

3, STONE BUILDINGS

PENSIONS SEMINAR

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'DC or not DC'

A Commentary on *Bridge Trustees v Yates & Others*

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Introduction

1. Prior to the Pensions Act 1995, the distinction between defined benefits and benefits deriving from defined contributions - DB or DC - was of limited relevance. Schemes established at an earlier date sometimes did not, and did not need to, draw a clear dividing line. But the distinction became crucial, particularly in terms of scheme funding and winding-up priorities. Although, on wind-up, the introduction of the PPF and FAS has reduced the impact on members, the question whether benefits are salary-related or money purchase, and whether part of a scheme can be treated (e.g. for PPF purposes) as a separate money purchase scheme, remains a critical issue.

Bridge - the facts

2. The **Bridge** case¹ is a decision of Sarah Asplin Q.C., sitting as deputy judge of the Chancery Division, on the winding-up priorities in the Imperial Home Decor Scheme, now being wound up in deficit following the insolvency of the principal employer. The judge gave permission to appeal to all the rep. bens.; and word on the grapevine is that an appeal is now on foot.

¹ Bridge Trustees Ltd v Yates & Ors [2008] PLR 261

3. The history of the scheme and its resulting benefit structure are complicated. Briefly (and with some simplification, even if at the expense of accuracy):-
- (i) It began life in 1972 as a conventional final salary scheme.
 - (ii) In 1983 it was restructured to reduce DB benefits, but introduce an additional DC element on the basis of voluntary contributions, matched (within limits) by an employer contribution ("VIP benefits").
 - (iii) In 1992 it was restructured again, by the introduction of "MoneyMatch" benefits, which were, or were treated as, pure money purchase benefits relating to contributions by member and employer. Existing members were divided into 3 categories (depending on age, length of employment and what options they chose to exercise), as set out in para 12 of the judgment:-
 - (a) Option 1 members were those who had elected to convert their accrued final salary benefits into MoneyMatch and to accrue future benefits under the MoneyMatch section;
 - (b) Option 2 members were those who retained their accrued benefits in the final salary section but accrued future benefits under MoneyMatch; and
 - (c) Option 3 members were those who both retained their accrued benefits in final salary form and continued to accrue future benefits in final salary form and therefore, did not participate in MoneyMatch at all. They could accrue VIP benefits, this option being open only to those continuing to accrue final salary benefits.
4. Other key factors are as follows:-
- (1) Pre-1983 members were entitled to a guarantee introduced at that date ("the 1983 guarantee"), partially guaranteeing that the actuarial value of their benefits would not be less than the actuarial value of what their benefits would have been if remaining in the original final salary structure;

- (2) The scheme was contracted out of SERPS until 1997, with protected rights thereafter, so that most members had an entitlement to GMPs.
- (3) A proportion of MoneyMatch contributions in respect of a member were allocated to a "Guaranteed Investment Fund" and the excess invested in specific funds chosen by the member. The Guaranteed Investment Fund was, it seems, a notional fund, rather than an actual, segregated fund. The investment return on this notional fund was guaranteed by the employer. Moreover, despite the fact that MoneyMatch benefits were ostensibly money purchase, the rules included an employer balance-of-cost provision.
- (4) When pensions came into payment the scheme provided, at the member's option, for internal annuitisation. The member's money purchase pot ("the Member's Interest") was applied in the provision of an annuity by the trustees, based, it appears, on (i) the amount of the pot (ii) actuarial factors applying to the member and (iii) the comparable market cost of provision of an annuity by an insurance company. The objective, clearly, was to make annuities available for members at better rates than the market, by eliminating the profit element of an external insurance company. The member could, however, elect for external purchase.
5. The scheme commenced winding-up on 15 October 2003. Winding-up priorities under s.73 Pensions Act 1995, as modified by the OPS (Winding Up) Regulations 1996, therefore applied under the legislation in force at that date. The legislation has, of course, been modified since then. But the basic issues raised in *Bridge* remain of continuing importance.

The key issues

6. The judgment tackles a number of points of varying difficulty:-

(1) **Internal annuitisation:**

(a) ***Benefit before NRD***

Does the fact that an active or deferred member has the **option**, on bringing his pension into payment, to secure that pension by internal annuitisation mean that his DC benefits are not money purchase benefits under s.73?

