

# Review

## Human Capital (Pensions)



### The Ilford case: an improper proposal

In the case of *Independent Trustee Services Limited v Hope and Others* the High Court ruled that, when taking decisions regarding buy-outs, pension scheme trustees cannot properly have regard to the prospects of compensation from the Pension Protection Fund ('the PPF').

#### BACKGROUND TO THE 'ILFORD' CASE

The Ilford Pension Scheme ('the Scheme') is significantly underfunded. It is common ground that the Scheme will qualify for entry into the PPF following a successful petition from the Scheme Trustee for the sponsoring employer (which is currently in administrative receivership) to be compulsorily wound-up.

A group of former employees took early retirement pensions in 2000 on enhanced terms (ie, without actuarial reduction for early payment) at a point when the Scheme funding position was "healthy", the sponsoring employer was solvent and the PPF did not exist. Their annual pensions are £40,000 and above. Most of this group of pensioners are still under the Scheme's normal retirement age, which means that if the Scheme entered the PPF they would receive a maximum of 90% of their pension, subject to the PPF's current cap of £31,936.32<sup>1</sup>. This would mean an estimated pension reduction of up to 56% for the most badly hit pensioner.

#### THE PROPOSAL

The group of pensioners, realising that they would be significantly worse off if the Scheme entered the PPF, proposed that the Trustee should exercise its discretion under the Scheme rules to purchase annuities from an insurance company. This is not permitted once a scheme enters a PPF assessment period.

The proposal, if implemented, would have involved spending the bulk of the Scheme assets on the purchase of annuities to cover the full benefits of a small number of pensioners ie those under the Scheme's normal retirement age who would have been faced with a shortfall between the level of benefits offered by the PPF and their expected benefits from the Scheme. The proposal also covered buying-out specific benefits for pensioners over normal retirement age, to act as a top-up to PPF compensation. The pensioners would therefore be insulated from the full consequences of the Scheme's subsequent entry into the PPF.

The proposal is unusual in that it is specifically designed to take account of PPF compensation. It does not contravene any legislation and would secure a better outcome for many pensioners. The Scheme Trustee, having been advised by leading Counsel that the proposal may be improper, asked the Court to consider whether it could proceed with the annuity purchase.

#### THE EFFECT ON THE PPF

When a scheme enters the PPF its assets are a source of funding for the PPF (in addition to levy payments). It follows that a reduction in assets of any eligible scheme, before it enters the PPF, will later prejudice the PPF unless the liabilities have also proportionately reduced.

The proposal considered above would result in the Scheme having vastly reduced assets upon entry to the PPF, largely because benefits for the pensioners under normal retirement age would have been bought out at 100% of the uncapped level, rather than the PPF provision of 90% of the capped level. The PPF would still be responsible for meeting the Scheme liabilities that were not bought out.

The PPF and the Pensions Regulator argued that approval of the proposal would open the "floodgates" for other arrangements designed to take advantage of the PPF. This would mean an increase in PPF levies and/or reduction in PPF benefits, or it could even threaten the continued existence of the PPF. Although, in fairness, the circumstances of this case were unusual in that the Trustee has the power to trigger the insolvency event that will lead to the Scheme entering the PPF assessment period.

<sup>1</sup> The cap is subject to adjustment upwards or downwards for members older or younger than 65.

## THE RULING

Although the Trustee had the power under the Scheme rules to buy out the benefits, the High Court considered that this would constitute an improper exercise of that power. The purpose of the buy-out rule was to enable the Trustee to provide a level of benefits as a substitute for Scheme benefits using an amount of money that “fairly represents” those benefits. Without the existence of the PPF, the use of a disproportionate amount of assets to buy out benefits for the relevant pensioners would be detrimental to the remaining members of the Scheme. This is contrary to the fundamental purpose of the Scheme as a whole.

This conclusion lead to a second question: if the Scheme rules were amended to consider PPF compensation as a Scheme asset, could the Trustee then take account of its existence? The Judge said: “I ask myself whether there is any principled basis upon which the court can intervene to nip behaviour of this kind in the bud”. The Judge duly found his “principled basis”, deciding that the Court can lay down relevant factors for trustees to take into account in the exercise of a power or discretion in such cases. In this regard, the Court’s approach could be shaped and guided by considerations of public policy. The Judge recognised that public policy is an “unruly horse”, but one which judges can mount when a trust provision offends against it. The Judge ruled that, in the circumstances, the availability of PPF compensation is not a relevant factor for the Trustee to take into account in the exercise of the buy-out power because it would be against the clear legislative policy of Parliament and would be contrary to public policy.

The Judge expects a similar approach to be adopted by the Courts in any instance where trustees seek to take advantage of the existence of the PPF as a justification for acting in a way that would otherwise be improper. In short, “any attempt to amend the scheme rules so as to permit, or oblige, the Trustee to take the existence of PPF compensation into account in exercising its power to buy out benefits would clearly be void.”

## EFFECT OF EUROPEAN INSOLVENCY DIRECTIVE

As a separate but important point, a question arose about whether the PPF adequately protects the interests of pensioners following the insolvency of their former employer under the European Community Insolvency Directive<sup>2</sup>, especially in cases where the PPF compensation cap applies. The Judge reflected that members who suffer a reduction in benefits following entry to the PPF may consider arguing this point and we may see further reference to the European Court of Justice before this is resolved.

## CONCLUSION

This ruling has obvious implications for underfunded defined benefit pension schemes. In brief, trustees cannot allow their decisions to be distorted by the existence of the PPF.

<sup>2</sup> Council Directive 80/987/EEC

## FURTHER INFORMATION

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