Newsletter

BURGES SALMON

Pensions

May 2014

Welcome

Welcome to Pensions, our bimonthly newsletter keeping you informed of developments in pensions law.

To find out more about how we can help you with pensions issues, please email richard.knight@burges-salmon.com or call him on 0117 939 2259.

In brief

Legal

Interpretation has limits

There are limits to how far the legal rules about interpreting documents can stretch. After a number of judgments where the High Court has rescued flawed scheme documents by applying the rules liberally, the Court of Appeal has taken a firm line in the recent *Honda* case. The decision could act as a check on liberal reading.

Duties of good faith breached

The High Court has found that IBM breached its *Imperial* duty of good faith to members when it closed two DB schemes to future accrual and withdrew favourable early retirement terms. The breach was that the changes thwarted *"reasonable expectations"* about the future of the schemes that IBM had engendered in the members.

This is the first time a breach of this duty has been found on a closure exercise.

The court also found IBM breached its separate contractual duty of trust and confidence to the members as employees. These breaches lay in the way it presented proposals for elements of pay to be non-pensionable and the manner in which it consulted about all the changes.

Put simply, it was not the changes that were unlawful but the manner in which they were made.

Definitions of DC benefits

The final transitional regulations accompanying the new definition of DC benefits are about to be published. They will come into force in July. Generally speaking, their effect will be to apply the new definition prospectively (only) from the date they come into effect. Schemes will not be expected to review actions taken since July 2011 as the draft regulations proposed in certain areas.

Pensions on asset sales

From 6 April the conflict between the auto-enrolment requirements and the protection for pensions on sales of businesses (and like transactions) has been resolved. In many cases, the new owner will now need to contribute only the auto-enrolment minimum.

Auto-enrolment

The DWP has identified the categories of jobholder employers will not be required to auto-enrol e.g. those about to leave their jobs or retire, and those who have cancelled their membership after being enrolled contractually. These exceptions will be created under powers in the Pensions Bill.

Tax

Tax rules and scheme rules

New flexibilities allowed by the Budget are available to members and trustees only if scheme rules also allow them. During the current transition to the initial set of relaxations and again from April 2015, what scheme rules say will be in the spotlight.

PPF

PPF levy

It is correct to read the rules on the risk-based levy strictly even if the outcome appears harsh.The courts have backed the PPF on this twice recently. At the end of May, the PPF will issue a consultation about its new insolvency scoring system with Experian.

Policy

DC quality standards

The DWP is consulting about proposals to improve the quality of DC schemes, particularly in relation to cost. The measures will be mandatory and will to come into effect in two main stages, April 2015 and April 2016. They will apply to occupational and personal pension schemes (PPSs) used for auto-enrolment. PPSs will be required to have an independent governance committee (IGC) exercising oversight and acting in members' interests.

EU pensions directive

The European Commission's proposals for revisions to the EU's pensions Directive concentrate on governance, communication and risk management, on all of which the UK is some way down the road. As expected, funding is largely untouched but otherwise this is a full overhaul. The revised text has four times as many Articles and they go into a lot more detail.

continued overleaf

Legal

Interpretation has limits

There are limits to how far the legal rules about interpreting documents can stretch.

After a number of judgments where the High Court has rescued flawed scheme documents by applying the rules liberally, the Court of Appeal has taken a firm line in the recent *Honda* case. The decision could act as a check on liberal reading.

The *Honda* case now comes as a reminder that there are limits on how far the courts will go. The Court of Appeal has agreed with the original judgment that a deed of participation expressed to *"… extend… the benefits of the Scheme…"* to a new employer's workforce meant they would enjoy the scheme's existing benefits and not a new, lower scale the employer had planned to provide.

An announcement setting out the lower scale had been issued. But it was not attached to the deed of participation and the deed did not otherwise specify the intended benefits. These were not formally documented in the scheme rules until several years later.

The Appeal Court held that the rules on interpretation would not stretch to finding that the deed of participation created a new section of membership with lower benefits.

Rectification

Interpretation involves looking at the terms of a document. Where it fails in a case like this, one option for a party unhappy with the result is to look at whether it can persuade a court to "rectify" the document. This involves examining evidence outside the document.

The argument is that the document fails to reflect the common intention the parties at the time they signed it. There needs to be objective evidence of this common intention. Whether an application for rectification succeeds generally depends on being able to find (often long after the event) enough compelling evidence.

Unless there are further moves in court, the scheme will need to be administered on the footing that all members earned the higher scale of benefits until the lower scale was eventually included in the rules.

