To what extent should a trustee refund some or all of a surplus on winding-up to an employer rather than augment benefits?

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Introduction

1. The fact we often speak of refunding rather than simply paying surplus to an employer suggests that somehow the surplus has already been handed over to the scheme by the employer. That may be how many employers see it, but regardless of its contribution history, the ability of any employer to benefit from a surplus on winding up will turn on:

    a. The specific terms of the winding up power; but also
    b. The terms of the power to put the scheme into winding up.

The terms of the winding up power

2. Winding up powers usually take one of 5 possible forms in term of the disposal of surplus:

    1) All surplus is payable to the employer
    2) There is a trustee discretion to augment benefits following which the residual surplus is payable to the employer.
    3) There is a duty to augment benefits up to Revenue limits, and only then is any residual surplus payable to the employer.
    4) There is an express prohibition on the return of any surplus to the employer. This is likely to be accompanied by a similar restriction on using the POA to bring about a return of surplus to the employer.
    5) There is no explicit provision dealing with any surplus or residual surplus so a resulting trust arises:

3. Only in situation 2) does a trustee actually have a discretion to choose between augmenting benefits and paying surplus to an employer. I will

return later to the considerations that should inform the exercise of that discretion.

4. We will also look at the applicable principles for deciding the destination of a surplus under a resulting trust.

5. However first it is important to note that the provisions governing the destination of surpluses under a winding up power need not necessarily be determinative of the how surplus is distributed.

The importance of the power to put the scheme into winding up

6. In most cases where there is a surplus the winding up can only be triggered either by the employer unilaterally or with employer's agreement.

7. A trustee sometimes does have unilateral powers to wind up a scheme but generally only where there is a solvency issue (which by definition will not be the situation we are considering).

8. The power to control whether and when a winding up occurs in a surplus situation, gives the employer real leverage in a surplus situation especially where members cannot otherwise access surplus without a winding up (i.e because there is no unilateral trustee power to augment benefits while the scheme is ongoing)

9. Whether the employer is prepared to exercise its power to put the scheme into winding up (or agree to consent to a winding up) will obviously be influenced by whether they stand to gain from any surplus a winding up.

10. In situations 2), 3) and 4) above the employer might not be willing to trigger a winding up at all if it appears to the employer that it will not benefit (or not benefit sufficiently) from any surplus which then becomes available for distribution.

Agreements to put the scheme into winding up and divide surpluses

11. Depending on the terms of the power to put the scheme into winding up in some cases it may be possible to agree a division of surplus as the price for triggering a winding up.

12. I will assume for the purposes of this talk that the schemes we are discussing is already closed to accrual so putting the scheme into winding up will not prejudice the continued accrual of benefits.

13. Looking at situation 2), if the trustee were minded to exercise its discretion to benefit the employer, no agreement to wind up will be needed because the employer will already have an incentive to put the scheme into winding up (assuming the trustee does not change its mind).

14. Where however the trustee would be minded topay some or all of the surplus to the members, and the employer is not willing to put the scheme into winding up on this basis, agreement as to how surplus will be divided between the employer and the members ought in principle to be possible. The agreement to pay more surplus to the employer than the trustee might otherwise be minded to pay, or the certainty that employer will benefit to a from winding up, to a pre agreed level, becomes a quid pro quo for the employer's agreement to putting the scheme into winding up in the first place.

15. Situation 3: Where the power of amendment permits it, It may even be possible to reach an agreement to amend the scheme so as to revise the existing division of surplus in situation 3 (where there would otherwise be a duty on winding up to use surplus to augment benefits).

Justification for doing a deal in situation 2 and 3

16. In both situation 2 and 3:

a. a trustee can probably justify doing a deal to fetter their future discretion over surplus or to amend the scheme to allow surplus to be paid to the employer in situation 2 or 3, if certain conditions are satisfied:

    i. the trustee is satisfied that the employer's power to put the scheme into winding up will not be forthcoming if all the surplus would or might be paid to the members in that event.
    ii. the members are otherwise be unlikely to benefit from the surplus other than on a winding up, because the power to augment benefits while the scheme is ongoing also requires employer consent (as it usually will)

b. If both these conditions are satisfied, a deal over surplus (on appropriate terms) can be justified as in the interests of the members as well as the employer.

c. Absent such an agreement (it can be argued) members (particularly older pensioners) are likely to receive nothing at all because they may die before any surplus is distributed, and ultimately the company has the ability (if so minded) to wait until all members have died before triggering a winding up, effectively reducing the members claims to surplus to zero.

d. A deal can therefore be justified as "a bird in the hand".

