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Pensions Legal Update

Legal Update Contents

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Do one thing this month

The Court of Appeal has ruled on what counts as money purchase benefits in a "hybrid" scheme i.e. a scheme which provides both defined benefits and money purchase benefits.

The court appears to have held that pensions in payment derived from a money purchase account in a hybrid scheme remain money purchase benefits. This means they must be bought out in full if the scheme winds up in deficit. They would not be reduced under the statutory priority order which applies to defined benefits.

Trustees of hybrid and money purchase schemes should consider the implications for their scheme.

Post-valuation improvements

The Regulator has issued the guidance in response to the exceptional market conditions suffered in early 2009; it relates to schemes which had an effective valuation date around 31 March 2009. The Regulator considers that it may be reasonable for these schemes to take account of post-valuation events when agreeing the recovery plan and schedule of contributions.

Summary. The Pensions Regulator (the Regulator) has published guidance on taking into account post-valuation improvements in asset values when agreeing a recovery plan and schedule of contributions (the guidance).

Background. Scheme-specific funding requirements are contained in Part 3 of the Pensions Act 2004. The trustees must put in place a schedule of contributions (usually with the employer's agreement) and, if a scheme's valuation reveals a deficit, a recovery plan. The recovery plan sets out the level of additional contributions needed to address the scheme's deficit over a specified period.

A recovery plan and schedule of contributions may be reviewed, and if necessary revised, if the trustees consider that this is justified (*regulation 8 and 9, Occupational Pension Schemes (Scheme Funding) Regulations 2005*) (*SI 2005/3377*).

Facts. The Regulator has issued the guidance in response to the exceptional market conditions suffered in early 2009; it relates to schemes which had an effective valuation date around 31 March 2009. The Regulator considers that it may be reasonable for these schemes to take account of post-valuation events when agreeing the recovery plan and schedule of contributions. However, the guidance will not automatically apply to future situations, so in normal market conditions, trustees should be wary of taking such action.

In particular, the guidance states that:

- Recovery plans should reflect what is reasonably affordable, be in accordance with the statement of funding principles and be in the best interests of members. The Regulator would expect any variation to affect the length of the plan rather than the level of annual payments.
- Recovery plans can allow for changed market conditions by building in an assumption as to future asset returns, and allowing reduced contributions for outperformance.

- If market conditions were extremely favourable at a scheme's valuation date, trustees should consider post-valuation changes to reflect a decline in the scheme funding position. If conditions deteriorate again, it may be necessary to advance the next valuation or conduct an inter-valuation review.
- **Comment.** This is helpful guidance for schemes which are currently putting in place recovery plans following an effective valuation date around 31 March 2009 because of the substantial recovery in asset values which has accrued since then.

Source: Effective valuation date around 31 March 2009 - taking account of improvements in the fund since the effective date, January 2010, www.thepensionsregulator.gov.uk/guidance/schemeFunding/technical/5360.aspx.

Closure to future accrual

Summary. The Pensions Ombudsman (the Ombudsman) has rejected a complaint about closure to future accrual.

Background. Restrictions on amendments to scheme rules which prohibit adverse changes to benefits "secured by past contributions" or to "accrued pensions" prevent amendments which would break the link between past service and future increases in pensionable salary from being broken (*Re Courage Group's Pension Scheme [1987] IWCR495*).

For example, where a member has accrued 10/60ths, this kind of restriction is thought to mean that the scheme cannot be amended so that the member is entitled to 10/60ths of salary at the date the scheme is closed to future accrual. Rather, the member must remain entitled to 10/60ths of salary at the date of his future retirement or leaving service.

Facts. B was a member of the pension scheme (the scheme), a defined benefit scheme, and was employed by F.

In mid-2005, F was restructuring its business and asked the scheme trustees to agree to a proposal to cease future accrual in the scheme to reduce its pension costs. Part of the proposal was that active members who were not made redundant during the restructuring would be treated as deferred members on the date that future accrual ceased. The scheme trustees agreed to the proposal and purported to close the scheme to future accrual with effect from 30 September 2005 (the date) by amending the scheme rules.

Members were told in advance that because of rising costs, the scheme would be closed to future accrual and that active members (like B) would be treated as leaving the scheme from the date. Benefits would be based on "your earnings and service to the date of closure", so that the final salary link was broken as at the date. This was documented in a formal amendment of the scheme's rules.

B argued that the scheme's amendment power contained a similar restriction to the amendment power that was cited in *Re Courage* and that his pension should continue to be linked to his final pay at retirement (and not based on final pay as at the date), so that it did not contravene the amendment power.

This act of leaving the scheme broke the final salary link so that future accrual could cease properly on the date.

The trustees argued that the final salary link was broken when members were deemed to have left the scheme, that is, on the date.

Decision. The Ombudsman did not uphold B's complaint. The Ombudsman agreed with the principles laid down in *Re Courage* but explained that the key issue in this case was what constituted "final pensionable pay".

