Pensions Case Law

Update

Welcome

This is the Linklaters Pensions Dispute Resolution Group's Case Law Update.

The aim of this publication is to provide a look back and commentary on recent cases that have come before the courts and that are relevant and interesting.

Please do not hesitate to get in touch if you would like to discuss any of the issues mentioned below or indeed any contentious issues on which the Linklaters Pensions Dispute Resolution Group may be able to assist.

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Do trustees of occupational pensions schemes owe duties to the sponsoring employer?

Key points:

> Trustees of an occupational pension scheme do not owe fiduciary or equitable duties to the sponsoring employer, but may have regard to the interest of sponsoring employers.

> Trustees must not subordinate their primary duty to the beneficiaries to any other interests.

“Trustees must not…subordinate their primary duty to the beneficiaries to any other interests”

In *KeyMed (Medical & Industrial Equipment) Ltd v Hillman and Woodford*, the High Court rejected a claim that two former directors had conspired to maximise the value of their pensions at the expense of their employer.

The main allegation against the directors was that they had breached various duties owed to their employer by establishing an executive pension scheme, independent of the main occupational pension scheme, to improve the security of their benefits. In doing so, it was alleged that they had breached fiduciary duties owed to the sponsoring employer of the occupational pension schemes and their directors' duties set out under the Companies Act 2006.

It was also alleged that the defendants had disapplied certain Inland Revenue limits and removed a young spouse reduction provision to improve their own benefits, and that they had adopted an unnecessarily conservative funding strategy to increase the security of their benefits and produce larger transfer values for their pensions.

Following a four-week trial, Marcus Smith J dismissed all of the employer's claims. In his judgment, he said that trustees of occupational pension schemes do not owe a "fiduciary or equitable duty" to the sponsoring employer. They owed such duties only to the members and other beneficiaries.

The judge gave an example from the scheme rules to illustrate the risk of dividing the trustees' loyalties. The trustees were required to set the level of the employer's contributions, and in doing so they had to consider whether to seek high contributions and risk the employer's insolvency, or seek low contributions and risk creating a deficit that would not be filled. He decided that the trustees could *"only serve one master"* and should seek to serve the interests of the beneficiaries in such a context. The court would not create conflicts of interest for trustees without good reason.

However, the judge did acknowledge that it is not improper for trustees to have regard to the interests of the employer. Such interests may be considered even if the beneficiaries of the scheme are indifferent to those interests. The trustees must not, however, subordinate their primary duty to the beneficiaries to any other interests.

The employer's claims that the defendants had breached their directors' duties also failed. The decisions to establish the executive pension scheme and remove the relevant Inland Revenue limits had been honestly and properly made, and the directors had properly declared their interests at the relevant meetings.

The Court did not agree that the defendants had adopted an unduly conservative investment strategy. The approach had minimised the risk of a shortfall, had been advantageous to scheme members, was applied to both the executive and main staff pension schemes and was continued by subsequent trustees. Marcus Smith J held that *"the mere fact that a conservative investment and funding strategy is being followed in no way justified an inference of impropriety or breach of duty towards the scheme".*

This decision provides guidance on the duties of trustees, although in the context of quite unusual factual circumstances. The comments about the trustees' "discretion" to consider the employer's interests have a different emphasis from the first instance decision in *British Airways v Airways Pension Scheme Trustee*. In that case, Morgan J decided that the trustees had a "duty" to take account of all relevant factors, including the interests of the employer. It therefore seems likely that the relationship between trustees and the sponsoring employers of occupational pension schemes more broadly will be considered by the courts again in the future.

When will transitional arrangements in pension reforms constitute unlawful age discrimination?

Key point:

> Transitional arrangements in relation to changes to firefighters' and judges' pensions were age discriminatory as they did not meet a legitimate aim and therefore could not be objectively justified.

"There was [no] rational justification for the transitional arrangements"

The Court of Appeal has considered the transitional arrangements introduced to the firefighters and judges' pension arrangements in *Lord Chancellor v McCloud and Mostyn; Sargeant v London Fire and Emergency Planning Authority*. The Court heard the firefighters' and judges' cases together because of the similarities in the relevant provisions.

In both cases, new career average pension schemes were introduced in 2015 to replace old final salary pension schemes. The new schemes provided less valuable retirement benefits, including less favourable accrual rates and later retirement ages.

