
***IAPF TRUSTEE FORUM
ASSOCIATION OF PENSION LAWYERS IN IRELAND***

***- Surpluses in Occupational Pension Schemes –
- Best Practice for Trustees -***

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1. Common Trust Provisions

- 1.1 Invariably, provisions in trust deeds dealing with refund of monies to an employer are only material in the case of defined benefit schemes. It is these arrangements alone which this paper deals with. Neither is it going to deal with trustee considerations on applying surplus on a wind-up nor deal with what is a surplus.

From a representative trawl through the trust deeds in my cupboard I concluded that the following are the typical variations which you are likely to see.

- 1.2 Either the trust documentation will be entirely silent and there will be a prohibition on any amendment enabling a refund to the employer, or there will be no such prohibition or there might be a freestanding rule (usually part of the rule or set of rules dealing with how actuarial valuations are to be carried out and contributions payable by the employer).

Because until relatively recently it was a Revenue requirement that surplus money on an ongoing basis was not payable to the employer many documents will reflect this. Modern documents will not. Instead, they are also likely to be silent in relation to disposal of surplus, as this may seem very remote at the inception of the plan. However, it is desirable to frame the documentation in a flexible way having regard to the employer's instructions at the time that the plan is established.

Let's deal with the three possibilities in turn¹:-

- 1.3 The scheme documentation is silent, but the amendment power (exercisable jointly by the employer and trustees) prohibits return of surplus. What ought the trustees do? It is likely in this circumstance that the employer has proposed that augmentation in favour of members will only occur provided it participates in some of the goodies as well.

It is common for many defined benefit plans to be silent as to whether or not ongoing surplus may be paid to the participating employers. In that event the governing trust deed and rules will need to be altered by the amendment power. This power may provide that no future alteration may be made pursuant to it which would have the affect of refunding assets from the fund to the employer. Consequently, it would appear that the trustees are not permitted to agree to anything which would repatriate surplus. It behoves the trustees to see if there is any way around this apparent total ban. It's worth considering whether that prohibition was validly adopted in the first place. Possibly, it was not

¹ The considerations and principles I refer to under each of the three scenarios are not scenario specific and need to be looked at in all situations but I have spread them across the three common scenarios.

included in the scheme from its inception in which case it might be arguable that its subsequent inclusion is a fetter on the trustees powers and they may be permitted to ignore it following the reasoning in the *Courage*² case. However, you would need to think carefully about this and look at all the circumstances at the time. The trustees need to be on very safe ground to overcome an apparent express provision in the of trust deed and rules and this is an important point to bear in mind.

Alternatively, it might be that the relevant rule indicates that the prohibition of a return of monies to the employer is subject to Revenue approval in which case this should be relatively straightforward (given that the Revenue are not keen on surplus being built up in a pension scheme) to secure this.

Usually the trustees are not there to negotiate the benefit increases on of their members. However,

“where the employer seeks repayment the trustees or committee can be expected to press for generous treatment of employees and pensioners and the employer to be influenced by the desire to maintain good industrial relations with its workforce” – Millett J in Courage

Consequently, where the employer seeks repayment, the trustees have a duty to negotiate the best bargain they can in the circumstances having regard to the relative balance of power in the trust deed rules between themselves and the principal employer and the circumstances in which they are operating.

Obviously the trustees must carry out their duties in accordance with the terms of their trust i.e. by following the provisions of the trust deed and rules in the context of trust and pensions law.

- 1.4 Turning then to the next scenario, where there is no express power in the deed authorising the return, but there is nothing prohibiting it either.

The plan could be amended to permit the refund to occur. Let us assume the amendment power is exercisable jointly by the employer and trustees. In that case the trustees require to make sure that they are exercising their amendment power in the best interests of the beneficiaries taking into account the interest of the different classes of beneficiaries. It is necessary to consider the interests of the active members, the pensioners and the deferred members.

It may be the case that the proposals envisage benefiting one set of beneficiaries and not another. Following from the UK Edge case³, this may not necessarily be fatal. In Edge active members benefited from

² Re Courage Group's Pension Schemes 1987 1 ALL ER ChD 545

³ Thomas Edge & Ors – V – The Pensions Ombudsman & Anor [1999] PLR 215

the augmentations and not pensioners or deferred members. The trustees were aware of this and felt that it was appropriate in the circumstances (and especially in light of the fact that pensioners had participated in improvements in benefits when in service and also enjoyed increases in excess of CPI) to facilitate the employer in rationalising its business so that it would have a business in the future and thus the longevity of the scheme would be preserved. However, it is reasonable for trustees to consider the allocation of surplus in accordance with the relative liabilities of each category of member. Bearing in mind their duty to argue for improvements it is appropriate that it raise the issue, the trustees should argue on behalf of each set of beneficiaries. If the employer is not pressing for repayment the trustees are not required to negotiate improvements.

