans not been unauthorised payments, they would have been (i) outside the scope of the trustees' investment powers (as they were not true investments, made with the purpose of obtaining a return) [58]-[64] and (ii) a fraud on the power of investment, as they were made for an ulterior purpose.

76. Another Dalriada pensions liberation case partly considered by the Courts, *Dalriada Trustees Limited v Woodward* [2012] EWHC 21626, will be covered in the written notes to follow this lecture series.

[67] See the Judgment at [46]-[49].

77. In this case, the operators set up two occupational schemes (the Pennines and the Mendip Retirement Benefit schemes) which invested their assets as follows:



78. Around £19m was transferred into the schemes from around 480 people.

79. Dalriada were appointed as independent trustees, and commenced legal proceedings against the former trustees seeking to restore the assets of the scheme, arguing that the transfers were outside the scope of the trustees' powers and unauthorised payments.

80. Somewhat surprisingly, the matter came before the Chancery Division on an application for summary judgment by the Hedge companies, who argued Dalriada had no real prospect of succeeding against them for knowing receipt of assets transferred in breach of trust. The Hedge entities argued that the transfers were at most voidable by the Scheme members, as each member's pot was a separate sub-trust.

81. The Chancellor of the High Court Sir Andrew Morritt rejected the "sub-trust" argument. The separate accounting of each member's benefit involved in a money purchase scheme did not involve the establishment of a series of sub-trusts[68]. Further, the issue of whether the transfers were voidable or void was beside the point, as (on Dalriada's case) the Hedge companies would be unable to say they took trust property without notice that it was transferred in breach of trust. The judge thus dismissed the summary judgment application brought by the Hedge companies, allowing the claim to continue.

82. In late November 2012, Dalriada got *Beddoe* relief to continue with the proceedings, and in early 2013 lodged its own summary judgment application. It appears from the Dalriada website that a deal in principle was eventually done whereby the control of the various Hedge companies and their assets would be transferred to Dalriada as trustees, however it is not clear that this has yet been finalised. Nor is it clear whether the loans paid to members will be treated as *"unauthorised payments"*[69]. Separately, it appears that one of the people behind the Pennines and Mendip schemes (Andrew Meeson) is now in prison in relation to a separate fraud[70].

83. A further example of a pension liberation scheme coming before the Courts related to the Lincoln Umbrella Pension Funds: *The Pensions Regulator v A Admin Ltd & Others* [2014] EWHC 1378. In that case, a structure was set up along the following lines:

    83.1. Each member set up a company to become an employer of a trust-based scheme;

    83.2. That member's benefits were transferred to that scheme;

    83.3. Members then surrender their benefits;

    83.4. The benefits would then belong to their company, which would hold them on a separate family trust for the member's dependants;

[68] See the Judgment at [32]-[35]
[69] http://dalriadatrustees.co.uk/pennines-and-mendip/(accessed 18 June 2015)
[70] http://www.iexpats.com/jailed-tax-boss-linked-to-pension-liberation-schemes/ (accessed 18 June 2015)

83.5. Their company would also loan sums to the member.

84. This was said to get around the provisions relating to inalienability of pension benefits in the Pensions Act 1995 s. 91[71], as s. 91(5)(b) provided that inalienability did not apply to:

> *"a surrender, at the option of the person in question, for the purpose of…*
>
> *(i) providing benefits for that person's widow, widower, surviving civil partner or dependant"*

85. Over 1400 members transferred over £134m to these schemes[72].

86. On a trial of certain preliminary issues, Mrs Justice Rose determined that the trust-based schemes in question were void for uncertainty. But in any event, the judge decided that the provision in s. 91(5) Pensions Act 1995 which permitted surrenders for the purpose of providing benefits to dependants only applied to benefits provided *under the same scheme*, and thus did not save surrenders in this case.