The changes made to both schemes also included similar transitional arrangements. Active members within 10 years of normal pension age on 1 April 2012 remained in the old final salary pension schemes, whilst active members between 10 and 14 years of normal retirement age on 1 April 2012 were given tapered protection from the changes. Those who were more than 14 years from normal retirement age on 1 April 2012 were given no protection from the changes and were transferred directly to the new schemes. Benefits already accrued under the old schemes were protected for all members.

It was accepted in both cases that the transitional arrangements treated younger members less favourably because of their age and so were potentially age discriminatory. However, the question for the Court was whether the arrangements were nonetheless *"a proportionate means of achieving a legitimate aim"* which would render them lawful under the Equality Act 2010. Equal pay and indirect race discrimination claims were also brought in both cases, as the older cohorts of firefighters and judges included fewer women and members of ethnic minorities.

The Employment Appeal Tribunal had previously found against the government in both cases. It decided that, although the government had established a legitimate social policy aim in seeking to protect those closest to retirement, the transitional arrangements were not a proportionate means of achieving that aim. The Court of Appeal dismissed the government's appeals, but for different reasons.

Where there is alleged discrimination, the Court of Appeal considered the government should be given a margin of discretion to achieve its policy aims. However, it is for a court to determine the appropriate margin of discretion on a case-by-case basis and an objective assessment of the circumstances is required. The Court of Appeal did not agree that there was a rational justification for the transitional arrangements on the basis of the government's stated aim of protecting those closest to retirement.

The government had argued that the oldest scheme members would be least able to re-arrange their financial affairs. However, the court noted that those members closest to retirement would also be the least affected by the reforms, as rights already accrued under the final salary schemes were protected. Arrangements that are potentially age discriminatory must be objectively justifiable based on robust economic evidence, and such evidence had not been provided in this case.

As the Court of Appeal did not consider the government's aim to be legitimate, it did not need to consider whether the transitional arrangements were a proportionate means of achieving it. The court also did not need to consider the equal pay and indirect race discrimination claims further.

The decision is expected to have significant implications for the government, as several other public-sector pension schemes are understood to have similar transitional arrangements. However, the case also is also relevant to private sector employers and trustees, who should consider the case carefully when implementing transitional measures in relation to benefit changes.

Do employees dismissed on the grounds of ill health automatically qualify for an ill health early retirement pension?

“The Trustee had to…[make] its own determination on eligibility”

Key points:

> When considering claims for ill health early retirement benefits, pension scheme trustees may make their own assessment of a member's health and ability to work.

> A member who is considered incapacitated under their employment contract will not always be entitled to ill health benefits from their pension scheme,

In *Universities Superannuation Scheme Ltd v Scragg*, the High Court ruled that trustees may come to their own conclusions on a member's entitlement to ill-health early retirement (IHER) benefits and they are not bound by the conclusion reached by the employer.

Mr Scragg had been employed by Dundee University until his dismissal on the grounds of ill health in December 2016. As a member of the Universities Superannuation Scheme (USS), he applied for an IHER pension. Under the scheme rules, members were eligible for IHER pensions if:

> their employer found that they were suffering from incapacity; and

> the USS Trustee found that they were either partially or totally incapacitated.

The USS Trustee found that Mr Scragg was not incapacitated at a total or partial level and rejected his application.

Mr Scragg complained to the Pensions Ombudsman, who found in his favour. The Ombudsman decided that the Trustee's role was only to determine whether the member was totally or partially incapacitated, and not to consider whether he was incapacitated at all, as that determination had already been made by the employer. The Trustee appealed to the High Court.

The High Court upheld the Trustee's appeal and rejected the Ombudsman's interpretation of the scheme rules. The Trustee was not bound by the employer's decision as to whether Mr Scragg suffered from incapacity, and it could determine for the purposes of the USS whether he suffered from total or partial incapacity or no incapacity at all.

The Court ruled that the employer's view on incapacity *“may well be an important element of the evidence”* considered by the Trustee, but the weight given to that element will depend on the quality of the evidence provided by the employer and the member. The judge reviewed the process set out in the scheme rules under which medical evidence was to be considered by the Trustee, and concluded that that process was inconsistent with an interpretation of the rules which did not allow the Trustee to reach is own conclusion on incapacity.

