CLIFFORD CHANCE

Pensions Newsletter
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UK: Pensions Update

1. TUPE – Procter & Gamble v SCA

A High Court decision last month has provided some clarity in relation to the types of pension benefits that will transfer under The Transfer of Undertakings (Protection of Employment) Regulations 2006 ("**TUPE**"). Broadly, TUPE protects an employee's employment rights on a business transfer by requiring a purchaser to replicate them. However, "*benefits for old age, invalidity or survivors*" ("**Old age benefits**") under an occupational pension scheme do not transfer. Two decisions (**Beckmann** and **Martin**) from the European Court of Justice in 2002 and 2003 ruled respectively that contractual rights relating to redundancy and enhanced early retirement will transfer. Since then there has been some uncertainty as to which rights under an occupational pension scheme transfer under TUPE.

The case concerns the interpretation of certain contractual and statutory provisions in the contract for sale between Svenska Cellulosa Aktiebolaget ("**SCA**") and The Procter & Gamble Company ("**P&G**") which sought to take account of the transfer of certain early retirement benefits ("**ERBs**") in the Procter & Gamble Pension Fund (the "**P&G Fund**") by way of adjustment to the purchase price. The transferring employees who became deferred members of the P&G Fund following the sale lost the benefit of particular enhancements offered on early retirement to active members. These enhancements were, for an active member who elected to retire early after age 55 (subject to the employer consent), a bridging pension paid from retirement to State pension age and an actuarially reduced pension which was more generous for those with 15 years' service.

The parties disputed the level of price adjustment and the extent to which the ERBs in the P&G Fund constituted a liability that would transfer under TUPE. Although P&G offered to deal with the uncertainty generated by the ERBs transfer in the usual way by means of an appropriate indemnity, this was not taken up by SCA.

The court was asked to consider whether the loss of the enhancements to the ERBs was something that P&G can and should be held liable to SCA. The court identified and ruled on the following three issues:-

- *Whether the transferring employees had rights and the transferor obligations, such as to transfer pursuant to TUPE?*

  The court held that whether an entitlement is discretionary (in this case the early retirement pension was subject to employer consent) and may be varied or even terminated unilaterally by the employer, did not remove it from the ambit of "rights and obligations" which TUPE is required to safeguard. The provision for ERBs in the P&G Fund must be treated as a liability which transfers to SCA. However, Justice Hildyard accepted that the right which transferred here was the right to be considered for early retirement. This right was also capable of being valued and could be calculated by reference to the actuarial assumptions referred to in the contract for sale.

- *Whether liability for all ERBs or only liability in respect of the enhancements, transfer under TUPE?*

  This issue concerns the "smiling pensioner" or "double pension issue", that is whether, as a consequence of the operation of TUPE, P&G would be required by the contract of sale to pay SCA the cost of providing duplicate pension benefits when it is already liable to fund the deferred pension in the P&G Fund.

  Justice Hildyard took the view, on the basis of European law, that it cannot have been the intended effect of TUPE that there should be a dual liability to ensure the

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funding of the scheme. Only those rights or benefits comprised within the ERBs which had not already been met in the P&G Fund would transfer over to SCA. Therefore, the only liabilities transferring under TUPE would be the enhancements (the right to be considered for early retirement and the generous reduction factors in respect of qualifying service for the early payment of pension), not the full early retirement benefits. For the avoidance of doubt, he also concluded that the contract of sale should not operate so as to give SCA a windfall profit.

- *What was the scope of TUPE and the meaning of Old age benefit?*

  Justice Hildyard characterised the payment of pension benefits made after normal retirement age ("**NRA**") as Old age benefits even if the pension had originated as an early retirement benefit. Consequently, early retirement benefits could be classed as Old age benefits, and therefore not transfer under TUPE provided they continued to be paid from the same scheme after NRA.

Although this case provides some much needed clarity on which pension rights transfer under TUPE and puts an end to the possibility of a double recovery claim by an employee, there are still some unanswered questions, for example, how might the right to be considered for early retirement where this is subject to employer consent be valued, and indeed how a purchaser would then exercise its discretion when considering whether or not to give consent to members for early retirement.

