

# Pensions Legal Update

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## Do one thing this month

**The Pensions Act 2008 amends the Pensions Act 2004 to allow the Regulator to issue a contribution notice when actions or failures by a sponsoring employer or a connected or associated person have a materially detrimental effect on the likelihood of members receiving their benefits. The Pensions Regulator (the Regulator) has finalised its code of practice on material detriment.**

**If parties require certainty on such issues they can apply to the Regulator for clearance.**

### Scheme funding: employer covenant

**Summary.** The Pensions Regulator (the Regulator) has issued a statement summarising its recommended approach to scheme funding and the employer covenant (the statement).

**Background.** The statutory requirements for funding defined benefit pension schemes are contained in Part 3 of the Pensions Act 2004 and underlying regulations (together, the funding regime). The value to be placed on a scheme's accrued liabilities is known as a scheme's "technical provisions". The estimate of technical provisions requires assumptions to be made about the future (such as mortality and investment returns). Under the funding regime, trustees are responsible for setting their scheme's technical provisions after obtaining actuarial advice. Where a scheme is in deficit, a recovery plan must be agreed for addressing the deficit (the recovery plan).

The Regulator has issued two previous statements in October 2008 and February 2009 one to employers of defined benefit schemes and one to trustees, drawing their attention to circumstances under which they should consider reviewing recovery plans. The statements highlight the fact that the funding regime is sufficiently flexible to cope with the current economic downturn.

**Facts.** The statement includes the following **guidance**:

- **Technical provisions.** Trustees need to decide on the level of technical provisions, based on prudent assumptions in relation to their assessment of the employer covenant. In current circumstances, funding by reference to the assumptions used for the accounting framework for pension schemes (*Financial Reporting Standard 17 "Retirement benefits"/International Accounting Standard 19 "Employee benefits"*) is unlikely to represent an adequate level of prudence.

*The statements highlight the fact that the funding regime is sufficiently flexible to cope with the current economic downturn*

- Where an employer is weak, funding assumptions should be chosen so that the scheme is “self-sufficient”, which means that technical provisions should be set so that they can meet the full accrued liabilities and expenses in future on the basis that the scheme had been closed and all risk minimised. Such a measure would be based on a very low risk investment strategy with a reserve held for future administrative expenses and a very prudent mortality assumption.

Where the employer is strong relative to the scheme, it is possible to assume a prudent level of investment out-performance over and above a risk-free rate of return.

- The employer covenant. Assessing the employer covenant is complex and requires transparency and co-operation between trustees and employers. Trustees should be clear about the questions they need to have answered. As well as estimating what value might flow to the scheme on the employer’s insolvency, the employer’s likely future performance should be considered in any covenant assessment. Trustees should ensure they have mechanisms in place for regular monitoring and review of the employer covenant; to assist this they should address conflict of interests and confidentiality issues.
- The recovery plan. Trustees should aim for any shortfall to be eliminated as quickly as the employer can reasonably afford. What the employer can reasonably afford can be worked out from an assessment of the employer’s covenant. Whatever structure or duration of recovery plan is considered, the trustees must ensure their scheme is treated fairly in relation to other creditors and shareholders. Where employers are having cash-flow problems, back-end loading of employer contributions is a reasonable approach.

Consideration should also be given to contingent assets (assets over which the pension scheme has a claim in certain circumstances i.e. employer insolvency) and specialist advice should be sought. Employers will want to ensure that such assets do not hamper their ability to do business, while trustees will want to ensure that they have adequate access to the assets, as and when required.

**Comment.** The statement is a useful summary of the issues which trustees should consider in funding negotiations with employers.

*Source: The Pensions Regulator’s Statement – Scheme funding and the employer covenant, June 2009, [www.thepensionsregulator.gov.uk/pdf/EmployerCovenantStatementJune2009.pdf](http://www.thepensionsregulator.gov.uk/pdf/EmployerCovenantStatementJune2009.pdf).*

## The material detriment test

**Summary.** The Pensions Regulator (the Regulator) has finalised its code of practice on material detriment (the code).

**Background.** A contribution notice is an order which requires a person to make a payment to an occupational pension scheme.

Section 126 of the Pensions Act 2008 amends the Pensions Act 2004 to allow the Regulator to issue a contribution notice when actions or failures by a sponsoring employer or a connected or associated person have a materially detrimental effect on the likelihood of members receiving their benefits .

In December 2008, the Regulator consulted on a draft code of practice covering this area (the consultation).

*The code sets out the circumstances in which the Regulator expects to use its power to issue a contribution notice*

**Facts.** The code sets out the circumstances in which the Regulator expects to use its power to issue a contribution notice. It broadly replicates the draft code under the consultation, but with some clarifications. One of the concerns arising from the consultation was that the application of the material detriment test was uncertain and that there was a risk that ordinary corporate transactions may be caught by the code. The Regulator has said that it is not expecting there to be any undue impact on routine business. However, it will publish further guidance on the legal framework to help allay these concerns, as well as providing illustrative examples on areas such as payment of dividends, general poor trading and buy-outs to show how the code would work in practice. If parties require further certainty on such issues they can apply for clearance.

The Regulator expects to issue contribution notices on the grounds of material detriment in any of the following circumstances:

- The transfer of a pension scheme out of the UK jurisdiction.
- The transfer out of the UK jurisdiction of the sponsoring employer or the replacement of a UK sponsoring employer with another employer outside the UK jurisdiction, if by doing so there is a substantial reduction in the level of employer support or legal and regulatory protection for scheme members. Following the consultation, the Regulator included the concept of “replacing” the employer in this section.
- Sponsor support is removed, is substantially reduced or becomes nominal. Following the consultation, the Regulator has clarified that “substantially reduced” implies that the reduction in sponsor support is major, non-routine and could lead to the virtual abandonment of the scheme.

