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Pensions Legal Update

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Legal Update Contents

1. **Do one thing this month**
2. **Revaluation changes.** The Pensions Act 2008 will change the statutory minimum revaluation in deferment from RPI up to 5% to RPI up to 2.5%.
3. **Employer contributions.** The Court of Appeal has dismissed an appeal by a scheme employer relating to the construction of the scheme's contribution rule.
4. **Employer debt.** The High Court has upheld a partial buy-out arrangement designed to increase a debt under section 75 of the Pensions Act 1995.
5. **Changes to the employer debt legislation.** The Department for Work and Pensions is carrying out an informal consultation on the employer debt legislation.

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Do one thing this month

The Pensions Act 2008 will change the statutory minimum revaluation in deferment (currently RPI up to 5%) to RPI up to 2.5%. The change is expected to come into force on 6 April 2009.

Trustees should consider doing the following:

- **Review the scheme provisions on revaluation in deferment to see whether they contain an explicit cap of 5% or whether they simply refer to the legislation.**
- **Schemes containing an explicit 5% cap will need to be amended if a reduced cap of 2.5% is to be adopted. Schemes will need to consider whether an amendment requires consultation with the members.**
- **Schemes referring to the statutory requirements will automatically provide a reduced level of revaluation unless the rules are amended to retain the 5% cap.**
- **Trustees should consult with the employer about what level of revaluation they wish to provide.**
- **Check members' booklets. If they refer to revaluation up to a 5% cap, schemes should consider announcing any change to the basis of revaluation to members.**

Revaluation changes

Summary. The Pensions Act 2008 contains provisions to change the statutory minimum revaluation in deferment from RPI up to 5% to RPI up to 2.5%.

Facts. Under the Act, deferred pensions in final salary schemes will still have to be revalued according to the rate of inflation over the period of deferment, but capped at 2.5% per annum rather than the current 5%. Changes to the legislation will only apply to deferred pensions attributable to pensionable service after the Act comes into force. The existing revaluation requirements will continue to apply to deferred pensions attributable to pensionable service completed before the Act comes into force. It is currently expected that the change will come into force in April 2009.

The effect of the changes will depend on a scheme's revaluation provisions. If a scheme's rules contain an explicit cap of 5%, an amendment will be needed to adopt a reduced cap of 2.5%. If an amendment is required employers should consider whether they need

Trustees should consult the employer to agree whether to change the revaluation rate, take legal advice on whether the rules need to be amended, consult the scheme actuary if applicable and ensure that members understand any changes.

to consult with members. Schemes which simply refer to the statutory requirements will automatically provide a reduced level of revaluation unless the rules are amended to retain the 5% cap.

Because the change is not mandatory, trustees and employers will need to agree the level of revaluation that they wish to provide. Before taking any decisions, trustees and employers may wish to consult their scheme actuary to consider the implications of any change to revaluation. The actuary will be able to advise on whether reducing the revaluation cap is likely to result in savings for the scheme, and whether there is likely to be any effect on future contribution rates. If there is to be a change, trustees should communicate this to the members, by amending the scheme booklet, or by making an announcement.

Comment. Trustees should consult the employer to agree whether to change the revaluation rate, take legal advice on whether the rules need to be amended, consult the scheme actuary if applicable and ensure that members understand any changes.

Employer contributions

Summary. The Court of Appeal has dismissed an appeal by a scheme employer relating to the construction of the scheme's contribution rule.

Background. Where employer contribution rates are determined by the actuary without the agreement of the employer, the actuary has to provide an extra element of actuarial certification (the actuarial underpin) (2005 Regulations).

Facts. A was the principal employer of two defined benefit pension schemes (the schemes). These were multi-employer schemes in deficit and were subject to the new scheme funding regime under the 2005 Regulations. Both schemes had the same two employer contribution rules: Rule 12.1 dealt with future collective contribution rates and Rule 18.7.5 dealt with past service deficit collective contribution rates.