Duties of good faith breached

Duties of good faith

The recent *IBM case* was about the employer's duties of good faith (or trust and confidence) and whether a power to exclude members could be used to close to accrual.

Imperial duty

The High Court found that IBM breached its *Imperial* duty of good faith to members when it closed its DB schemes to future accrual and withdrew favourable early retirement terms.

The breach was that the changes thwarted *"reasonable expectations"* IBM had engendered in the members by what it said about the future conduct of the schemes during earlier cost-reduction exercises.

The *Imperial* duty (named after a case) is a duty about how an employer exercises its powers under its pension scheme.

This is the first time a breach of this duty has been found on a closure exercise.

Contractual duty of trust and confidence

The court also found IBM breached the separate contractual duty of trust and confidence it owed to the members as employees. These breaches lay in the way it presented staff with non-pensionability agreements and the manner in which it consulted about the package of changes.

In their original form, the non-pensionability agreements said employees would not receive any future pay increases unless they agreed to them being excluded from pensionable pay.

During the consultation IBM withheld certain information for tactical reasons and, to the judge's mind, did not consult in an open and transparent manner.

Simply put, in relation to both duties it was not the changes themselves that led to the adverse ruling, but the manner in which it they were made.

Same terms, two duties

The judge recognised the two duties - *Imperial* and contractual - can be stated in the same terms: *"an employer should not without reasonable and proper cause conduct himself in a manner calculated or likely to destroy or seriously damage the relationship of trust and confidence between employer and employee"*. But he emphasised that their content can be quite different.

Power to exclude

The second issue was whether IBM was entitled to use a power to exclude people from membership of the schemes as a way of closing them to future accrual. This was a question of construction. The power said the employer *"may by notice in writing to the Trustee direct that any specified person or class of persons shall not be eligible for membership, or shall cease to be a member or members".* The court accepted the active membership counted as a *"specified … class of persons"*, so the power could be used to end accrual. This broad interpretation will be welcomed by employers.

However, on the facts of the case, the power had to be read subject to a *Courage* style restriction because it had been introduced into the rules by an exercise of the power of amendment with such a fetter. *Courage* restrictions require that past service accrual continues to be linked to members' final pay when their service eventually ends.

The case has further to go. An appeal is thought likely. Even without one, there will be a further hearing to decide the remedies (e.g. damages or the unwinding of actions).

Derisking exercises

The case has given substance to the *Imperial* duty and illustrated how the contractual duty of trust and confidence can operate in the pensions context. Employers in particular but also trustees need to consider what constraints these duties might impose on any derisking exercise they engage in. The steps IBM took - closing to accrual and issuing contracts capping pensionable pay - are after all commonplace now.

Communication needs careful thought too. It was a stumbling block twice for IBM - reassuring statements on earlier exercises created *reasonable expectations* ready to be dashed and the consultation exercise proved to be less than an open minded engagement.

There is considerably more detail to extract from this case. We will return to it in a future briefing.

Definition of DC benefits

As we go to press, the final transitional regulations accompanying the new definition of DC (or money purchase) benefits are about to be published. They will come into force in July.

The new definition makes clear benefits are only DC if there cannot be a deficit. It is being introduced with retrospective effect to 1 January 1997 (sic), subject to transitional arrangements.

The final regulations will be substantially different from the draft. Generally speaking, their effect will be to apply the new definition prospectively (only) from the date they come into force. Schemes will not be expected to review actions taken since July 2011 as the draft regulations proposed in certain areas.

It appears the new definition will not apply to schemes already in wind-up.

The Government's response to the consultation on the draft regulations will be published at the same time. This will explain the policy thinking behind the changes.

Pensions on asset sales

From 6 April the conflict between auto-enrolment requirements and the protection for pensions on sales of businesses (and like transactions) has been resolved. In many cases, the new owner will now need to contribute only the auto-enrolment minimum.

This is helpful for employers.

Until now the pensions protection on transactions subject to the TUPE regulations has often demanded more than the auto-enrolment minimum going forward.

The TUPE regulations transfer employees' contracts of employment from the seller of a business to the buyer. They do the same on outsourcings and on transactions like the transfer of a business within a group of companies.

There is no change in the pensions protection where the new employer offers a DB occupational scheme for future service. Briefly, the scheme must be contracted-out or provide benefits to a value of 6% of pensionable pay plus the member's contributions. Or the new employer can match the member's contribution up to 6% of basic pay.

