

Challenging decisions made by sponsoring employers and trustees Important guidance from the High Court in the Prudential case

This is an important case about the employer's duty of good faith, in particular in the context of discretionary pension increases.

The case was also the first opportunity for the High Court to apply the Court of Appeal's decision in *Pitt v Holt* and *Futter v Futter* – see our Legal Update of 10 March 2011 on *Hastings-Bass*.

KEY POINTS

Where the rules of a scheme give the employer absolute discretion to determine pension increases, that employer is entitled to take its own interests into account. The test as to whether the employer has breached its duty of good faith in exercising its power in a particular way is whether that employer has made a decision which is irrational or perverse. The decision does not have to be "fair".

This sets the bar high for any members seeking to challenge an employer's discretionary increase policy.

There is no absolute obligation on trustees to know the full scope of every power given to them by the rules – the extent of their duty will depend on what is reasonable in the circumstances.

Trustees will welcome the confirmation that the extent of their duty to be familiar with their powers depends on what is reasonable in the circumstances. If trustees are minded to act in a particular way, they have a duty to clarify whether they have the power to do so. But there is no need to embark on unnecessary investigations to clarify the scope of their powers where that would not serve any practical purpose.

THE ISSUES IN SUMMARY

In *Prudential Staff Pensions Limited v The Prudential Assurance Company Limited & Ors* the Court considered the implications of the employer's decision to change its policy on discretionary pension increases, so that future increases would normally be capped. It had for a number of years awarded increases broadly in line with RPI.

The two most significant issues arising from the judgment are:

- the test for establishing a breach of the employer's duty of good faith to members; and
- when decisions taken by trustees can be set aside where they had not considered the full extent of their powers.

MORE INFORMATION ON THE DUTY OF GOOD FAITH

It is well established that the duty of good faith between an employer and employee also arises in the context of an occupational pension scheme. It is clear that the employer can have regard to its own interests and that the test is not whether the employer has acted in a reasonable manner. But the exact scope of the duty has been the subject of debate for some time.

In this case, the debate focussed on whether the duty of good faith was essentially an obligation to act fairly or whether there was a higher threshold.

When an employer is exercising a power under the rules which gives it an unrestricted discretion, it is entitled to take its own interests into account – the test applied by the Court to determine whether the employer has breached its duty of good faith was whether its decision was irrational or perverse. Importantly, the duty of good faith does not require an employer to arrive at a decision which is substantively fair.

Although many of the points addressed in the case are very fact specific, one issue of more general application is whether an employer must have regard to members' interests and expectations.

The Judge concluded that members' interests and expectations may be relevant when considering whether an employer has acted irrationally or perversely. There may be circumstances where the employer might breach the duty by overriding expectations which it had itself created. However, the fact that the employer is

entitled to have regard to its own interests when making decisions severely limits the circumstances in which the exercise of the employer's discretion will be irrational or perverse.

As such, as in this case, members' expectation that a particular increase practice will continue to be followed, based on longstanding practice, will not be sufficient to give them the right to insist that it continues.

MORE INFORMATION ON THE HASTINGS-BASS ISSUES

The rule in *Hastings-Bass* had been understood to mean that where trustees exercise a discretion but the effect of doing so is different from what they had intended, the Court will intervene where it is clear that they would not (or in some cases, might not) have acted as they did had they not failed to take into account relevant considerations or had they not taken into account irrelevant considerations. The *Hastings-Bass* decision allowed the exercise of the discretion to be declared void – giving an opportunity for past decisions to be revisited.

Following *Pitt v Holt* and *Futter v Futter*, it is now vital that members are able to prove that the trustees had acted in breach of their fiduciary duties. This is now a necessary step before *Hastings-Bass* can be invoked to try to have past decisions set aside.

So, are trustees in breach of their duties if they do not appreciate the full extent of their powers?

Although trustees must clearly familiarise themselves with the rules of the scheme and the powers they hold, the extent to which they are required to understand the scope of particular powers will depend on the circumstances – the underlying question is whether the trustees have acted with reasonable care and skill.

One of the issues in the Prudential case was whether the trustees had taken into account the full extent of their powers – and if they had not, would that have been a breach of fiduciary duty? The Judge concluded that there had been no breach of duty on the part of the Prudential trustees. The principles adopted by the Judge in coming to this conclusion should apply generally to the decisions trustees make in exercise of their powers.

The Judge said that if trustees are minded to act in a particular way, they have a duty to clarify whether they have the power to do so. But there is no need to embark on unnecessary investigations to clarify the scope of powers where that would not serve any practical purpose.

Trustees may be disappointed that *Hastings-Bass* is no longer available to enable them to revisit decisions they have made which have had an unexpected effect – and is instead now only a tool for beneficiaries seeking to attack decisions. However, trustees can take some comfort from the Court having taken a pragmatic and reasonable view of what trustees are (and are not) required to investigate before they exercise their powers.

If you would like more information, please get in touch with your usual contact at Mayer Brown.

Philippa James

Partner, Pensions Group

+44 20 3130 3700

pjames@mayerbrown.com

Stuart Pickford

Partner, Litigation and Dispute Resolution Group

+44 20 3130 3967

spickford@mayerbrown.com

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