As soon as B left the scheme on the date and became a deferred member, he was entitled to deferred benefits which were based on final pay at the date of leaving. This act of leaving the scheme broke the final salary link so that future accrual could cease properly on the date.

Comment. It will be interesting to see if this case is followed in other cases as arguably it appears to undermine the principles laid down in *Re Courage*.

Case: Determination of The Pensions Ombudsman in relation to Mr L Barton (74532/2).

GMP equalisation

Summary. The government has issued a statement about equalising the payment of guaranteed minimum pensions (GMPs).

While the statement applies principally to schemes eligible for the FAS, it may imply a wider effort to push trustees to equalise GMPs.

Background. Before 6 April 1997, a scheme contracting out of the second-tier state pension on a final salary basis had to provide members with GMPs. GMPs are based on the old state pension ages of 60 for women and 65 for men.

The European Court of Justice held in *Barber v Guardian Royal Exchange* and subsequent decisions that schemes had to provide equal benefits for men and women for service after 17 May 1990, based on the same retirement age. It has not been clear whether this also applies to GMPs.

The government has had to consider equalisation of GMPs in the context of legislation drafted for the Financial Assistance Scheme (FAS), the compensation arrangement for members of schemes which wound up in deficit with an insolvent employer before 5 April 2005. This follows guidance on this issue published by the Board of the Pension Protection Fund last year.

Facts. On 28 January 2010, pensions minister Angela Eagle stated (in the context of the draft FAS legislation) that the government intends to bring forward amending legislation when parliamentary time allows. However, she stated that, in the meantime, it is the government's opinion that, in order to ensure full compliance with EU law, trustees and others should act as if existing domestic legislation requires equalisation in respect of differences resulting from GMPs, whether or not real comparators exist.

Comment. While the statement applies principally to schemes eligible for the FAS, it may imply a wider effort to push trustees to equalise GMPs.

Source: Hansard HL Deb, 28 January 2010, www.publications.parliament.uk/pa/cm/cmtoday/cmwms/archive/100128.htm#hddr_15.

Money purchase benefits

Summary. The Court of Appeal has ruled on the meaning of money purchase (MP) benefits.

Background. MP benefits are those where the rate or amount is calculated by reference to a payment or payments made by the member or by any other person in respect of the member and which are not average salary benefits (*section 181, Pension Schemes Act 1993*).

Pensions granted by way of an internal annuity from a scheme are MP benefits. Converting a money purchase account to a pension which is provided from the scheme using actuarial factors does not prevent it from being a MP benefit.

A guaranteed minimum pension (GMP) is the minimum level of salary-related (SR) benefit that must be provided in a contracted out pension scheme for service before 6 April 1997. It is based on the amount a pensioner would have received had they remained eligible for state scheme benefits. GMPs ceased to accrue after 5 April 1997.

Protected rights are the minimum benefits which must be provided from a contracted out money purchase scheme.

A hybrid scheme provides a mixture of MP benefits and SR benefits.

Section 73 of the Pensions Act 1995 (section 73) sets out a statutory priority order for determining which benefits have priority in a salary-related occupational pension scheme (including a hybrid scheme) which winds up with insufficient assets to pay all benefits in full. MP benefits are normally excluded from section 73, but benefits derived from the payment of voluntary contributions and underpin benefits in hybrid schemes (that is, MP benefits which are only provided under the scheme if their value exceeds the value of other benefits which are SR benefits) are subject to section 73.

Aon Trust Corpn v KPMG (a firm) & Ors contains judicial guidance on the interpretation of MP benefits; in that case, the scheme was held not to be a money purchase scheme.

Facts. A hybrid scheme (the scheme) began to wind up in October 2003 in deficit. Not all members would receive their benefits in full under section 73. The scheme had various types of benefits.

In May 2008, the High Court ruled on whether these different types of benefit were MP benefits. The High Court's decision was appealed and the Department for Work and Pensions intervened on the ground that the case raised issues of general public policy.

The Court of Appeal considered seven questions relating to whether the different types of benefit were MP benefits.

Decision. The court held that:

- *KPMG* was not decided incorrectly, but a court must be cautious in taking general statements from one case, and applying them in another case and in a different context. The statutory definition of MP benefits should be construed in a fair and reasonable manner in the context of the scheme.
- Employer contributions which match members' voluntary contributions are derived from voluntary contributions and therefore within section 73 (as it stood in October 2003).
- The use of notional investment returns on invested contributions does not prevent those benefits being MP benefits.
- Pensions granted by way of an internal annuity from a scheme are MP benefits. Converting a money purchase account to a pension which is provided from the scheme using actuarial factors does not prevent it from being a MP benefit.
- The existence of a requirement to provide a GMP does not prevent a benefit from being a MP benefit. Where the GMP was notionally satisfied from the money purchase account, this was still a MP benefit. The function of the GMP was to identify the minimum below which the pension calculated by reference to the contributions by or in respect of the member may not fall. However, to the extent that these benefits accrued before 6 April 1997, they were underpin benefits which fell within section 73.
- The existence of a salary-related guarantee in respect of the benefits of one group of members did not prevent those benefits from being MP benefits.
- Money purchase protected rights are MP benefits and outside section 73.