Rule 18.7.5 provided that if the actuary's report disclosed a deficit, the employers collectively had to pay such amount (by lump sum or periodic payment) which would "in the opinion of the actuary restore the solvency of the fund; such amount to be paid by the participating companies in such proportions as the actuary shall certify and within such period as the trustees may, on the advice of the actuary, agree with the principal company".

When the rules were executed, the Pensions Act 2004 and the 2005 Regulations were not in force, so Rule 18.7.5 fell within section 58(6)(b) of the Pensions Act 1995 (the minimum funding requirement).

Under the minimum funding requirement, the schedule of contributions had to show the rates and due dates of the contributions payable by, or on behalf of, each person who is an employer in relation to the scheme (1996 Regulations).

A and the schemes' trustees agreed that the actuary (alone) set the collective contribution rates in Rule 12.1. However, they disagreed on the construction of Rule 18.7.5 and whether the actuarial underpin applied. A asked the court whether the wording of Rule 18.7.5 relating to the proportions and timescale of the payment made it necessary for the actuary to obtain the sponsoring employer's agreement in setting the contribution rate.

The High Court held that the actuarial underpin did apply to Rule 18.7.5. A appealed.

Decision. The court dismissed the appeal, holding that the second part of Rule 18.7.5 is directed to contributions payable by individual employers and not to contributions to be paid by employers collectively, and therefore the collective directions in Rule 18.7.5 have the same effect as the directions in Rule 12.1.

The court noted that the second part of Rule 18.7.5 met an obvious need for the principal employer's agreement to be obtained for the period within which each individual employer was to pay its contributions, having regard to the overall period fixed by the actuary.

This decision is a useful example of the application of the scheme funding regime.

Construing Rule 18.7.5 as requiring the actuary to obtain A's agreement to the period over which the solvency of the fund should be restored would create potential for conflict with the 1996 Regulations. The court stated that where contractual provisions had been drawn with statutory provisions in mind, it is appropriate to construe the contractual provisions in a manner that avoids conflict.

Comment. This decision is a useful example of the application of the scheme funding regime.

Case: Allied Domecq (Holdings) Limited v (1) Allied Domecq First Pension Trust Limited and (2) Allied Domecq Second Pension Trust Limited [2008] EWCA Civ 1084.

Employer debt

Summary. The High Court has upheld a partial buy-out arrangement designed to increase a debt under section 75 of the Pensions Act 1995 (1995 Act) (section 75).

Background. Section 75 provides that if, at the "applicable time", the value of the assets of a scheme is less than the value of the liabilities, the difference in value will constitute a debt due from the employer to the trustees of the scheme.

Before June 2003, the value of the liabilities was calculated by reference to the minimum funding requirement (MFR), which applied before the Pensions Act 2004 came into force. "Applicable time" is defined as any time that a scheme is being wound up before the sponsoring employer becomes insolvent.

Facts. The employer's operations had ceased. The pension scheme was being wound up and was in deficit, although no insolvency event in relation to the employer had occurred. Before the winding up of the scheme could be completed, it was necessary to compute and recover the debt due from the employer under section 75, and to apply both the proceeds of that debt and the scheme's other assets in securing the benefits due to members in accordance with the scheme rules.

The measure of the scheme's liabilities on the MFR basis was less than the cost of securing those liabilities by buying annuities from an insurer. As a result, the debt due from the employer would be insufficient to provide for the members' benefits in full.

The trustee sought a partial buy-out to minimise that insufficiency, which involved:

- Applying the existing assets of the fund to buy annuities for members (stage 1).
- Fixing an "applicable time" for the computation and recovery of the debt from the company (stage 2).
- Applying the proceeds of that debt to buy further annuities for members (stage 3).

This case may assist schemes that commenced wind-up before that change to increase the debt that can be claimed from the employer.

The trustee reasoned that the effect of stage 1 would be that the debt due from the employer under section 75 would be increased. This would allow the amount secured at stage 3 to be more than it would have been following the conventional route.