The judge also noted the balance between the interests of Mr Scragg's employer and those of the body of funders of the large multi-employer pension scheme. In such a context, although an individual employer may support an employee's application for IHER benefits (as Dundee University did in Mr Scragg's case), they would only bear a very small proportion of any burden for increased contributions. The Trustee had to safeguard the assets of the scheme overall, and it could do so only by making its own determination on eligibility for enhanced IHER pensions.

The Court also rejected an attempt by Mr Scragg to raise additional arguments challenging the Trustee's assessment of the medical evidence. This argument had not been raised as part of the Trustee's internal dispute resolution procedure, and the Pensions Ombudsman had not ruled on it. The High Court found that to allow a member to raise additional arguments before the Ombudsman or on appeal would be contrary to the dispute-resolution framework set out in the pensions legislation.

The relevance of this case to other schemes will depend on the wording in their scheme rules. However, where trustees are to assess whether a member is incapacitated following a decision by the employer, this makes clear that they are able to reach a different decision to that of the employer. The case is also a useful reminder that a decision under the IDRP is usually required on a matter before the Pensions Ombudsman will investigate the complaint.

How should pension scheme rules be interpreted?

> “
> RPI had to be replaced…before the trustees could adopt the replacement
> ”

Key points:

> On the wording of the Barnardo's scheme rules, there was no power to change from RPI to CPI.

> The primary focus in interpreting pension scheme documents should be on textual analysis, rather than the background factual circumstances.

In *Barnardo's v Buckinghamshire*, the Supreme Court looked at whether the wording of the relevant scheme rules allowed a switch from RPI to CPI as the index for calculating pension increases. Both the High Court and Court of Appeal had previously decided that the Rules did not permit such a switch.

The scheme rules provided for pensions in payment to be increased by reference to the Retail Prices Index, which was defined as *"the General Index of Retail Prices published by the Department of Employment or any replacement adopted by the Trustees without prejudicing Approval"*. The question was whether this meant that:

> RPI had to be replaced by the official body responsible for its publication before the trustees could adopt the replacement; or

> the trustees could choose another index as a replacement for RPI, whether or not RPI continued to be published.

Upholding the earlier decisions of the High Court and the Court of Appeal in this case, the Supreme Court decided that the first interpretation of the scheme rules was correct. RPI had to be replaced by the official body responsible for its publication before the trustees could adopt the replacement.

In reaching this decision, the court set out the approach which should be used in construing pension scheme documents, which differed in some respects to certain previous decisions. The court noted that a pension scheme has several distinctive characteristics, which are relevant when interpreting the rules. These include that:

> the rules are a formal document prepared by specialist legal draftsmen;

> the rules are not the product of commercial negotiation;

> unlike most commercial contracts; the rules are designed to operate for the long term;

> the rules confer important rights on parties who have no involvement in the drafting, including the members of the scheme; and

> members of the scheme may not have easy access to expert legal advice.

As a result of these factors, the court considered that there should be a focus on textual analysis, rather than the background factual circumstances (of which members may not have been aware).

This case adds to a growing list of court decisions on RPI and CPI and will be of interest to schemes and employers considering whether their scheme rules permit a switch from RPI to CPI. However, it will also be relevant when considering the approach to take to interpreting pension scheme documents more generally.

Do trustees need to equalise benefits in respect of GMPs?

Key points

- > Trustees are under a duty to equalise benefits for the effect of GMPs.
- > There is a default methodology which trustees will need to use, unless the employer gives its consent for a different methodology.
- > There are still a number of unanswered questions about equalisation, which trustees will need to consider.

“trustees are under a duty to equalise benefits for the unequal effect of GMPs between men and women”

On 26 October 2018, the High Court handed down its judgment in *Lloyds Banking Group Pension Trustees Limited v Lloyds Bank PLC*, and confirmed that trustees are under a duty to equalise benefits for the unequal effect of GMPs between men and women. The question of whether (and, if so, how) schemes need to equalise for GMPs had been unclear for many years. The Court has now answered at least some of the questions.

The Court highlighted that there are two key causes of inequality in GMPs:

- > there are different pensionable ages for GMPs: 60 for women and 65 for men; and
- > the formula for calculating post-88 GMP means it generally accrues more quickly for women.