It is also relevant to consider the prevailing circumstances and implications of the employer attempting to exercise undue pressure on the trustees and the beneficiaries.

The employer is subject to the implied duty of good faith and to “the implied limitation that [its rights] shall not be exercised so as to destroy or seriously damage the relationship of confidence and trust between the company and its employees and former employees (Imperial – 1991).⁴

There the court held that in

“every contract of employment there is an implied term that the employers will not, without reasonable proper cause, conduct themselves in a manner calculated likely to destroy or seriously damage the relationship of confidence and trust between the employer and employee”.

It is not relevant whether the company is acting reasonably. It has to be open to the company to look after its own interests, financially and otherwise, in the future operations of the scheme in deciding whether or not to give consent to a particular use of a power of amendment. But the obligation of good faith does require that the company exercise its rights, first, with a view to the efficient running of the scheme established by the fund, and secondly, not for the collateral purpose of forcing the members to give up accrued rights.

Rarely would be it that, as trustees, you will be asked to consent to an arrangement as happened in Imperial where pensioners were asked to give up part of their pension entitlements in return for a higher future level of pension increases. But there may be a different type of facts which you may feel you need to stand back from and consider whether you are being bullied.

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Imperial Group Pension Trust Ltd – v – Imperial Tobacco Ltd [1990] PLR 239

In the 1997 UK case of Hillsdown⁵ the duty of good faith was considered in conjunction with the bargaining process described by Millett J in *Courage*, referred to above.

In Hillsdown, Knox J considered that he saw no irreconcilable conflict in the two. *“It is common for employers whilst under the obligation of good faith nevertheless to be free to negotiate with their employees or representatives.”* In Hillsdown he pointed out that there was an important distinction which arose between negotiating over issues in which both parties had locus standis, a legitimate interest to preserve, on the one hand and negotiating over a matter where only one party has a legitimate interest to preserve and therefore no locus standis on the other.

This brings me on neatly to the requirement that where you are negotiating you must appreciate your bargaining position and by this must understand the balance of power within a scheme. First, a practical example:

In Hillsdown, the trustees, when negotiating a transfer payment from a scheme with surplus which prohibited a repatriation of same to the employer to a scheme which was not in surplus without such prohibition (in consequence of which part of the surplus was repatriated to the employer), had not appreciated the full extent of their power of disposal of surplus in the transferor scheme. They had thought that they were required to dispose of surplus in conjunction with the employer. In fact they had full control over the disposal of surplus.

Had they realised that they held all the aces they would have been able to make a better bargain for their beneficiaries.

Let's look for a moment at what is meant by the balance of power provisions within a scheme. In particular, in this context, it means who can decide how the surplus is applied. If it is the trustees alone (usually acting on actuarial input) then they control the matter. In that event they can decide, within the terms of the particular surplus rule, how the surplus is to be divided up.

Balance of power also covers who pays contributions under the plan, whether the employers can appoint trustees and bring about a winding up of the plan (frequently by giving notice of cessation to pay contributions); and destination of surplus on a wind up; argumentation and amendment powers; power to admit new participating companies.

There may be other provisions in the document which give the trustees the greater bargaining position. For example, the power of amendment might be exercisable only by the trustees. In that event the trustees

⁵ Hillsdown Holdings Plc – v – The Pensions Ombudsman

will need to consider that the employer is also a beneficiary under a scheme.

I cannot emphasise enough how important it is to read the detail of the trust deed and rules and how they operate as a whole and also, where reliance on the amendment power is required, to also look at how it may have evolved over the lifetime of the scheme. It is also appropriate to have an appreciation of what is the employer's role and its rights. You will understand this if you have an overall appreciation of the balance of power within the Scheme.

Increasingly, the practice is to look at the current governing documentation and not to delve into the archaeology of the scheme. However, where a large asset is to be transferred out of the scheme it is important that the trustees are correct.

- 1.5 Let's then consider the third scenario mentioned above, namely that the refund of surplus is proposed pursuant to the documentation itself and without any requirement for an amendment to the rules.

The rule may provide that if the actuarial valuation discloses a surplus the trustees and/or the employer, with actuarial input, are required to apply the surplus in any combination of holding it as a reserve in the fund, taking an employer contribution holiday, permitting an employee contribution holiday, providing for augmentations or refund to the employer. (Sometimes the set of rules will also expand on what is to happen in the event of the valuation disclosing a deficit. It is not unusual for an equivalent obligation to that right conferred by the surplus clause to apply. In other words, if the surplus rule enables the employer to access the surplus then a deficit rule is likely to require the employer to make good the deficit. Correspondingly, if the surplus rule enables its members to benefit by way of augmentations the deficit rule is likely to provide that a reduction in benefits could arise.)