The change is where the new employer's scheme is an occupational DC or stakeholder scheme. The employer can either:

- as before, match the member's contribution up to 6% of basic pay or
- this is the new part - if the old employer was obliged to contribute (e.g. under auto-enrolment) and all its contributions (ignoring additional contributions paying for DB life cover) went to provide DC benefits, the new employer need contribute only the same as the old employer. For example, this allows it to match what the old employer was paying during the phasing in of auto-enrolment contributions.

In its response to the consultation on these amendments, the DWP makes clear it was never intended that the regulations setting out this protection should create a right for transferred members to select their own contribution rate in the new scheme.

Auto-enrolment

When it becomes law, the Pensions Bill (currently in its final stages in Parliament) will give the Government powers to stipulate categories of jobholder employers need not auto-enrol. Following public consultation the DWP has said it will exclude those:

- with protected tax status e.g. enhanced protection,
- on verge of leaving their job e.g. have given notice,
- about to retire and
- who have cancelled their membership after being enrolled contractually.

There are no plans to exclude:

- those in serious ill health,
- non UK residents or
- new starters, or short term or casual hires.

Nor are there plans to create an easement allowing groups with multiple employers to align their staging dates.

Interpretation: judges at work

If you are interested in more detail of how interpretation works, here is a neat summary by one of the Appeal Court judges in the *Honda* case:

"The task is to determine what the words of the instrument, read against the relevant background, would have meant to a reasonable reader. It is an iterative process in which possible meanings are checked against their likely consequences and the background facts. If the language is reasonably susceptible of two or more meanings, the court should choose that which best serves the object or purpose of the transaction, objectively ascertained. Any interpretation must, so far as possible, be one that is not impractical or over-restrictive or technical in practice.

But three further points are of importance in this case. First, the question is not what the parties meant to say; but what is the meaning of what they did say. Second, the language that they used is likely to be the most important factor, unless the court

can conclude that something has gone wrong with the language. Third, where the parties have themselves defined their own terms, the court must give effect to those definitions."

Other, more technical statements of the process are available

Tax

Tax rules and scheme rules

HMRC is publishing occasional bulletins about how far the measures announced in the Budget can be acted on pending changes to tax legislation through the Finance Bill.

The latest update was published on 24 April: **http://www.hmrc.gov.uk/pensionschemes/pensionflexibility.htm**

This is only part of the story, however, because the legislative changes will not in general override scheme rules. Schemes will need to ask whether their rules allow members to take advantage of the transitional arrangements. Similarly, where legislation allows trustees to make payments without member consent (e.g. commutation up to £10,000), they need to check whether their rules give them power to do so.

Sometimes a widely worded rule allowing discretionary benefits might be sufficient to allow a transaction to go ahead. Any consents the rule requires would need to be obtained (from the principal employer, say). Otherwise rules will often need to be amended.

Looking at the wider options proposed from April 2015, some employers and trustees might have reservations about allowing

members the full range of choice. This might be because of the potential administrative work or because it is seen as incompatible with an scheme designed for retirement saving. But if a scheme is restrictive, members could simply transfer out.

This looks like the flexible retirement debate, only writ much larger.

Meanwhile we await decisions on how far, if at all, tax legislation will allow the new options in DB schemes.

One way and another, what scheme rules say, or do not say, will be in the spotlight in the next couple of years.

PPF

PPF levy

In two recent cases the courts have backed the PPF in its strict interpretation of its levy rules. In rejecting a levy payer's appeal, one judge commented: *"I am not concerned with the fairness of this result, but merely its correctness".*

On the other hand, the PPF argues that, because its rules are published and apply to all affected schemes, the only way to be fair all round is to operate them to the letter.

The action point for employers and trustees is to read each year's levy rules carefully in order to be in a position to achieve the best outcome.

There is an added incentive for 2015/16 because the switch to Experian for insolvency ratings could mean more changes than usual.

The PPF normally issues a consultation draft of its rules in September and the finalised rules in December.

Read on if you would like more detail about the two cases.

Year apart

One case involved two risk measurement dates a year apart and a corporate restructuring that took place in-between.

The rules on contingent assets for levy year 2011/12 specified March 2010 as the date for measuring a multi-employer scheme's *risk profile*, including identifying its statutory employers. But the date stipulated for measuring *risk reduction* was March 2011.

During the year, the scheme was reorganised from one with a dozen participating employers with moderate covenants to one that had a single employer (the principal employer) with a much stronger covenant. Aiming to reduce the levy, the principal employer put up a contingent asset guarantee covering the liabilities of the original dozen.