These factors mean that, even if the total pension amount for a male and female is the same at their date of leaving service, it can diverge and become unequal over time. This is due to different rates being used for revaluation and pension increases for GMP and non-GMP pension.

The Court considered a number of different methods for equalising GMPs. The Court confirmed that the minimum required to achieve equality would be to carry out a year-by-year calculation of the pension the member would receive under existing provisions and the pension they would receive had they been of the opposite sex. The scheme must pay the greater of the two calculations. If the year-by-year comparison switches from favouring one sex to the other, the scheme must then pay the less generous amount, until the accumulated gains prior to the switch are equal to the accumulated losses after the switch. At this point the scheme must revert to paying the higher of the male and female benefit each year. Interest from the date of payment to the date of calculation is allowed for when looking at accumulated gains prior to the switch and losses since the switch. (This method is referred to in the judgment as method C2.)

However, the Court also confirmed that the trustees and the employer could agree to convert GMPs to non-GMP benefits using the GMP conversion legislation. This would involve identifying whether the actuarial value of the member’s future unequalised benefits is less than the actuarial value of the future unequalised benefits that would apply to a member of the opposite sex and providing post-conversion benefits based on the larger of the compared values (and which are the same for men and women) into payment. (The Court referred to this as method D2)

For members who have already retired, trustees are obliged to make back-payments – potentially going back to 17 May 1990. However, this will depend on the rules of the relevant scheme. If a scheme limits back-payments to six years (or gives the trustees discretion to apply such a limit), this limit can be applied. Where back-payments are made, simple (as opposed to compound) interest should be paid at the rate of 1% above base rate.

A further hearing is expected later this year to address questions on how historic transfers-out should be dealt with. In addition, DWP has recently issued guidance on GMP conversion and further guidance is expected from HMRC on tax issues which could arise.

The decision provides some of the answers to the long-running issue of GMP equalisation, but there are a number of areas where uncertainty remains. Trustees will need to consider these areas carefully when deciding how to implement GMP equalisation in their schemes.

When can trustees change from RPI to CPI?

“

Whether RPI has ‘become inappropriate’…is a question of objective fact

”

Key points:

> Whether RPI has “become inappropriate” for pension increases is a matter of objective fact.

> RPI has not ‘become inappropriate’ as a result of being de-designated as a national statistic and the formula used being frozen.

The Court of Appeal has handed down its judgment in another RPI/CPI case, *British Telecommunications plc v BT Pension Scheme Trustees Limited*. As with the *Barnardo's* case, the Court decided that the Rules did not currently permit a change from RPI to CPI.

The Court considered the meaning of two forms of wording. The first form of wording allowed for a switch if RPI *“becomes inappropriate”*, while the second allowed for a switch if RPI is *“so amended as to invalidate it in the view of the Principal Company as a continuous basis for purposes of calculating increases”*.

In relation to whether RPI had “become inappropriate”, the High Court had previously decided that:

> BT does not have the power to determine whether RPI has “become inappropriate” – instead, it is a question of objective fact and, in the absence of agreement between the employer and the trustee, is to be determined by the Court;

> in order for RPI to have “become inappropriate”, RPI must have become inappropriate (and not just less appropriate than any alternative index) for the purposes of calculating pension increases payable to scheme members; and

> the de-designation of RPI as a national statistic, the decision by the UK Statistics Authority to freeze the formula used to calculate RPI and the impact on the formula effect (which causes RPI to be consistently higher than CPI) of a change to the collection and use of clothing prices in 2010 did not make RPI in appropriate.

On the question of whether RPI had been *“so amended as to invalidate it in the view of the Principal Company as a continuous basis for purposes of calculating increases”*, the High Court decided that the scope of the wording is significantly narrower than the “becomes inappropriate” wording considered above: the rule is not engaged at all unless there has been an amendment to RPI (i.e. a direct change to the way RPI is calculated). Further, the rule requires not just any amendment, but an amendment which invalidates RPI as a continuous basis for the purposes of calculating increases. The High Court did not consider the events listed above, either by themselves or in combination, to be sufficient to permit the employer to form the view that RPI had been amended so as to invalidate it as a continuous basis for calculating pension increases.