In the UK there has been a lot of case law focusing on these types of situations. It is clear that where this route arises the trustees need to be absolutely certain that what they are doing falls within the terms of the rules. It may be that, procedurally, the trustees would rely upon the relevant rule, but would also require to execute a deed of amendment to give effect to it. In that event, the requirements of the amendment rule would also come into play. Alternatively, the provision may be a stand alone one and all the trustees need to do is to take actions pursuant to it. In *Edge*, referred to above, the Court set out a non-exhaustive list of items trustees ought to consider when exercising their power of disposal over surplus. I will deal with this later.

2. **Other Issues**

- 2.1 In exercising their duties the trustees have to be mindful of their standard of care in the trust documentation and they need to look at

this and to see how this is expressed. The deed may give an exoneration which would protect the trustee from liability. Alternatively there may be no such exoneration and liability might enure to the trustee if it gets this exercise wrong.

Sometimes trust documents will provide that instead of (or in addition to) exempting trustees from liability for breach of duty, the trust instrument may prevent any duties arising in the first place. This occurs where there is an exoneration clause which operates by saving the trustees from legal liability. This would say that the trustee is not responsible or chargeable in any manner in respect of any loss or depreciation in the assets of the fund or as a result of any powers exercised by the trustee or discretions including acts and omissions or anything except wilful default or negligence in the case of a professional trustee. If there is an exoneration clause this should give the trustee some comfort.

The standard of care which a trustee is required to uphold has been held in case law in Ireland to act as a prudent businessman would act looking after his or her personal affairs. If there is an exoneration clause which exempts the trustee from liability for breach of duty in the first place the standard of care of the prudent businessman will not apply.

Another consideration for the trustee is whether or not there is any indemnity in the event that his/her actions are regarded subsequently by a court as a breach of trust.

Again, careful reading of the trust deed and rules will be required to see if this arises. If not it is open always to the trustees to obtain an indemnity from the sponsoring employer. A word of warning: it could be that an indemnity will be obtained from the recipient of the cash, but in due course that entity might be wound up and have no assets at a time when reliance on the indemnity would be required. So, even if a trustee does obtain an indemnity this may not be the end of the matter. Therefore, it is best to organise matters so that no liability would arise in the first place and therefore there is no requirement to rely on the indemnity.

- 2.2 I would now like to say a few words about trustees' conflicts of interest. Frequently, where application of ongoing surplus arises, members augmentations are made in return for a refund to the employer. The trustees need to establish if they are potential beneficiaries of that augmentation. If so, unless the documentation enables them to benefit from the augmentation, they might be prohibited from doing so under the self dealing rule which applies to trustees. By self dealing I mean that because the trustees are in a fiduciary position in relation to the trust they are not entitled to receive payment for their services unless authorised by the trust documentation. Depending on the circumstances an application to Court may be necessary to enable

them to benefit from the augmentation. This happened in the Drexel⁶ case but the costs of any such application would need to be considered. These may far outweigh the cost of augmentation and it may be best to see if there is any way around this. Possibly some trustees might retire in favour of new trustees who will not be benefiting from the augmentations. Edge casts doubt on Drexel as there the High Court considered that no conflict arose for member trustees who agreed a reduction in the member contribution rate. This stance appears to have been approved by the UK Court of Appeal but it is unclear if an Irish Court would consider that member trustees are not exempt from the self dealing rule.

- 2.3 Another issue which is appropriate to consider is whether or not member consent for the proposals ought to be obtained. From a practical point of view if the documentation is silent and does not require consent it is easier logistically if a ballot of members is not required. The logistics of obtaining members' (i.e. actives, pensioners and deferreds) consent and explaining the issues arising, so that this would be an informed consent, may be quite problematic. However, the advantage for the trustees in obtaining consent is that it has polled the members and if a reasonably large percentage have voted in favour of the proposal the trustees may draw some comfort that they have consulted and sought member approval. The disadvantage, of course, is that a less than 100% favourable response casts doubt on the agreement of members. It is always worth raising this point and debating it. The costs of the exercise must also be considered, especially if the membership is large. The view can be taken that why should the trustees go to the bother of obtaining consent if they have made an informed decision that the proposal is in the best interest of beneficiaries.

Obviously, if consent is required under the terms of the surplus provisions or the amendment power, then the trustees are obliged to follow the formalities without derogation.

- 2.4 Carefully consider the actuarial and legal input which you need and have been offered. It may be appropriate to take independent advice.