87. After the preliminary issues hearing, the operators agreed to discontinue the scheme by deed of dissolution. The Regulator has indicated that tax penalties on individual members who had accessed their funds via the Lincoln Umbrella Pension Fund are still a possibility, but commented that the High Court proceedings "*leave the way open for those members who consider they have suffered loss to take action"*.[73]

88. Two interesting features arise from these cases:

88.1. One, it is unlikely pension liberators are done trying to find novel ways of enabling people to access their pension cash before the age of 55 without incurring tax charges;

88.2. Two, there are a range of arguments one can deploy to undermine a pension liberation scheme, in particular one set up under a trust. Several of the cases have

[71] For a full description of the scheme see the Judgment at [9] and the Pension Regulator's report at http://www.thepensionsregulator.gov.uk/docs/section-89-report-lpa-umbrella-trust.pdf (accessed 18 June 2015)
[72] Ibid.
[73] Ibid.

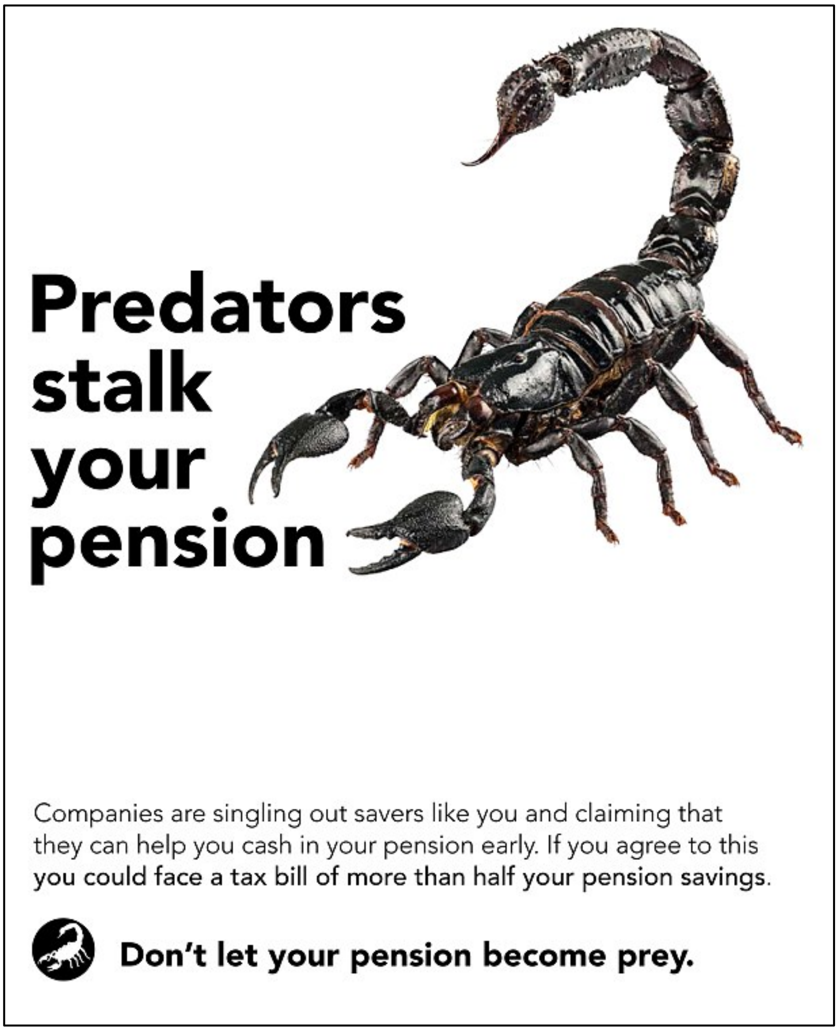
attacked the structures set up on the basis that they are outside the trustees' powers or a fraud on the power.