Comment. This is an important case. The court appears to have decided that pensions in payment which are derived from a money purchase account remain MP benefits. If so, this raises significant practical questions about how such pensions are financed where a scheme's assets are less than is needed to pay for those pensions.

Source: Houldsworth & Anor v Bridge Trustees Ltd & Anor & Secretary of State for Work & Pensions (Intervening) [2010] EWCA Civ 179.

The *Enviroco* case – meaning of "subsidiary"

Summary. The Court of Appeal decision in *Enviroco Limited v Farstad Supply A/S* (the **"Enviroco case"**) has implications for whether a company falls within the definition of "subsidiary" used in UK companies legislation if the shares owned by its holding company have been charged to a lender.

Although not a pensions law case, the *Enviroco* case may have implications for pension schemes.

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Background. The Companies Act 1985 (the **"1985 Act"**) contained the following definition of "subsidiary":

> *"A company is a 'subsidiary' of another company, its 'holding company', if that other company:*
>
> *(a) holds a majority of the voting rights in it; or*
>
> *(b) is a member of it and has the right to appoint or remove a majority of its board of directors; or*
>
> *(c) is a member of it and controls, alone, pursuant to an agreement with other members, a majority of the voting rights in it,*
>
> *or if it is a subsidiary of a company which is itself a subsidiary of that other company."*

When the 1985 Act was repealed, this definition of "subsidiary" was reproduced without any material amendment in the Companies Act 2006 (the **"2006 Act"**). The 2006 Act definition remains in force. The Court of Appeal decision in the *Enviroco* case relates to the 1985 Act definition, but applies equally to the 2006 Act definition.

Facts. F owned an oil rig supply vessel which was chartered to A UK. Substantial damage was caused to the vessel as a result of a fire which broke out while E was cleaning the vessel's oil tanks and F brought proceedings against E for damages.

E sought to avoid liability by relying on an indemnity in the charter agreement which applied to A UK and its "affiliates". The term "affiliate" was defined by reference to the definition of "subsidiary" in the 1985 Act. E asserted that it was an "affiliate" of A UK because both were subsidiaries of A plc. The relationship between A plc and A UK was not in dispute. The issue in question was whether E was a "subsidiary" of A plc within category (c) of the 1985 Act definition.

A plc owned 50% of the shares in E and, pursuant to an agreement with the other shareholder, controlled alone a majority of the voting rights in E. However, A plc had charged its shares in E to a bank and the bank had been registered as the holder of the shares.

The Court of Appeal decided that, as a result of A plc having charged its shares in E to the bank, A plc was not "*a member of*" E for the purposes of category (c) of the 1985 Act definition. This meant that E was not a "subsidiary" of A plc - and therefore E was not entitled to rely on the indemnity in the charter agreement.

Comment. This Court of Appeal decision has potential implications where a holding company has charged shares in a “subsidiary” to a lender and the “subsidiary” would otherwise have fallen within category (b) or (c) of the 1985 Act definition. However, a “subsidiary” falling within category (a) of the 1985 Act definition is not affected by the decision – and, in practice, the majority of subsidiaries fall within this category.

The *Enviroco* case is unlikely to have any material implications for most pension schemes. This is because pensions legislation does not generally use the definition of “subsidiary” in the 1985 Act (or the 2006 Act) – and instead uses equivalent expressions in the Insolvency Act 1986. However, the following two points may be worth considering:

- The trust deed and rules of some pension schemes may contain a provision whereby a participating employer automatically ceases to participate in the scheme if it ceases to be part of the same corporate group as the principal employer. If this is the case, the question arises as to whether the 1985 Act definition of “subsidiary” (or the 2006 Act definition) is used in determining the extent of the principal employer’s corporate group. If so, a participating employer falling within category (b) or (c) of the 1985 Act definition (or the equivalent categories of the 2006 Act definition) could inadvertently drop out of the principal employer’s corporate group (and therefore cease to participate in the scheme) as a result of the *Enviroco* case.
- If there is a proposed disposal by way of a share sale of all or part of a corporate group which contains a pension scheme, it may be that the pension warranties in the share sale agreement will only apply to participating employers which, in relation to the target company, fall within the definition of “subsidiary” in the 1985 Act (or the 2006 Act). If so, the buyer would need to check whether any of the participating employers have ceased to be a “subsidiary” as result of the *Enviroco* case and have therefore fallen outside the scope of the pension warranties.

Case: Enviroco Limited v Farstad Supply A/S [2009] EWCA Civ 1399

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