The decision is expected to be appealed.

2. Seldon

The Supreme Court has ruled in a case regarding age discrimination, providing useful guidance on what aims are likely to succeed as legitimate aims for the purposes of meeting the test for objective justification. In particular, the court has said that a distinction must be drawn between direct and indirect discrimination. Direct age discrimination must be justified by reference to social policy objectives under the European Directive on equal treatment in occupation and law; individual aims relating to the employer's situation, such as cost reduction or an improvement in competitiveness would not, on their own, qualify as legitimate aims.

Mr Seldon was a partner in Clarkson, Wright & Jakes (the "**Firm**") who had been compulsorily retired under the terms of the Firm's partnership deed at the end of 2006, following his 65th birthday. He brought a claim for unlawful direct age discrimination under the Employment Equality (Age) Regulations 2006 (the "**Age Regulations**"), now repealed and replaced by the Equality Act 2010. Age discrimination can be justified if it can be shown that the alleged act of discrimination is a proportionate means of achieving a legitimate aim. The case was appealed repeatedly through the employment tribunals and courts, reaching the Supreme Court earlier this year.

The Supreme Court ruled that the directly discriminatory imposition of a compulsory retirement age of 65 could be justified, on the basis of the legitimate aims of:-

- giving associates the opportunity of partnership after a reasonable period (**staff retention**);
- facilitating partnership and workforce planning (**workforce planning**); and
- limiting the need to expel partners through performance management, thus increasing "collegiality" within the firm (**collegiality**).

In terms of the aims according with the social policy objectives under the Directive, the legitimate aims of staff retention and workforce planning identified by the Firm were directly related to the social policy aim of sharing out professional employment opportunities fairly between generations. The collegiality aim was directly related to the "dignity" aim, that is avoiding the need to dismiss older workers on the grounds of incapacity or underperformance.

The case has been remitted back to the Tribunal to consider whether the Firm's compulsory retirement age of 65 was an appropriate choice of age for achieving the collegiality aim, that there are no other less discriminatory measures which could achieve the same aim.

This case confirms that employers can continue to set a compulsory retirement age provided the age can be objectively justified by reference to their own and public interest needs.

3. The Pensions Regulator issues its first annual funding statement

This statement, aimed at scheme valuations with effective dates between September 2011 and September 2012, sets out the Regulator's view on how defined benefit occupational pension schemes should be funded. By following the guidance set out in the statement, the Regulator expects trustees and employers to reach funding agreements which are acceptable and which will reduce the risk of regulatory involvement.

In summary, the Regulator has adopted a robust approach to funding, believing that most schemes will be able to meet previously agreed plans notwithstanding the challenging economic conditions that currently prevail.

The Regulator expects trustees to base the scheme's technical provisions on prudent assumptions in relation to their assessment of the strength of the employer's covenant, with any changes to a funding arrangement being backed up by "viable contingency plans" which should be properly documented. Trustees should also ensure that the pension scheme is treated fairly alongside other demands on the employer's resources, for example, in relation to investment or dividend payments which should be re-assessed if the scheme is at risk. Reductions to deficit-repair contributions and any extensions to a recovery plan will require "sound justification".

4. High Court upholds switch from RPI to CPI

The High Court has held that on a true construction of the governing documents of the QuinetiQ Pension Scheme (the "**Scheme**"), the switch from the Retail Prices Index ("**RPI**") to the Consumer Prices Index ("**CPI**") as the basis for calculating pension indexation and revaluation would not adversely affect members' "subsisting rights" under section 67 of the Pensions Act 1995.

Under the Scheme's rules, rates of indexation and revaluation were determined by reference to the "*Index*" which is defined as "*the Index of Retail Prices published by the Office of National Statistics or any other suitable cost-of-living index selected by the Trustees*". The court was asked whether this wording allowed the trustees to change the measure of inflation to CPI without falling foul of section 67 which protects accrued pension rights.

