C/M/S/ Cameron McKenna

Pensions update

Commentary on key legal issues

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Pension Lawyers
of the Year

The Pensions Act 1995 introduced the concept that trustee bodies should have one-third of their number nominated by the members. However, the fairly simple idea was implemented by way of some of the most complex regulations issued under that Act and the complexity of those Regulations was heavily criticised. The Pensions Act 2004 sets out to simplify matters.

Mark Atkinson

Implementing the new member-nominated trustee requirements

The Pensions Act 1995 regime allowed employers to "opt-out" of the statutory requirement for schemes to have one-third member-nominated trustees (MNTs) if the scheme members approved the employer's alternative proposals. The majority of schemes went down this "employer opt-out" route. The Government felt that some were not complying with the spirit of the legislation and it wanted to ensure that more members were involved in the running of their pension schemes.

As a result, the MNT provisions in the Pensions Act 1995 have been replaced with new requirements under the Pensions Act 2004. Broadly speaking, where an employer opt-out is currently in place, these new requirements will apply to schemes on the earlier of the existing opt-out expiry or 31 October 2007.

The Pensions Regulator has issued a Code of Practice which deals with the implementation of the new requirements and in most cases trustees will have a maximum of six months after the new requirements apply to them to decide on their arrangements for appointing MNTs and then a further six months to implement their arrangements (these are not rigid time limits and could be extended if circumstances warranted it).

> *"...these new requirements will come into force on the earlier of the existing opt-out expiry or 31 October 2007."*

What happens to MNT arrangements which are in place now?

There is nothing under the new legislation which provides for the automatic removal of MNTs appointed under existing opt-out arrangements and it is quite likely that their terms of office will not expire at the same time as the current opt-out arrangements.

There are several alternatives available to schemes, including:

- considering whether existing opt-out arrangements comply with the MNT requirements under the Pensions Act 2004 and existing MNTs can therefore be counted towards satisfying the one-third requirements.
- asking existing MNTs to resign and if they will not, the employer will probably have a power to remove them under the scheme rules (they will have lost any protected status they had as they are no longer MNTs).
- allowing existing MNTs to serve out the remainder of their current periods of office at the same time as the trustees implement the new MNT requirements.

Exactly which option is the best for a particular scheme will depend on the provisions of its existing opt-out arrangement and both the employer and existing trustees will need to discuss the best way forward for the scheme.

The new requirements – nomination

The nomination process must involve at least all of the active members and pensioners (or organisations which are adequately representative of them). The involvement of pensioners in the process may be something which schemes have not done in the past and they will need to give thought as to exactly how this is intended to work.

It is possible for trustees to use constituencies in the nomination process. The code of practice says that trustees may do this, for example, by site, by category of member, or by section of the scheme.

However, "in considering the use of constituencies, trustees should have regard to the principles of proportionality, fairness and transparency. For example it would not, in general, be fair for a constituency of 100 members to nominate two MNTs, and a constituency of 10,000 members to nominate only one".

The new requirements – selection

When the number of nominations does not exceed the number of vacancies, the arrangements may (but need not) provide that the nominees are automatically selected. However, the trustees may still choose to have a selection procedure.

If the number of nominations received is more than the number of vacancies, the trustees must carry out a selection process. A selection procedure must involve at least some of the members (members for these purposes includes deferreds).

The Regulator's Code of Practice does not specify a particular selection process but suggests some possible selection methods, including member ballots, selection panels, and selection by representative committees, pension management committees, trade unions or the existing trustees themselves.

What is appropriate in any given case is likely to vary depending on the circumstances of the scheme, and a combination of methods may be the most appropriate. However, if selection is by a panel, other group or the existing trustees, then the trustees must ensure that it includes some scheme members.

Trustee companies

The MNT arrangements apply in the same way to directors of trustee companies. However, there are several additional considerations for corporate trustees:

- Are the articles of association wide enough to allow for appointment of directors in accordance with the new regime or do they need to be amended?
- If the company is trustee of more than one pension scheme, does it wish to

treat all of the schemes as a single scheme for the purposes of implementing the MNT requirements (such 'aggregation' is allowed under the Act)?

Conclusions

The Regulator has said in its Code of Practice that the trustees' watchwords in meeting these statutory requirements must be proportionality, fairness and transparency.

The obligation to implement the new requirements rests with scheme trustees and they should be considering how they intend to do so now.

If elections for new trustees come up before the opt-out expires, trustees and employers should consider whether they should be appointed on a basis which complies with the new regime.

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"The Pensions Regulator has commented in its Code of Practice that the trustees' watchwords in meeting these statutory requirements must be proportionality, fairness and transparency."

Emma Frost

The Employment Equality (Age) Regulations came into force on 1 October 2006. However, their implementation in relation to pension schemes was delayed until 1 December 2006 and amending Regulations have been published.

Age discrimination – what does it all mean?

The Regulations prohibit direct or indirect discrimination against an employee on grounds of age unless that different treatment can be justified as a "proportionate means of achieving a legitimate aim".