(b) ***Benefit after NRD: internal annuity in payment***

If a member has already exercised that option, and is in receipt of a pension/annuity from the scheme, is that pension a money purchase benefit or a salary-related benefit?

(2) **Underpin benefits:**

For purposes of s.73, are the benefits of some members precluded from treatment as money purchase on the grounds that they constitute underpin benefits (i.e. underpinning salary-related benefits) by reason of:-

(a) the 1983 guarantee; and/or

(b) GMPs.

(3) **Voluntary contributions:**

Where members' own voluntary contributions were (to some extent) matched by employer contributions, are the employer's matching contributions also "voluntary contributions" for purposes of s.73?

And taking those issues in turn:-

Money purchase benefits: the effect of a right to internal annuitisation

7. The first question is whether the fact that a member, ostensibly entitled to money purchase benefits, has the **option** to apply his money purchase pot in securing an

annuity provided by the scheme mean that his benefits all along cannot be regarded as money purchase for s.73 purposes.

8. The definition of "*money purchase benefits*", imported from PSA 1993 s.181, is as follows (plus the addition, now, of a reference to a surviving civil partner):

"money purchase benefits", in relation to a member of a personal or occupational pension scheme or the widow or widower of a member of such a scheme, means benefits the rate or amount of which is calculated by reference to a payment or payments made by the member or by any other person in respect of the member and which are not average salary benefits"

9. In the earlier case of **Aon Trust Corporation v KPMG & Ors**² the Court of Appeal had considered the meaning of money purchase benefits in relation to the KPMG Staff Scheme. Benefits were related to contributions, but members' pension entitlement was not pure money purchase, since the calculation of benefits involved, at its first stage, the application of actuarial factors. It was a CARE scheme in which the pension purchased by contributions, coupled with length of service, were pre-defined on an actuarial basis. Jonathan Parker LJ, giving the lead judgment, held:

171 In my judgment the inclusion in the first stage of the calculation process of the actuarial factors to which I referred earlier is fatal to such a contention. The expression 'calculated by reference to' means, in my judgment, 'calculated only by reference to', in the sense that the benefit in question must be the direct product of the contributions (that being the basic characteristic of a money purchase scheme, as that expression is commonly understood: see Part 3 above). Neither the standard pension nor bonuses fall within that category.

² [2005] PLR 301

10. In **Bridge** the deputy judge pointed out that those scheme provisions were "vastly different". Leaving aside for the moment the 1983 guarantee and GMPs, a member's money purchase pot was determined on the amount of contributions plus investment return - and nothing else. Only when - and if - a member elected for internal annuitisation was his pot converted into a pension by use of market factors and actuarial assumptions: judgment para 132.
11. The distinction appears to me to be a valid one. In **KPMG** a member never had a money purchase pot: from day 1, his entitlement was an entitlement to pension derived from the application of actuarial tables to the amount of the contributions made by or in respect of him. As Jonathan Parker LJ said, it did not **look** like a money purchase scheme. In contrast, the members in **Bridge** did accumulate money purchase pots. The prospective application of actuarial factors on conversion of the pot to pension at NRD did not alter the essential nature of their benefits as money purchase benefits.
12. One may say that this was the case, *a fortiori*, where internal annuitisation was merely one of the options that the member might exercise at NRD. But, from the reasoning of the judgment, the option does not appear to be a crucial factor. What matters is that the member became entitled to a money purchase pot which was converted to an annuity, on commercial terms applicable at his NRD. The benefit depended on the size of the pot - not some actuarial tables or assumptions pre-determined by the rules of the scheme.
13. The comparison between KPMG and Bridge emphasises, yet again, the difficulty of laying down principles of general application. The answer depends - the answer almost always depends - on the rules of the particular scheme.

Pension in payment under internal annuitisation

14. The position is different where the member has reached NRD and has elected to take a pension from the scheme under the option for internal annuitisation. Prima facie the annuity constitutes a pension in payment for purposes of s.73(3)(b).
15. The general proposition was advanced by the trustees, based on the KPMG case, that such pension could not be a money-purchase benefit since the benefit, once converted into an internal annuity, involved actuarial factors and was not therefore calculated solely by reference to a money purchase pot. That was rejected: see judgment para 147. The benefit was still calculated by reference to the money purchase contributions, albeit that its conversion involved the application of actuarial factors to the resulting pot at the point of conversion. In other words a money purchase benefit does not lose its character as such by reason of internal annuitisation.
16. However, the argument that the pension should be treated, for purposes of s.73 as a money purchase benefit fell at the next hurdle. Reg 13 of the OPS (Winding Up) Regs 1996 SI 1996/3126 provides that s.73 applies to money purchase benefits as if –
 - (i) *the liabilities of the scheme did not include liabilities in respect of those benefits, and*
 - (ii) *the assets of the scheme did not include the assets by reference to which the rate or amount of those benefits is calculated*