Scorpion campaign

89. These cases give us some insight into the work the Pensions Regulator has been doing to combat pensions liberation.

90. Another main focus of the Regulator has been on education – trying to encourage people to be vigilant to protect themselves from the perils of pensions liberation. This has resulted in the Scorpion Campaign, a cross-government initiative involving Action Fraud, HMRC, SFO, FCA and the Pensions Regulator to name but a few, which arose out of the Project Bloom taskforce set up to address liberation scams.

91. The campaign dates back to 2013 when it was primarily considered with pensions liberation scams targeting the under 55s.



92. The recent campaign has broadened its remit to the pensions freedoms now available to those over 55, and with this has come a change in terminology. Members are warned to "*scam proof*" their pensions, and to *"Check the facts to stop a lifetime's savings being lost".*

93. The Pensions Regulator has produced an information booklet for members, which it asks trustees to include in members' annual benefit statements and when issuing transfer packs[74].

Other responses

94. HMRC have tightened their rules on registered schemes, in particular ending the practice whereby a scheme was automatically registered on submission of the correct form, with any checks being carried out later. HMRC have also been given further powers to refuse registration or de-register a scheme they consider likely to be a pensions liberation scheme[75].

95. The Pensions Liberation Industry Group have produced a Code of Good Practice in relation to combating pensions scams, which has been welcomed by the FCA, the Pensions Ombudsman and the Pensions Regulator[76]. This Code provides helpful guidance for scheme trustees and administrators who are faced with a transfer request to a potential liberation scheme or other scam, and takes accounts of the series of recent Pensions Ombudsman decisions relating to this issue. The Code of Good Practice includes questions to ask the member, decision flow-charts for each of the various types of possible transfers and sample letters. It also identifies a list of investments linked to high risk fraud, for example: carbon credit schemes and land banking schemes. The limits of the measures suggested in the Code of Good Practice are, however, clear:

> *"These measures will not protect members of schemes from making poor investment choices; their intention is to help prevent members' pension pots from being at risk of a pension scam"*

New liberation challenges

96. The vigilance required of trustees, administrators and consumers is ever-growing. Press reports have noted that pension liberator operators have adapted their approach to try and

[74] http://www.pensionsadvisoryservice.org.uk/content/publications-files/uploads/members_detailed_booklet_7_page.pdf, http://www.thepensionsregulator.gov.uk/trustees/pension-scams-trustees.aspx (accessed 19 June 2015)
[75] For a summary, see https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/293303/pl-budget14.pdf (accessed 19 June 2015)
[76] http:www.combatingpensionscams.org.uk/ (accessed 19 June 2015)

defeat trustee attempts to block suspicious transfers, in particular by using more opaque vehicles such as Self-Invested Personal Pensions or Small Self-Administered Schemes[77].

97. It is against this ever-evolving “bad” liberation background that the new pensions freedoms have come into play. If the pensions liberation saga has taught us anything, it is that liberation, both good and bad, is likely to be fertile breeding ground for scammers and fraudsters.

Looking into the future

98. The Chancellor announced last week[78] that, since Pension Freedoms Day, around 60,000 people have withdrawn a total of £1bn from pension schemes. He therefore heralded the reforms as “*a real success*”. Hargreaves Landsdown had estimated that 30% of this has been spent on cars and holidays[79].

99. These are early days, but already some causes for alarm have been detected. It was reported on Perspective on 3 June, for example, that a website using the name “*pensionswise.help*” has been shut down after being reported by the Treasury to the Financial Conduct Authority. Further, Xafinity has recently reported[80] the results of a survey carried out since the new pension freedoms were introduced to the effect that 36% of pension schemes have observed potential scam activity relating to transfers out of DB schemes.