Avoiding a *Hillsdown* challenge

17. There is a risk that such deals might be attacked on the basis that the employer had improperly pressurised the trustee into giving up its discretions or members rights to surplus (as occurred in the case of *Hillsdown Holdings* [1997] 1 All ER 862). This was said to be a breach of the employer's so called *Imperial* Duty: see *Re Imperial Tobacco* [1990] PLR 263

18. Although the merits of such challenges will always be fact specific in my view in most cases *Hillsdown* is likely to be distinguishable.

19. In *Hillsdown* the reason the deal over surplus between the trustee and the employer was set aside, was that a unilateral trustee discretion to augment benefits from surplus had already arisen and the trustee's duty was to exercise that discretion. Instead, it was pressured out of it by threats by the employer to use up the surplus by suspending contributions and "swamping" the scheme with transferred in members.

20. In the type of cases we are considering the scheme will not already be in winding up and the employer will not generally be under a duty to put the scheme into winding up to benefit members. Nevertheless, it is important that the employer does not appear to pressure the trustee to reach a deal and that the employer does not threaten "never" to exercise its power to put the scheme into winding up. An employer cannot properly rule out the exercise of its powers "for ever".

21. It should however be enough that the employer is not "currently minded" to put the scheme into winding up and not "currently minded" to augment benefits while the scheme is ongoing, and while not ruling a change of position out, is not currently expecting its position to change.

Blessing a deal in Court

22. Particularly in situation 3 it would be highly advisable, if not essential, to obtain the blessing of the Court for the agreement with the employer, and any amendment to the scheme which facilitates the revised distribution of surplus. Because the members' rights are being overridden by amendment (before they are triggered) such an agreement does not technically involve a compromise by the members of their rights. However given the trustee's justification of the

amendment will be that it is in the members' interests to give up the hope of a larger distribution of a larger surplus in future for a guaranteed distribution now, it makes sense to allow the beneficiaries themselves to have a say as to whether they consider the deal is in their interests, before the Trustee commits to it.

23. It is not however essential that the representative beneficiary consents to the deal, only that they do not persuade a Court that the deal reached by the Trustee is so poor it is outside their discretion to enter into it.

Agreements over surplus in situation 4

24. It will not generally be possible to do such a deal over surplus in situation 4 (i.e. where there is an express prohibition on the return of any surplus to the employer and a similar restriction on using the POA to bring about a return of surplus to the employer).

25. This is because, where there is not already a power to pay surplus to the employer, prima facie it will be necessary for the trustee to agree to amend the scheme to allow this, and this would not be a permissible amendment.

26. A *possible* exception to this is where there is bona fide dispute between the parties as to the extent of their rights in relation to surplus, in which case a compromise may be possible. The power to depart from the terms of the winding up provision would be conferred by a representation order binding beneficiaries to the deal.

Distributing surplus where a winding up has been triggered without an agreement as to a division of surplus.

27. Situations 1, 3 and 4 are easy as there will be a duty to pay the surplus either to the employer or the members.

28. Only in situation 2 does a trustee actually have a discretion to choose between augmenting benefits and paying surplus to an employer.

29. In situation 2, provided the trustee takes into account relevant considerations of which it can be expected to be aware, and excludes irrelevant considerations, the Trustee will have a very wide discretion to benefit either to the members or the employer. The only challenge would be one of irrationality which is clearly a very high bar.

30. The key to resisting a challenge is therefore to be able to show that in reaching its decision the trustee tookintoaccount relevant considerations and disregarded irrelevant ones.

31. The key factors are likely to be:

    a. The source of the surplus. Back in the 1980s and 1990s when surpluses last arose, schemes were still open, members were still contributing and the surpluses had resulted from a long period of benign investment conditions, inflating the future value of both member and employer contributions. At this time, the Courts were resistant to the idea that employers surpluses were morally or legally the property of the employer because of their balance of cost obligation. However that was in circumstances in which, in most case, that balance of cost obligation had not seriously been called upon.

    b. In contrast in 2024, the emergence of any surplus will in many cases have been preceded by an extended period of deficit during which members ceased to accrue benefits (and make contributions) but during which the employer was required to make substantial deficit repair contributions "DRCs"). While each case will turn on its own facts, in such situations it is easier to justify the conclusion that it is the employer's most recent deficit repair contributions (or "over-contributions") that are the proximate cause of the surplus.