- The transfer of liabilities of the scheme to another scheme or arrangement that leads to a significant reduction in the sponsor support or funding levels. Following the consultation, the Regulator accepted that the use of “sufficient” to describe appropriate levels of employer support or scheme funding was too vague, and has taken steps to replace this with a test of “significant reduction.”
- Use of a business model or the operation of the scheme in a way that is designed to create a financial benefit for the employer or some other person from the scheme, but where inadequate account has been taken of the interests of the members of the scheme, including where risks to members are increased.

**Comment.** The code is intended to assist trustees, employers and other related parties to understand the practical application of the new ground for contribution notices.

*Source: Code of practice No. 12 : Circumstances in relation to the material detriment test*

## Equitable Life

**Summary.** Sir John Chadwick has set out initial proposals (the proposals) on relevant issues for the proposed compensation scheme for investors.

**Background.** The Parliamentary Ombudsman’s (Ombudsman) report into the regulation of Equitable Life was published in July 2008. It made ten findings of maladministration and injustice by various public bodies including the Financial Services Authority and the government Actuary’s Department. The government’s formal response was published in January 2009 and Sir John Chadwick was asked to advise on matters relating to an “ex-gratia” compensation scheme for investors. Sir John is only required to consider the Ombudsman’s findings of maladministration and injustice which the government had accepted. These were:

- Fourth finding: a lack of scrutiny of regulatory returns was maladministration, with injustice arising for policyholders who relied on information contained in the returns.
- Sixth finding: a failure to scrutinise reinsurance arrangements of 1998 amounted to maladministration, creating injustice for policyholders who joined after 1 May 1999.
- Tenth finding: the publication of misleading information regarding the solvency of Equity Life was maladministration, causing injustice to policyholders who reasonably relied on this information, and this reliance caused their financial loss.

**Facts.** The proposals suggest that losses could be considered under two heads:

- Head A: Loss suffered as a result of decisions that policyholders would not have taken had they not been misled as a result of maladministration, which includes decisions to take out new policies, to pay non-obligatory premiums under existing policies, to take annuities with Equitable Life, and not to require funds to be transferred to another pension provider.

- Head B: Loss suffered as a result of the weakened financial position of Equitable Life because it did not take the steps it would have taken if regulatory intervention had been threatened or made.

Sir John suggests his role will be to identify the distinct incidents of maladministration which arise from the Ombudsman's findings, to consider what might have been expected to happen had the incident not occurred, to identify the classes of policyholders affected and to measure the extent of losses suffered by them.

He identifies several issues concerning the assessment of loss (and invites responses) including:

- Whether his terms of reference preclude any loss under Head B in relation to the fourth and sixth finding.
- As loss could occur as a result of more than one act of maladministration, how double-counting should be dealt with. Sir John's provisional view is that the loss should be measured on the basis of which is most advantageous to the policyholder.
- What provisions should be made for policyholders who have died, surrendered their policies, or whose policy has been transferred to another life assurance or pension provider.
- To what extent relative gains should be netted off against relative losses.
- To what extent policyholders' losses have already been compensated by other parties.

**Comment.** There are concerns about the length of time investors have had to wait for resolution, particularly given that many have already retired. While progress has been made through these proposals, details of the compensation scheme remain many months away.

*Source: Equitable Life ex-gratia payment scheme*

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## Death benefit

**Summary.** The Pensions Ombudsman (the Ombudsman) has ordered trustees to reconsider distribution of a lump sum death benefit.

**Background.** Trustees must take account only of relevant information, construe the rules and law correctly, and reach a decision that is not perverse. Trustees who are exercising a discretionary power are not required to give reasons (*re Londonderry's Settlement [1988] Ch 918*). However, the Ombudsman has in the past determined that a failure to give reasons amounts to maladministration (*Decision of the Ombudsman in the case of Mr C Allen L000370*)

**Facts.** The trustee had wide discretion to distribute a lump sum death benefit under pension scheme rules on C's death. The trustee elected to distribute a lump sum to five children of C and his wife. Two of the five children had been adopted as babies, and had no contact with C and his wife since their adoption, and three children were in foster care. C's wife was named as the sole beneficiary under C's will but no "expression of wish" form was completed by C.

It was apparent from a visit by the company's occupational health specialist (HS), and subsequent enquiry with C's parents and sister-in-law, that C's wife was not living with C at the time of death, but that she frequently visited C with her new partner. Oral evidence was provided by HS to the trustee, but the trustee considered no other evidence.

C's wife argued that she had not left C at the time of death, and debts left by C would mean she would have to sell the family home rather than keep the home for her and the children.

**Decision.** The Ombudsman held that because the trustee reached a decision which it recorded without identifying its reasons, there was no evidence that its decision was rational. Further, the trustee failed to take into account sufficient information, which meant that it did not have all relevant matters before it. The trustee was directed to consider its decision again in the light of representations from C's wife.

**Comment.** This decision shows the importance for trustees who are investigating complex family circumstances to seek appropriate information about potential beneficiaries. The case may turn on its facts but it shows the Ombudsman's willingness to challenge trustees who do not provide reasons for their decisions in circumstances where a court would not order them to provide reasons.

*Case: Determination of the Pensions Ombudsman relating to Mrs HA Curran [974746/1], 28 May 2009.*

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