Justice Vos confirmed that they could make the change without it breaching section 67. In his view, it was a question of timing so that for pensions in payment, scheme members did not have a right to have an increase at a particular rate, rather it was a right to have any increase each April "*by an amount equal to the percentage increase in the Index*", and such right did not crystallise until the calculation was done. In other words, the member's entitlement is only to a future increase at a rate that the trustees have power to change.

Likewise with deferred pensions where the revaluation to be applied is calculated only at the end of the member's period of deferment, using CPI to determine the revaluation amount for future retirements would not breach section 67. The judge took the view that the application of a particular measure of inflation was only protected by section 67 at the point when the calculation to determine the increase was made because under the rules of the Scheme, the trustees had the power to vary the calculation.

The wording of the Scheme's rules was fairly unusual, but schemes with similar wording in their pension increase rules conferring a discretion or power to change the rate of increase can make future changes secure in the knowledge that the amendments will not be caught by section 67.

On a separate though related note, regulations came into force on 6th April this year requiring employers with occupational pension schemes to consult with affected employees in advance if they wish to switch from RPI to CPI for the purposes of indexation and revaluation of benefits. The obligation to consult only applies where the change would (or would likely to be) less generous to all members or members of a particular description. Transitional provisions exempt those changes which were notified to a scheme's active and prospective members before 6 April 2012.

5. The Pensions Regulator issues a financial support direction ("FSD") against ITV plc

The Pensions Regulator's Determination Panel has issued an FSD against ITV plc and its four subsidiaries (the "**Targets**") requiring financial support to be put in place for the Box Clever Group Pension Scheme (the "**Scheme**"). The five companies had never participated in the Scheme, and it is also worth noting that in this particular case the Regulator deemed it appropriate to issue an FSD in respect of events which pre-date the inception of the moral hazard legislation in 2005.

The Scheme's sponsoring employer, Box Clever, now in administration, had borrowed £860 million to fund a business acquisition but used a vast proportion of the funds to pay dividends to the Targets. In the event, Box Clever was unable to meet its repayment obligations and went into administration leaving the Scheme with a deficit of approximately £62.1 million.

In determining whether it was reasonable to impose the FSD, the Panel found that the Targets were "associated" with the Scheme's participating employers because they controlled the exercise of voting power in three participating employers through an intermediate company.

Although the Panel did not find any misconduct on the part of the Targets, weight was given to the value of benefits received by the Targets from the employers and the Targets' relationship with those employers.

With regard to the claim that the Targets had no real control over the deficit in the Scheme, the Panel confirmed that the FSD jurisdiction was not fault-based.

Finally, the Panel gave useful guidance on procedure, confirming that the Regulator, can, depending on the particular circumstances of a case, depart from the argument and evidence contained in a warning notice provided that:-

- evidence adduced after service of a warning notice must be adduced in circumstances where all parties could fairly take account of it;
- the parties were given a fair opportunity to respond meaningfully to any new arguments raised on the basis of that evidence; and
- those new arguments remained within the scope of the warning notice.

ITV has appealed the issue of the FSD to the Upper Tribunal and the appeal will be heard later in the year.

6. FSA transfer incentive guidance

The Financial Services Authority ("**FSA**") has issued updated guidance together with new rules for advisers in relation to pension transfers from defined benefit schemes. The new rules came into force on 1 May 2012. The changes reinforce the message that the starting point for any pension transfer advice is that the transfer will not be in the member's best interests.

The guidance also states that when recommending a transfer, the adviser must draw the client's attention to the various risks, covering in particular, the extent to which benefits may fall short of replicating those in the defined benefit pension scheme, the lack of a precise level of benefit that can be secured by the purchase of a future annuity, and the investment risk to which the client is exposed until an annuity is purchased

The NAPF and other pension industry bodies have published a voluntary code of practice dealing with member incentive exercises in defined benefit pension schemes.