c. This is not however a blanket rule. Obviously in all cases actuarial advice should be taken, but the conclusion that deficit repair contributions led to the surplus is not foregone. It would depend (for example) on the amount of the DRCs made by the employer compared to the surplus. It will obviously be easier to infer that the surplus is a result of employer contributions where the employer has made total DRCs of £200 m and there is now a surplus of £20 million than it would be if DRCs ere £20m and the surplus is £200m other way round.

d. Another important factor will be the investment performance of the other assets held by the scheme. The scheme might have received a large windfall from a well-judged investment.

e. It may also be relevant to ask whether the employer had previously taken a contribution holiday while members continued to contribute and did not get augmentations of their benefits.

f. It would also be relevant to consider whether the surplus has resulted from scheme rules working to the detriment of some or all members, which might give members a moral claim to an augmentation.

g. For example in larger schemes there may be particular groups of members who may claim to have been disadvantaged by the way the rules work in relation to them, for example in relation to bridging pensions, or commutation rates.

h. While, by definition, members benefits will be met in full, where the scheme has in the past provided only limited inflation protection there may be cohorts of members the real value of whose benefits has been eroded by high inflation exceeding increases payable by the scheme. That might be said to have benefitted the scheme.

i. There may also be a case for augmentations if one reason there is now a surplus was a decision to move from RPI to CPI in the past, or if the scheme was closed to future accrual in order to save money and replaced with a less generous alternative.

32. This is not intended to be an exhaustive list. The important thing is that the trustee considers the competing claims of different members and the employer. The trustee is not obliged to prefer one or the other and provided they can be seen to have taken both into account it would be very difficult to establish that their decision was irrational.

Situation 5 – resulting trust

33. The final situation I want to consider is situation 5, where a surplus falls to be returned to the employer or the members on the basis of a resulting trust.

34. The leading case on this remains *Air Jamaica v Charlton* [1999] 1 WLR 1399.

35. In *Air Jamaica* the PC concluded that the Members' share of the surplus should be divided pro rata among the Members and the estates of deceased Members in proportion to the contributions made by each Member apparently without regard to the benefits each had received and irrespective of the dates on which the contributions were made.

36. However the background to the *Air Jamaica* winding up was very different to the current economic backdrop. In particular:

a. There was no suggestion that the employer had been required to make deficit repair contributions.

b. The scheme had entered wind up when the original employer was privatised and original winding up rule that would have required the surplus to be used to augment benefits was struck down as infringing the rule against perpetuities.

c. The PC therefore considered that Members had made a bargain to join a scheme that would augment their benefits from surplus on a winding up (which could not happen).

In these particular circumstances it is not perhaps surprising that the PC indicated that they considered members to be entitled to at least a share of surplus.

37. These unusual factors are unlikely to be replicated other cases, such as where the surplus appears to have arisen as a result of employer DRCs which ultimately proved excessive.

38. Another problem thrown up by the *Air Jamaica* case was that, on the face of it the PC seem to suggest that members who had already died should benefit too under the resulting trust. They certainly did not appear to exclude such members. Yet contacting and distributing surplus to estates of deceased members would be far from straightforward. Obviously, similar issues would arise in relation to proposals to return surplus to dissolved former participating employer. It remains unclear how a court would now deal with them.

39. In the recent Scottish case involving the *abrdn pension trust* [2023] 061 PBLR (013) the Court of Session sanctioned an agreed division of surplus assets that would otherwise have been held on resulting trust between members and the employer, without clearly deciding what the position would have been absent an agreement.

40. The case is unsatisfactory because the judgment juggles two different issues – who was entitled to the surplus on a resulting trust and whether the trustee had power reach an agreement with the current employer to use part of the surplus to augment benefits and hand the rest over the employer. Further neither the members (past or present) were represented, nor were former employers.

41. As I read the judgment, the Court did not itself decide who owned the surplus on a resulting trust but was content to proceed on the basis that the Trustee was entitled to have decided that it belonged to the current (but not the former) employers and also did not belong to not members, because the scheme was essentially non-contributory. The agreement to divide the surplus benefitting current but not former members seemed to have been sanctioned on that basis.

42. Overall, the case raises almost as many questions as it answers. In consequence it seems yet to be decided how an English court would approach the question of law as to who benefits under a resulting trust in the case of a contributory scheme without the unusual features of the *Air Jamaica* case.

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