The employer argued that the consequence of the trustees' partial buy-out method would be only to discharge a proportion of the liabilities, valued on the section 75 basis, and the debt would not be reduced any further than if the conventional approach of proceeding immediately to collecting the section 75 debt before buying out the members' benefits was followed. The employer also argued that, once the partial buy-out route were taken, the trustees would have no power to fix the "applicable time" as the scheme would no longer be in the winding-up process. As a result, there would be no section 75 employer debt due at all and the scheme would be worse off.

The trustee sought a declaration from the court that, if it effected the proposed partial buy-out, it would be entitled to fix an "applicable time" after the partial buy-out.

Decision. The court held that the trustee was empowered by section 75(3) of the 1995 Act to fix an "applicable time" for so long as the scheme was being wound up and before the occurrence of any relevant insolvency event in relation to the employer. In this case, the scheme would still be classified as being wound up, even after a partial buy-out.

The subsequent calculation of the employer debt (after the trustee had fixed the "applicable time") was to be based on the liability of the trustee to provide the benefits to members, rather than by reference to the MFR quantification of those benefits.

However, the court also held that the trustee could not effect the partial buy-out process unless it was satisfied that the debt due from the employer would be materially increased by that process (having taken account of the costs of the process and any other relevant costs).

Comment. The basis for calculating the debt under section 75 has changed so that it is now the cost of securing benefits with an insurer. This case may assist schemes that commenced wind-up before that change to increase the debt that can be claimed from the employer.

Changes to the employer debt legislation

Summary. The Department for Work and Pensions (DWP) is carrying out an informal consultation on the employer debt legislation.

Background. Where an employer participating in a multi-employer defined benefit pension scheme ceases to employ active members, this triggers a statutory debt under sections 75 and 75A of the Pensions Act 1995 (section 75 debt), based on the cost of buying benefits for members from an insurer.

A deregulatory review published by the DWP in July 2007 proposed that, on a group reconstruction of employers in a multi-employer scheme, a section 75 debt should not be triggered where the original covenant is strong and, if the remaining employers' covenant remains as strong, following the reconstruction, as the original covenant. The government said that it would work with the industry to seek a practical solution to the difficulties created by the existing legislation.

Facts. The DWP's proposals are only intended to apply to employers who have a strong covenant so that reorganising their business would not cause detriment to their pension scheme or the employer covenant. The DWP has identified four different options:

- Allow scheme apportionment as the default. The section 75 debt that would otherwise be triggered on a merger or acquisition within the existing group would be automatically apportioned to the accepting employer. The trustees would still need to be satisfied that the funding test is met (this is contained in the Occupational Pension Schemes (Employment) Regulations 2005 and broadly requires the trustees to be satisfied that the remaining employers are able to support the scheme and that the security of members' benefits will not be adversely affected). This would be a departure from the current rules as the trustees would be obliged to agree to the apportionment if the funding test is met; currently, they can limit the extent of the apportioned debt.

This consultation will be welcomed by employers who have argued that there should be greater flexibility in the employer debt provisions.

- Set a de minimis threshold (where the outstanding section 75 debt is expressed as a percentage of the total scheme liabilities) below which a corporate transaction would not trigger a section 75 debt. The DWP has suggested that the threshold could be as high as 30%.
- Reduce the exiting employers' section 75 debt by calculating it on the greater of the statutory scheme specific basis and the level of Pension Protection Fund protected rights, rather than the full buy-out level. This option would only apply where the expectation of reaching and/or sustaining the funding target is not materially changed as a result of the corporate transaction and the strength of the overall employer covenant remains unchanged.
- Do nothing. The employer debt regime would continue unchanged for a reasonable period (two years is suggested) to assess the effect of the Occupational Pension Schemes (Employer Debt and Miscellaneous Amendments) Regulations 2008, which introduced greater flexibility for employers.

Comment. This consultation will be welcomed by employers who have argued that there should be greater flexibility in the employer debt provisions. The options that the DWP has proposed are not intended to prohibit intervention by the Pensions Regulator where the legislative tests are not met for the use of its regulatory powers.

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