Actuarial input will definitely arise and it is sensible to take separate advice from an actuary who is not representing the employer. He/she will be reflecting its interests and you must act impartially for the beneficiaries and where the employer presses for repayment, negotiate on their behalf. You will also need legal guidance as to what are your obligations under the deed and rules and how these sit with the general pensions law principles referred to in this paper. It may be appropriate (and usually is) to take separate legal advice. Being mindful of your standard of care as a trustee you are expected to act as a prudent business person acts in managing their affairs.

⁶ Manning V Drexel Burham Lambert Holdings Ind.

Given the size of the scheme and any difficulties in the documentation it may be appropriate (and do not rule it out) to go to Court to get Court sanction for what is proposed.

- 2.5 Other matters which require to be considered are the impact of whatever will be on the statute book in relation to the new proposals under the Pensions (Amendment) Bill 2001, which Peter Fahy has already discussed.
- 2.6 The trustees' obligations in the context of disclosure regulations need brief mention.

The Pensions Board's guidance notes on the regulations indicate, at paragraph 37, that trustees of a scheme must notify members within 4 weeks of a material change which occurs in the basic information specified in paragraphs 1-18 of paragraph 34 of the notes. This reflects Article 9(4) of the Regulations. The subsequent annual report also needs to note if such changes have occurred. In planning any distribution of surplus which will materially affect benefits or other matters specified the trustees will need to bear in mind this requirement and considering the implementation of this and the four week deadline shall be met. In the first place will the application of surplus make a material change? What is material? The trustees will need to evaluate this.

- 2.7 Having made your decision as to how the surplus is to be allocated, what then arises? You need to continue to follow the correct procedures, e.g. if the trust deed requires unanimity amongst trustees in making this decision, this route must be followed. Your decisions need to be recorded and where a deed needs to be executed. This step needs to be done correctly.

3. The Decision Making Process

In Edge the Court of Appeal in the UK set out issues which trustees need to take into account in the exercise of their discretions when applying on-going surplus.

Trustees do not have a duty to act impartially. They may exclude beneficiaries from particular benefits and prefer others. If their actions are being reviewed a judge may disagree with the manner in which the trustees have exercised their discretion, but unless they can be seen to have taken into account irrelevant, improper or irrational factors, or unless their decision can be said to be one which no reasonable body of trustees properly directing themselves could have reached, the judge cannot interfere. They must exercise their powers honestly and for the purpose for which the power was given and not for any other ulterior purposes. The matters which the trustees take into account

must be relevant. It is up to the trustees to decide what weight those relevant matters should be given.

Over many years the UK Courts have devised the following test:-

- the trustees must ask themselves the correct question;
- they must direct themselves correctly in law; in particular, they must adopt a correct construction of the pension fund rules
- they must not arrive at a perverse decision, i.e. a decision to which no reasonable body of trustees could arrive, and they must take into account all relevant, but no irrelevant factors.

The Court considered a non-exhaustive list of relevant factors in the particular circumstances which related to application of on-going surplus. These include:-

- consider the circumstances in which the surplus has arisen;
- always have in mind the main purpose of the scheme;
- consider the effects that any course which they are minded to make will have on the financial ability of the employers to make contributions which that course will entail;
- do not impose burdens which imperil the continuity and proper development of the employers' business or members jobs;
- consider the level of benefits relative to those under comparable schemes with the pensions market generally;
- is the plan attractive to members whose willingness to continue paying contributions is essential to its future funding?
- are the benefits seen by the members to be good value in relation to the contributions; would the members find it more attractive to pay higher contributions for higher benefits or to pay a lower contribution and then accept lower benefits?
- have pensions kept up with increases in the cost of living, so that the expectations of members during their service – that they were making adequate provision for their retirement through contributions to the scheme – are not defeated by inflation?
- be aware of your bargaining position.

I think these comments are germane to the topic of this paper and reflect helpful guidance for trustees when making their decision.

4. Conclusion

In conclusion, your starting point is to act in the best interests of the beneficiaries as a whole. This will require you to carefully follow the terms of the trust deed and rules to the letter. You will need to be fully aware of the balance of power provisions in the plan so that you understand your negotiating power if negotiating improvements with the employer. This is under the assumption that it is going to consent to augmentations in favour of your beneficiaries in return for participating in the surplus. Check out what is your standard of care and indemnity and, if necessary (and appropriate), try and see if you can get another better more secure indemnity. Consider the appropriateness of getting consent of members. Consider the allocation of surplus between the different categories of members/employer and whether this is fair in the circumstances. When considering the exercise of your discretion as to how to allocate surplus your needs take into account relevant factors and ignore irrelevant ones. You may need advice on what is relevant and irrelevant but it is up to you to attach whatever weight to those factors. Be mindful of the conflicts of interest which may arise. Watch the conflicts and take independent advice.