On both of these questions, the Court of Appeal agreed with the High Court's interpretation of the rules. The Court of Appeal also considered that the High Court was entitled to conclude that the clothing change, the freeze and the de-designation did not mean that RPI had "become inappropriate" or that RPI was invalidated as a continuous basis for the purposes of calculating increases.

This case is another in the growing list of cases where the Courts have found that a change from RPI to CPI was not permitted by the relevant scheme rules. However, as with all of the RPI/CPI cases, the outcome turned on the interpretation of the relevant scheme's rules, so the case will only be directly relevant to schemes with the same form of wording in their rules.

How should old Inland Revenue limits be applied to members' benefits?

Key points:

> Where a statutory power is the only means by which rules can be amended but is not expressly referred to in the deed of amendment, the Court will assume that the Trustee intended to exercise the statutory power so that the deed is valid.

"It was not necessary to have evidence of a positive intention to exercise that specific power"

In *Coats UK Pension Scheme Trustees Ltd v Styles*, the High Court considered an appeal against decisions from the Deputy Pensions Ombudsman by members of the scheme.

The members claimed that they were entitled to increases of 5% per annum, as the scheme rules provided this. Until 6 April 2006 ("**A-Day**"), the scheme was subject to Inland Revenue limits, which limited the increases to the higher of RPI and 3%. The members argued that, as from A-Day Inland Revenue limits no longer applied, although transitional provisions meant that they were not entitled to increases of 5% until the rules were amended on 4 February 2008. The Ombudsman had agreed with the members, ruling that they were entitled to increases of 5% per annum from 4 February 2008.

The Trustee argued that increases were still limited to the higher of 3% and RPI as the rules had been amended to preserve the previous Inland Revenue limits on increases.

In his judgment, Morgan J reviewed the position under the scheme rules and the relevant legislation. In particular, he noted that the scheme rules provided for increases of 5% for this category of members, but also contained a limit on benefits in line with the Appendix of Inland Revenue limits. The notes to the Appendix said that where the Inland Revenue permitted payment of a higher sum than described in the Appendix, the Trustee 'may pay' the higher sum. In 2006, a deed of amendment said that the scheme would operate as if Inland Revenue limits continued to apply until the end of the transitional period in 2011, although the Trustee and Principal Employer could relax those limits. In 2008, a deed was entered into which also said that the previous Inland Revenue limits would continue to apply except where the Trustee and Principal Employer agreed otherwise.

In construing the notes to the Appendix, Morgan J agreed with the Ombudsman that the words saying that the Trustee 'may pay' higher amounts, did not give the Trustee a discretion. Instead, they meant that, where a limit was relaxed, the Trustee was required to pay the higher amount specified elsewhere in the rules. As such, the members would be entitled to increases of 5%.

The 2006 and 2008 deeds had modified the scheme rules so that the Inland Revenue limits permanently applied, except where a decision had been taken to disapply them. The Ombudsman had ruled that the 2008 deed could not make this change as it would be contrary to section 67 of the Pensions Act 1995, which prevents detrimental modifications of benefits. The judge noted that there was an exception to section 67 that would have allowed the change, but the amendment power in the scheme contained a similar restriction on detrimental modifications. However, the judge went on to rule that the amendment had been validly made under section 68 of the 1995 Act. Section 68 gave the Trustee a power, exercisable by resolution, to modify scheme rules to achieve certain specified purposes, including to continue applying Inland Revenue limits until the Trustee and Principal Employer agreed to relax them.

The 2008 deed referred to the amendment power in the scheme but did not refer to section 68 of the Pensions Act 1995, and there was no separate resolution by the Trustee under that Act. However, the judge ruled that, as the deed was executed by the Trustee, this showed that the Trustee must have resolved to enter into the deed and to make the changes described in the deed. In addition, as the power was the only means by which the deed could be given effect, the Court ought to be prepared to assume that the Trustee intended to exercise that power. It was not necessary to have evidence of a positive intention to exercise that specific power; in fact evidence would be needed that the Trustee did not wish to do so for it not to apply.

This case is helpful in confirming that the courts will look beyond the face of a deed of amendment in considering the power used to make the relevant changes. The fact that a deed does not refer to a relevant power, will not prevent a court from finding the deed was made in exercise of that power.

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