7. The Pensions Regulator bans trustees for failing to observe their investment duties

The Pensions Regulator has prohibited three trustees of the Hugh Mackay Retirement Benefits Scheme (the "**Scheme**") from acting as trustees of any occupational pension scheme following "serious and persistent" breaches of statutory restrictions when investing in commercial property with the purchases financed by unauthorised borrowing.

In addition to the Scheme's disproportionate holdings in direct property and property-related investments, there were a number of other serious irregularities which included:-

- a failure to manage an acute conflict of interest because one of the properties acquired by the Scheme was from a company in which one of the trustees, Mr Hill, was a shareholder who was proactively involved in the negotiations relating to the sale;
- the other trustees were being paid salaries by the principal employer, Chartpoint, a property development company which was owned by Mr Hill;
- between 2006 and 2009 the Scheme paid £1.5 million to Chartpoint in respect of the provision of services to the Scheme and commission on the sale or refinancing of investments.
- the trustees appeared to have a scant understanding of their duties and responsibilities under the Pensions Act 2004 trustee knowledge and understanding regime.

As well as highlighting the importance of identifying and properly managing conflicts of interest, this case serves as a useful reminder to trustees to be conversant with the knowledge and understanding of the law relating to pension schemes and investment principles. Familiarity with the Pensions Regulator's guidance on the subject, and its toolkit for training purposes could have avoided the problems that arose in this case.

8. Capping pensionable pay not unlawful – John Bradbury v BBC

The High Court has ruled that imposing a 1% cap on increases in the pensionable salary of its employees by the British Broadcasting Corporation ("**BBC**") by means of an external contractual agreement with the member was legally binding notwithstanding the pension scheme's provisions. The case has implications for employers hoping to reduce pension liabilities by this route where to do so under the pension scheme would necessitate trustee consent.

In a bid to reduce its pension scheme deficit, the BBC consulted with members of the scheme and unions to cap future increases in pensionable earnings to 1%. The BBC did not consider it necessary to amend the scheme rules to reflect the cap on pensionable pay increases because it argued that the definition of "Pensionable Salary" was broad and flexible enough to give the BBC discretion to determine which proportion of salary was pensionable.

Mr Bradbury appealed to the High Court when the Pensions Ombudsman failed to uphold his complaint about the cap. The High Court was asked to consider whether (i) the BBC's contention that the definition of "Pensionable Salary" was wide enough for it to impose the cap was correct; and (ii) the imposition of the cap breached section 91 of the Pensions Act 1995 which provides that any assignment or surrender of a person's rights under an occupational pension scheme is unenforceable.

The High Court ruled that the terms of the scheme's trust deed and rules did not confer a sufficiently wide discretion to determine what would count as basic pay for the purposes of "Pensionable Salary". Justice Warren also confirmed that, in accordance with the principle laid down in a previous case **South West Trains v Wightman [1998]**, an agreement by a member to accept a pay rise on the basis that only part of it would be pensionable, was valid subject to the employer acting in good faith or complying with its implied duty of mutual trust and confidence. As the issue of the employer's good faith conduct had not been addressed by the Pensions Ombudsman, Justice Warren was unable to give it due consideration in the High Court.

As regards whether section 91 had been breached, Justice Warren did not consider that there would have been any alienation of any entitlement or right within section 91. As no one had a right to receive a pay rise, the extrinsic contract did not constitute a compromise of future rights. Accepting a salary increase on the basis that only part was pensionable did not involve a surrender of anything; the member became entitled to a greater future pension, albeit one that was smaller than if the whole increase was pensionable.

This case is notable because it seems to endorse the validity of extrinsic contracts for the purposes of capping of pensionable pay increases. However, in order for such contracts to be enforceable, the employer must take care not to breach the employment contract, in other words, ensure that it complies with the implied duty of good faith and mutual trust and confidence when implementing the proposed changes. In particular, the employer should ensure that the terms of any changes to pension rights are communicated clearly and made subject to the employee's express consent especially in circumstances where to effect the change under the pension scheme rules would not be possible because of restrictions or fetters in the scheme's amendment power.