Clearly occupational pension schemes may encounter problems under the Regulations as the benefits which they provide are based on age. While many typical occupational pension scheme provisions are specifically exempted from the legislation, inevitably, there are provisions which will be caught and which will therefore need to be reviewed. Every scheme will be treated as including a requirement that the trustees and the employer cannot discriminate against a member or prospective member of the scheme "in carrying out any of their functions in relation to it (*including in particular their functions relating to the admission of members to the scheme and the treatment of members of it*)".

> *"If trustees identify a discriminatory rule in their scheme they may amend or remove it or try and objectively justify it."*

If trustees find a discriminatory rule in their scheme they may amend or remove it (in accordance with the scheme rules) or try and objectively justify it. If scheme rules are amended, they may be amended to equalise benefits at the least favourable level for all members, although trustees need to be aware of the implications of Section 67 of the Pensions Act 1995 (i.e. the protection of subsisting rights). However, if no amendments were made to discriminatory provisions by 1 December 2006, the effect of the overriding non-discrimination rule will be to level up benefits for everyone until such time as an amendment is made. Depending on the benefits which are affected, there could be significant cost implications associated with this.

If schemes do have to make amendments to remove any age discrimination, they will have to consider whether they will need to comply with the new consultation requirements. For amendments which are effective on or after 1 December 2006, it seems unlikely that these requirements will need to be complied with as they are implementing a statutory requirement and are therefore exempt.

If trustees and employers breach the non-discrimination requirements, then members and prospective members may bring complaints to an employment tribunal or the Pensions Ombudsman.

What is allowed in occupational pension schemes?

The Regulations contain a list of typical provisions in occupational pension schemes which will not amount to discrimination which has been extended by amending legislation. The DTI have also issued a guidance note explaining how they interpret these provisions (which is also being revised by DTI).

The list of exemptions means that many common age-based provisions in occupational pension schemes should not cause problems under the new legislation. They cover:

- Where a scheme is closed or a section of a scheme is closed to members who joined after a particular date.
- Maximum and minimum ages for joining.
- The use of age-related actuarial assumptions. There will usually also be no discrimination where benefits are actuarially reduced because they are paid early or increased for being paid late. It seems that the DWP do not intend to put an unduly technical interpretation of the meaning of "actuarial" in these regulations.
- Different employer and/or member contribution rates to money purchase schemes depending on a member's age where the aim is to provide benefits in respect of comparable aggregate periods of pensionable service which are "more nearly equal". Employer and employee contributions may also be capped.
- Age-based contributions in final salary schemes, where the accrual rate is the same for all members regardless of age and their purpose "*is to reflect the increasing cost of providing the defined benefits in respect of members as they get older*".
- A minimum age at which members are entitled to payment of an early retirement pension, subject to an actuarial reduction (providing certain requirements are complied with), and a minimum age for payment of full scheme benefits without actuarial reduction. There are also provisions for enhanced early retirement benefits either where the benefit arises on redundancy or where an individual was a member or prospective member on 1 December 2006.
- There is no age discrimination where, on a member's death, there is a reduction in a pension paid to a dependant as a result of the dependant being more than a specified number of years younger than the member.
- Benefits may be calculated by reference to a member's pensionable salary (which generally increases with age). Schemes may also impose a maximum and minimum level of pensionable pay that they will take into account in calculating benefits (provided that the minimum is not above 1.5 times the Lower Earnings Limit or an amount intended to reflect basic state pension plus state second pension).
- Benefits may be calculated by reference to the length of a member's pensionable service.
- Schemes may impose a maximum number of years' service they will take into account in calculating benefits and under the amending regulations it will also be possible to impose a maximum amount of benefits by reference to a fraction of pensionable pay ($^2/_3$rds) and as the limit does not appear to have to be restricted to benefits under one scheme, this exemption may be wide enough to accommodate a deduction in relation to "retained benefits".
- It is also possible to impose a minimum of up to two years' service before a member qualifies for vested benefits or death benefits under a scheme.

Schemes which looked at age discrimination at a relatively early stage may need to revisit decisions which they have already taken in the light of the amending regulations. The timing of the amending regulations has in practice left schemes pushed for time.

The Regulations do not apply to benefits in respect of pensionable service before 1 December 2006, so discriminatory benefits accrued up to that date will not be affected by the new regime.

What might cause problems in occupational pension schemes?

The following are some of the issues which schemes may need to investigate further.

- Provisions which allow an employee to retire early with an unreduced pension where their age and length of service amount to a particular number (e.g. 85 or 90). (Although there have been arguments about the validity of such provisions, the recent Unison case does state that they are discriminatory but leaves open the possibility that they might be objectively justifiable).
- If a member remains in service after normal retirement age and the scheme does not provide for continued accrual or provides for different benefits.
- If a member takes scheme benefits and continues to work for the employer and is not permitted to continue to accrue benefits in the scheme on the previous basis.
- If an employer has a defined contribution scheme and a stakeholder scheme, the age-related contributions exemption which applies to the stakeholder scheme is different and looks at contributions paid in each year. Identical contribution structures could in theory therefore be treated differently.
- There is no longer an exemption for separate sections (other than closed sections) which means that if, for example, the scheme has a section only open to executives, the trustees will need to consider whether any of the other exemptions might apply or the benefits for executives are objectively justifiable.