100. So, what type of person is likely to benefit from the freedoms which were introduced on 6 April 2015? Given the additional tax charges which apply as a result of our system of progressive income tax bands, it is difficult to see how a person could be recommended to draw the whole of his or her pension in a single lump sum. I will use some figures by way of example (using tax bands for the 2015/16 year)[81]:-

[77] http://citywire.co.uk/new-model-adviser/news/pension-predators-evolve-in-face-of-gov-t-crackdown/a784838 (accessed 19 June 2015)
[78] Hansard, 16 Jun 2015, Column 179.
[79] Times, 17 June 2015.
[80] Press release dated 19 June 2015, reported on Perspective 22 June 2015.
[81] Personal allowance £10,600; 40% threshold: £31,785.

Example 1:
Pension pot: £30k
Tax at 20%[82]: £2,380

101. But this pot could have been taken under the rules introduced with effect from 27 March 2014

Example 2:
Pension pot: £50k
Tax at 20%: £4,237
Tax at 40%: £2,286
Total: £6,523

Example 3:
Pension pot: £100k
Tax at 20%: £4,237
Tax at 40%: £17,286
Total: £21,523

102. In Examples 2 and 3, tax is due, which could have been avoided by smoothing receipt over a number of years. I would suggest that the protection of taking advice is a willow the wisp unless it is possible to identify a substantial category of people who could be recommended to take advantage of the new rules, and who would not have been able to take advantage of the old rules.

103. The most obvious example of a person who might benefit is a person who needs or wants money now and who is prepared to take it at a knock-down price. One questions the wisdom of the reforms if the persons primarily intended to benefit include persons in necessitous circumstances. Further, if such persons are to be given this freedom, it is suggested that the policy of the Welfare Reform and Pensions Act 1999 in the context of bankruptcy should be reconsidered[83]. Why should a person be able to withdraw cash to pay for a Lamborghini, but not be required to do so to pay off his or her creditors?

104. One practical point is that many more people will be vulnerable to unlawful liberation schemes as a result of the publicity associated with the reforms. This is not assisted by the limited powers to block transfers enjoyed by those administering pensions schemes, a dilemma illustrated by a recent Pensions Ombudsman determination[84], in which a member brought a successful complaint against Prudential. An obvious category at risk is the under 55s, who are not of an age where they are able to access their pension funds. But, even in

[82] Tax quoted after 25% tax-free commutation.
[83] See the recent case of *Horton v Henry* [2014] EWHC 4209 (Ch).
[84] Determination in complaint by Mr Mark Harrison (PO-3184), 17 April 2015.

relation to the over-55s, no doubt there will be those unscrupulous advisers who hold out to members the prospect of access to cash without the income tax charges just described.

105. Even outside of the context of unlawful liberation schemes, there appears to be a clear possibility of scheme members obtaining bad advice. An obvious example here is people who might be persuaded to withdraw their pensions so that the adviser can reinvest the portfolio outside the pensions wrapper in investments with looser fee-charging rules. Therefore, a recurrence of mis-selling motivated by churning seems a distinct possibility.

106. Further, inflexibility within the insurance industry appears already to be causing deep frustration. A headline in the Daily Mail on 10 June 2015 was entitled: "*What a pensions shambles! Revolution in crisis as savers are barred from taking out cash and charged £1,000 just for advice … and scandal could be worse than PPI*". The article reported, amongst other things, that "*Money Mail has also heard from savers who have been told they cannot enjoy the freedoms unless they move to a new type of pension – at a steep cost … A typical problem occurs when someone wants to take their pension over the age of 55, but then discovers their contract prevents them from doing so without penalty before the age of 60 or 65*".

107. Concerns of this type have caused sufficient alarm that last week the Chancellor announced that he had asked the FCA to investigate and that the Treasury would be launching a consultation. On 17 June, the Treasury clarified[85] that it will launch a consultation in July, which will look at:-

107.1. Options to address excessive early exit penalties; and

107.2. Making the process for transferring pensions from one scheme to another quicker and smoother.

108. Having regard to all of the above, I will leave you to decide for yourself whether the Taxation of Pensions Act 2014 is a meaningful reform or is it just a political football.

[85] See Treasury press release dated 17 June 2015.

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