The PPF refused to recognise the guarantee because, as at the date for measuring risk reduction, the principal employer was no longer associated (in the necessary sense) with any of the employers' whose liabilities it purported to guarantee. This relationship is one of the formal requirements for a contingent asset guarantee.

The insolvency risk associated with the scheme was substantially reduced at the start of the new levy year, but the levy rules did not recognise the fact. This particular sequence of events cannot now be repeated because the rules have changed.

D&B overseas

In a separate case we have reported before, a Luxembourg company's failure score was worse than it might have been because it was based on old company accounts.

The court rejected a challenge to the resultant levy because, unlike the UK arm of D&B, its Luxembourg branch did not proactively collect accounts. Rather, its practice was to rely on the last accounts a company had sent in. Under the clear terms of the levy rules in relation to overseas entities, those were indeed, the court recognised, the correct accounts to use for the failure score.

Insolvency risk consultation

The PPF has confirmed plans to move to a scoring system for insolvency risk that is tailored to the sponsors of the schemes it protects. It believes the new system, provided by Experian, will measure the specific risks it faces more accurately than the generic model used in the past, and that it will provide greater transparency for levy payers.

At the end of May the PPF plans to publish a consultation about how the new model will work, how existing insolvency ratings will change and how levies might be affected.

Policy

DC quality standards

The DWP is consulting about proposals to improve the quality of DC schemes, particularly in relation to cost. The measures will be mandatory and will to come into effect in two main stages, April 2015 and April 2016.

The proposals cover occupational and personal pension schemes used for auto-enrolment.

April 2015

- Minimum governance standards will be required of trustees of occupational DC schemes and of new independent governance committees (IGCs) set up for workplace personal pension schemes.

  IGCs will be composed mainly of people independent of the provider. They will exercise oversight of the scheme and have an explicit duty to act in members' interests.

  They and trustees will have a statutory brief with a focus on the performance (including cost) and suitability of their scheme's default fund for auto-enrolled members. They will report annually to members on how well the scheme has done against the statutory quality standards.

  The requirements over costs begin a move towards more transparency that will be taken further in future.

  IGCs will be mandated under FCA rules and be required to report problems to the provider's board of directors (which will have a comply or explain obligation). Unresolved issues can be escalated to the FCA and through publicity.
- A charges cap of 0.75%, to include all member-borne deductions other than transaction costs. The cap will apply to deferreds as well as actives.
- The ban on consultancy charging will be extended to older schemes (established before May 2013) currently outside it.

April 2016

- A ban on active member discounts and similar charging structures.
- A ban on all member-borne commission.

Further ahead

- Providers to make full disclosure of all costs (including transaction costs) each year in a standardised format. The details of this will be subject to a later consultation.

The current consultation closes on 15 May.

EU Pensions Directive

The European Commission's (EC) proposals for revisions to the EU's main pensions Directive (the IORP Directive 2003/41/EC) concentrate on governance, communication and risk management. As expected funding is largely untouched, but otherwise this is a

full overhaul. The revised text has four times as many Articles and they go into a lot more detail.

No change

For day-to-day purposes, no major changes are proposed in these areas:

- technical provisions and scheme funding - as expected, no changes following the dropping of the Solvency II style proposals,
- cross-border schemes - there is no relaxation in current full funding requirements, contrary to some speculation before the draft revisions emerged. Home state investment rules will apply to a scheme operating cross-border, or
- investment - where the "prudent person" standard remains the cornerstone.

Changes

Material changes are proposed here:

- extensive and detailed governance requirements including a fit and proper person test for trustees and those carrying out key functions (risk management, internal audit and actuarial), the definition and conduct of those functions, documented risk assessment and a clear remuneration policy,
- wide-ranging requirements over the information to be given to members and how it is delivered. An annual benefit statement for all members in a standard EU-wide format is at the centre, and
- some 20 Articles detailing standards for EU member states' prudential supervisory systems for occupational schemes.

UK position

The impact on the ground in the UK could be fairly limited. Many of the themes new to the Directive have become familiar here over the last decade.

The proposed deadline for implementation in UK law is the end of 2016. But that may depend how fast the EU legislative process goes.

The EC does not provide an impact statement. But using estimates of cost in the EC briefing papers, the NAPF calculates the implementation cost for UK private sector at a one-off £328m, followed by a recurrent annual £7.5m.

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