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Objective justification

A discriminatory practice is not necessarily unlawful if it can be objectively justified. In order to justify the use of a discriminatory provision it must be "a proportionate means of achieving a legitimate aim". DTI guidance says in relation to objective justification that:

> *"legitimate aims might include business needs, efficiency, reducing staff turnover or providing promotion opportunities to retain good people."*

Trustees and employers will need to think carefully about any objective justification defence as it seems that costs alone will not be sufficient to justify a particular practice. If an individual brings a case against the trustees or an employer, it will not be possible to rely on assertions as to the justification and so it is important to keep a written record of what the legitimate aim was.

What needs to be done?

Trustees and employers should be reviewing their scheme rules now and identifying any potentially discriminatory features and looking at how they intend to deal with them.

It may be that the scope of the exemptions which we have ended up with are wide enough to cover the majority of benefits provided by occupational pension schemes and schemes will not therefore need to make significant amendments in the short term. However, there remains a possibility that the exemptions permitted by the UK legislation go beyond anything permitted by the underlying European Directive and may therefore be held to be unlawful in the future.

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A consequence of the ever-increasing legislation on pensions (and the no doubt well-meaning attempts by legislators to prevent unscrupulous employers from avoiding their obligations to scheme members) is that even innocent corporate activities can be fraught with danger for the unwary.

Mark Kowalik

Pitfalls of transferring undertakings between pension scheme employers

There may be many reasons for transferring an undertaking from one group entity to another. There may be a corporate reorganisation where the business of one company is transferred to one or more other group companies. Some groups may just feel that it is preferable for all their employees to be employed by a single company. Many unincorporated charities are now taking the opportunity to incorporate and this inevitably involves the transfer of the undertaking from unincorporated association to a new company.

All assets and liabilities, including employees' contracts of employment, can be transferred from one entity to another with little difficulty. However, the sting in the tail lies where the employer participates in a defined benefit scheme which has a deficit.

An employer is liable to pay its share of a scheme deficit "*if he ceases to be an employer employing persons in the description of employment to which the scheme relates when at least one other person continues to employ such persons*". So, if there is only one employer participating in the scheme and the whole undertaking passes to a successor, no debt is triggered because there are no other employers continuing to employ the employees at the precise moment the transfer takes effect.

However, where there are a number of employers in the scheme, the transfer of all the business from one to another will trigger a debt on the first. Furthermore, the share of the debt payable relates not just to the employees transferring, but also all the former employees of the old entity and the deficit is calculated on a buy-out basis. So the size of the sum involved may be such as to make the transfer unfeasible.

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However, it is not inevitable that a buy-out debt has to be paid in these circumstances.

One option is that a withdrawal arrangement can be entered into between the trustees and employer which is then approved by the Pensions Regulator. However, even then the exiting employer has to pay a deficit to at least the minimum funding requirement level (and in the future the scheme's specific funding level) and then another entity has to be found to guarantee the full buy-out cost if the scheme should enter winding up. The guarantor is supposed to have resources which make it more likely that it will be able to meet the deficit than the old employer. Where there is a transfer of the whole undertaking from one entity to a successor, it is unlikely that the new company would be in any different position to the old one and so no better able to meet the deficit.

A more acceptable alternative may be to apportion a debt amongst other employers, which is permitted under the Pensions Act 1995. This can result in no actual payment having to be made at the time of exit, regardless of the deficit. No withdrawal arrangement needs to be entered into with a guarantor and approved by the Regulator. However, this requires the scheme rules to have an appropriate apportionment power and if one doesn't currently exist the rules will need to be amended to introduce one.

Technically, the apportionment needs to be made to other employers which are participating at the time of exit by the old employer. That will be a problem if there is a transfer to an entirely different successor company because at the precise moment that all the employees transfer with the undertaking, the new company will not be a participating employer. This can be overcome by the device of transferring one employee in advance and letting the new employer participate in respect of that employee. The complete transfer of the undertaking can then follow. This arrangement does require the consent of a willing employee as his/her employment will not be transferred under TUPE.

However, even that process may leave exposure to a further payment by an employer. The Pensions Regulator has power under the Pensions Act 2004 to impose a contribution notice against an employer, or any person associated or connected to it. This applies where one of the main purposes of an act is to prevent the recovery of all or part of a debt due under section 75 of the Pensions Act 1995, or otherwise than in good faith, to prevent such a debt becoming due. The above arrangement would seem to fall squarely within that power. Therefore, before attempting this, it may be that a relevant employer would be wise to seek clearance from the Pensions Regulator to the whole transaction.

So, it is not impossible to arrange the transfer of a business from one undertaking to another in these circumstances. However, it is certainly not something to be undertaken lightly.

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Get to grips with the Pensions Act 2004 and all related regulatory publications by viewing our online **plain English guide to the Pensions Act**. You will need to be a subscriber to our Law-Now website (which is free) to access this guide. Register at **www.law-now.com/registerpensions**

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