But, on conversion to an internal annuity, the money purchase pot fell back into the general funds of the scheme and thereby lost its identity. There was no sectionalised or ring-fenced fund for the provision of such annuities. Hence, the regulations were not capable of operating so as to exclude the internal annuities

and assets referable to them. Reg 13 predicates the existence of separate funds: and see **Pitmans Trustees Ltd v Telecommunications Group plc**.³ Accordingly internal annuities in payment fell within s.73(3)(b).

17. An alternative argument that, in substance, suggested that a pensioner who had elected for internal annuitisation should be regarded as a purchaser (entitled by contract) rather than a member (entitled as a beneficiary) was unsustainable having regard to the scheme rules; and it was rejected: judgment para 148.

Money purchase: underpin benefits

18. The definition of money purchase benefits in reg.13 of the Winding Up Regs also excludes "underpin benefits", defined as –

money purchase benefits which under the provisions of the scheme will only be provided in respect of a member if their value exceeds the value of other benefits in respect of him under the scheme which are not money purchase benefits

This raises the question whether members' entitlement to the salary-related guarantee (the 1983 guarantee) and/or members' protected right to GMPs means that the money purchase element falls within that definition of underpin benefits.

19. ***The 1983 guarantee***
 - (1) Unlikely though it might be in practice, the very existence of such a guarantee predicates that, in some circumstances, the guaranteed (salary-related) benefits might exceed the money purchase benefits. The money purchase benefits are payable if, and only if, they exceed the salary-related benefits that are provided under that guarantee.

³ [2004] PLR 213, in particular at para 37.

- (2) It was held that, under reg.13, the money purchase benefits of the members concerned were to be regarded as underpin benefits, and thus not excluded from s.73.
- (3) It is difficult to see how the deputy judge could have arrived at any other conclusion on the statutory wording. But it may have wide implications; and the point still arises under the current provisions of s.73, as modified by reg.13.
- (4) It is not uncommon that schemes that changed the benefit structure from final salary to money purchase retained salary-related guarantees of this nature, in relation to past service of existing members. Alternatively, similar guarantees may have been given on scheme merger or on bulk transfers. It seems that, in all such cases, benefits that are ostensibly money purchase fall to be treated as underpin benefits and thus within the scope of s.73, no matter how small the guarantee or how unlikely it may be that it would take effect in practice.
- (5) However, when one looks at the PPF provisions, one finds that the disapplication of the PPF applies to "money purchase benefits"; and this is defined by reference only to the definitions in PSA 1993, with no reference to underpin benefits: and see PPF (Hybrid Schemes) (Modification) Regs 2005, SI 2005/449. There seems to be a mismatch between the regulations. Benefits are not money purchase for purposes of s.73 if they are underpin benefits as defined in reg. 13 of the Winding Up Regs, but prima facie they are still money purchase benefits for PPF purposes. The OPS (Winding Up) Regs 2005, SI 2005/706 have sorted out some of the inconsistencies between s.73 and the PPF legislation. But not this one. This problem may need to be resolved by further legislation.

- (6) Moreover, the inclusion in s.73 priorities of benefits categorised as underpin benefits means that the funds attributable to those underpin benefits fall into the common pool. Active or deferred members of a hybrid scheme who, on winding up, are happy in the belief that their money purchase pots are segregated, and safe, may well find themselves in the same boat as DB members. The "guarantee", far from being beneficial, has in fact deprived them of the security of their money purchase pots and driven them to rely on PPF or FAS benefits - if they are in fact eligible (see (5) above).

20. **GMPs**

- (1) The deputy judge held that GMPs similarly constituted underpin benefits. This finding involved some of the same points as the 1983 guarantee. But it also raised a further question. The regulation (see para 18 above) only applies where the benefits to which the member was entitled, as well as money purchase benefits, included "other benefits". Is a GMP an "other" benefit?
- (2) In **Marsh & McLennan v Pensions Ombudsman** [2001] PLR 51 Rimer J considered, obiter, the equalisation of GMPs and dealt with the question whether GMPs had a separate existence as pensions in their own right. At para 83 he stated:-

... the better analysis of GMPs is that they are in the nature of calculation factors rather than pensions themselves or discrete elements of the scheme pension. The scheme pension is one indivisible pension. No doubt an element of it can be regarded as satisfying the minimum benchmark represented by the GMP, but I regard it as incorrect to regard the scheme pension as comprising two elements made up of a GMP and the excess above it. The position does not become conceptually different if the fortunes of the scheme are such that only a pension equivalent to the GMP

becomes payable. In certain circumstances, even if the scheme pension exceeds the GMP, there will also be a liability to pay the anti-franking supplement, but I do not regard this supplement as constituting a separate pension, or as a discrete element of the pension either. Of course, the GMP calculation factors have roles to play other than the benchmark role. For example, in an insolvent winding up they will produce amounts that will enjoy priority over the balance of the pension obligations, but I do not regard this as converting the priority payment into a separate pension, although it may be realistic in practice to regard the GMP in this particular context as amounting to a discrete part of the pension, since it is a part in respect of which priority is enjoyed. But I do not regard this as requiring GMPs themselves to be regarded as deferred 'pay' for the purposes of Article 141.

21. In **Bridge**, the deputy judge held that, for purposes of s.73 and reg.13 of the Winding Up Regs, GMP was to be regarded as a discrete pension - discrete, that is, from the money purchase benefit - and thus as an "other benefit" in the context of reg.13. Hence the money purchase element fell within the definition of underpin benefit: see judgment paras 156-164.
22. One can see the reasons why, on a purposive approach, she came to this conclusion, despite Rimer J's indications to the contrary in **Marsh & McLennan**. Prima facie, s.73 treats a GMP as a separate pension, or at any rate as a distinct and separate benefit within the scheme pension. Moreover, there appears to be no real practical distinction between (i) money purchase benefits with a salary-related guarantee (the 1983 guarantee), and (ii) money purchase benefits with a salary-related guaranteed minimum pension. It would, in a sense, be illogical for the money purchase benefits to be treated as underpin benefits in the one case but not the other.
23. The deputy judge pointed out, correctly, that Rimer J was dealing with the question in a different context, in relation to different statutory provisions. But there is some conceptual difficulty with the proposition that, under the same Act and related subordinate legislation, a GMP can be a separate pension in one

context yet have no separate existence at all in another context. One can, however, finesse the point by contending that, although a GMP is not **as such** a separate pension, the scheme of s.73 and reg.13 necessarily imply that, for the purposes of those provisions, the GMP be treated **as if** it were a separate and distinct benefit. Rimer J's comments on s.73 can be construed in these terms; and it is to be noted that, although the deputy judge in *Bridge* stated (para 161) that the legislation "clearly envisages the GMP as a pension in its own right", she expressed her conclusion (para 162) in terms that, for purposes of s.73, "the GMP is to be **treated as** a separate benefit". In my view it therefore remains possible to reconcile the two approaches on the basis that the treatment of GMP as a separate pension for purposes of s.73 is notional rather than actual, albeit that this interpretation takes some liberties with the statutory wording.

24. There is much to be said for this compromise view. Many pension practitioners would be reluctant to abandon Rimer J's analysis, even if there are doubts as to its correctness. It provides a reasonable basis for the widespread, if unspoken, agreement within the pensions industry that there is no need to equalise GMPs - a conclusion that may or may not be right but is certainly convenient. Whether it is possible to maintain this position for much longer is an open question: see Richard Kandler's interesting, and rather alarming, article in the latest edition of *Pension Lawyer*, Issue 107, p.27. The **Bridge** judgment certainly adds some strength to the argument that the GMP is a separate benefit and thus (unless one can regard it as a social security benefit and not "pay") should prima facie be equalised.

Section 73: Whether "voluntary contributions" include matching employer contributions

25. Section 73(3)(a) gives priority to –

any liability for pensions or other benefits which, in the opinion of the trustees, are derived from the payment by any member of the scheme of voluntary contributions

26. Although it was argued in **Bridge** that "derived from" should be given a wide meaning, it was held that a liability was only "derived from" a payment from a member where the member's own payment constituted the source - not merely the cause - for that liability. Hence, employer's matching contributions were excluded; and the trustees' decision to the contrary was wrong in law.
27. Whether looked at as a strict construction of the statutory wording or on a purposive interpretation, this result appears to be plainly correct, although the members concerned will no doubt be disappointed.

Bridge on appeal?

28. All the rep. bens. were given permission to appeal. In view of the novelty and difficulty of the issues raised, it was plainly right that the beneficiaries concerned should not be denied the opportunity of testing the decision on appeal if they wished to do so and could get funding for this purpose. Moreover, this is not the only case where similar problems arise; and the decision in **Bridge** has wider significance.
29. I also understand neither the PPF nor FAS are happy with the fact that **KPMG** was distinguished. It is likely to be advantageous to the PPF and FAS that assets that might ostensibly be regarded as "money purchase" should instead fall into the common pool applicable for all members. Moreover, the approach in **Bridge** does mean that there is no single, uniform answer: the position can only be determined by examining the rules of each particular scheme, thereby adding to the administrative burden. It is not a box-ticking exercise.

30. I understand that rep. bens. have now obtained funding for the appeal despite the usual difficulties in obtaining pre-emptive costs for an appeal: see, e.g., **Chessels v BT**⁴ (in which I signally failed to do so). But I do not know whether they have obtained a pre-emptive costs order, trades union backing or, possibly, backing from the PPF, or the DWP on behalf of FAS, though this seems unlikely.
31. One can only hope that the appeal panel includes at least one LJ with some expert knowledge of pension schemes and pensions legislation. It is crucial that the Court of Appeal understands the legislative framework and the need to give the primary and subordinate legislation a coherent, consistent and workable meaning - as the deputy judge was careful to do. But it sometimes seems to me, in my more cynical moments, that the sole purpose of the CPR requirement that skeleton arguments are filed so early (with, or within 14 days after, lodging the Appeal Notice/ Respondent's Notice: paras 5.9 and 7.7 of the Practice Direction under CPR r.52) is to enable the CA Listing Office to select a panel, none of whom have any particular experience of the subject-matter of the appeal.

Issues on appeal

32. If there is an appeal, the principal issues are likely to revolve around the question of internal annuitisation, both in relation to accruing benefits of actives or deferreds, and as regards pensions in payment, when a member at NRD has exercised his option to take an internal annuity.
33. As regards accruing benefits, was the deputy judge right to distinguish **KPMG**? Personally, I take the view that she was. Certainly there were grounds for doing so, having regard to the essentially different provisions of the two schemes. The reasoning of the court in **KPMG** is very much dependent on the fact that, in that

⁴ [2002] PLR 141

scheme, actuarial factors were applied at the **first** stage of calculating the benefit. There was no money purchase pot and, instead, contributions translated directly into pension. That is plainly not the case as regards the scheme in **Bridge**.

34. Assuming that the benefit is a money purchase benefit in the first instance, does it change its character when converted into an internal annuity - or can one say "once a money purchase benefit always a money purchase benefit"? There seems to be no convincing reason why its character should change. In terms of funding, the source of the annuity is the money purchase pot, derived, and solely derived, from defined contributions. In fact, however, the point became largely academic in **Bridge**, since it seems that reg.13 of the Winding Up Regs cannot apply so as to segregate money purchase assets where there are no specific, ascertainable assets from which the benefit is payable (though this might not be the case under other schemes).
35. Perhaps the most interesting aspect of an appeal would be the apparent divergence between the deputy judge's decision and the dicta of Rimer J in **Marsh & McLennan**. Although the deputy judge was at pains to point out that they were dealing with different provisions of the 1995 Act and in a different context, the two judicial views are not entirely easy to reconcile. The idea that a GMP can have a chameleon-like existence, changing its character to suit the particular section of the 1995 Act in which it happens to find itself, is not altogether convincing. The compromise view referred to in para 23 above has its attractions, but whether the statutory wording permits that approach is another question. The Court of Appeal panel might, of course, include Rimer LJ, which would no doubt give the argument added zest.
36. In one respect, at least, the Court of Appeal might be very reluctant to overturn the judgment in **Bridge**, or any interlinked part of it. The judgment as a whole

produced a coherent and consistent interpretation of the legislation and provided a practical solution to the problems that the trustees put before the court. Individual points are no doubt arguable. But the challenge for any appellant is to produce an alternative interpretation that is equally coherent, consistent and practical. That will be no easy task.

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