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"There are many stakeholders involved in an occupational pension scheme (participating employers, active members, deferred members, pensioner members, spouses and/or children in receipt of benefits). As many defined benefit schemes approach maturity, some are in the fortunate position to have surplus assets. Such schemes may have broad powers on how to use such surplus assets on scheme wind up including augmenting some or all member benefits and/or returning surplus assets to the employers. What is the appropriate balancing act when Trustees are considering the competing interests of the main stakeholders' respective claims to surplus assets in a pension scheme context? In considering this query, please discuss the purpose of a pension scheme and whether some stakeholders should be preferred over others."

Introduction

Whilst a surplus may appear to be a welcome development for any pension scheme, the balancing act that trustees must undertake when considering the competing interests of the main stakeholders' respective claims to such a surplus is an unenviable task. Although the starting point for managing a surplus is the scheme trust deed and rules, the onus often falls upon the trustee to use its powers to determine how to apply a surplus. This paper explores the competing interests of stakeholders to determine if some should be preferred over others.

Context to Consider

Before endeavouring to establish who should have preferred ownership of a surplus, it is important to review the purpose of a pension scheme, so as to correctly frame the context of this discussion.

Simply put, pension schemes are set up to provide members (and often dependants of those members in the event of their death) with regular income after retirement. This is becoming increasingly important as average life expectancy continues to increase, giving rise to an ageing population. In this way, pensions serve a crucial function in the economy and are one of the most valuable assets that an individual can have. Their importance is recognised and bolstered by the State in the tax reliefs that are offered on both contributions made to the scheme, as well as growth on investments.

It is important to note at the outset, before exploring the competing claims for surplus, that a surplus *"does not in any intelligible sense belong to anyone."*[1] Who should have claim to a surplus depends on the respective rights of stakeholders under the scheme, or more importantly, the purpose of the scheme.[2] Therefore, although this question of entitlement has been a live issue for years, there can never be a binding answer as every scheme is different, hence why there is considerable inconsistency in the caselaw on this topic.[3] It is important to remember this throughout this paper, as to lay down specific guidelines regarding ownership would be a dangerous exercise.[4]

In determining how trustees should manage the competing interests of stakeholders in this context, the *Edge v Pensions Ombudsman* case should act as guide.[5] In the absence of any trust deed and rules prescribing what should be done, navigating this balancing act is essentially a matter of trustees deciding how to exercise their discretionary powers. In *Edge,* it was held that trustees should exercise such powers for the purpose given, taking all relevant matters into account.[6] Such factors may include the purpose of the

[1] *Taylor v Lucas Pensions Trust* [1994] OPLR 29.

[2] Kris Weber, *Tolley's Pensions Law Service* (Issue 147, LNUK 2024).

[3] Specialist News Analysis, 'Surpluses in pension funds – where are we now?' (2001) LNUK.

[4] UK Legal News Analysis, 'Who owns the surplus in pension funds?' (2001) LNUK.

[5] [1999] 4 All ER 546.

[6] ibid.

scheme, the effect of any decision on the employer's business and whether current benefits are aligned with inflation.[7] Consideration of all of these factors is vital in order to navigate this balancing act correctly.

Competing Claims of Stakeholders

Entitlement to a surplus is an emotive subject and is therefore frequently a cause of dispute amongst stakeholders.[8] Turning to employers in the first instance, it could be argued that they are entitled to a return of any surplus as its existence is simply reflective of excessive contributions made by them in the past.[9] The net result of this is that employers will have increased funds to further their commercial ambitions, which is arguably in the members' interests as well. This, however, ignores the possibility that the surplus could be due to scheme investment gains or actual scheme experience.[10] In addition, it could be argued that this practice should be discouraged to prevent employers from potential overfunding of schemes in order to abuse various tax privileges.[11] As against this, it should be noted that any refund of a surplus to an employer is taxable as a trading or professional receipt of that employer.[12]

Instead, the surplus could be used to reduce employer contributions or even stop such contributions altogether, giving rise to a contributions holiday. It has been argued that this allows employers to 'raid' pension funds, however this seems unfair in a situation where there are enough funds to meet employer liabilities without affecting members' benefits, especially given that defined benefit schemes are a massive cost for employers.[13]

It is clear that an asymmetry exists for contributing employers, in that they must share the responsibility for any deficit but do not even benefit from investment gains, let alone have any right to a surplus.[14] The trustee should be mindful of this when weighing up competing interests as it serves as a disincentive for employers to put more money into a scheme, and therefore relinquish control of those funds to trustees.[15]

On the other hand, members contend that any surplus should be used to improve their benefits. This is especially the case if such benefits are not aligned with the current cost of living. This approach is in line with the stated aims of pension schemes, which trustees are bound to follow. However, it could be argued that enhancing such benefits goes beyond this purpose and in fact becomes superfluous to the detriment of other stakeholders. As noted in *Edge,* the purpose of a pension scheme is not achieved by putting an employer out of business.[16] Therefore, whilst favouring members' interests in this way may ostensibly appear to be the most equitable approach, it could result in a 'lose-lose' situation.

The trustee should consider the balance of powers in scheme wind-up rules when considering augmenting members' benefits. It is common for an employer's consent or consultation to be needed for any such enhancement. However, trustees could use benefit improvements as part of a bargain with employers to permit repayment of part of the surplus to an employer.[17] In this way, a mutually beneficial agreement could be reached for all stakeholders.[18]

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[7] ibid.

[8] Lexis+ UK, 'Surplus - overview' (unknown) LexisPSL Pensions Overview.

[9] ibid.

[10] ibid.

[11] ibid.

[12] Taxes Consolidation Act 1997, s 782.

[13] n 4.

[14] Colin Sherwood, 'Myners report calls for many changes' (2001) 168 Occupational Pensions LNUK.

[15] ibid.

[16] n 5.

[17] Paul Fitzmaurice, 'Pension fund surpluses: What to do with them' (1990) Practical Law for Companies (October edn).

[18] Clive Weber; Douglas Sleziak and Matthew Harrison, *Sweet & Maxwell's Law of Pension Schemes* (Volume 1, Sweet & Maxwell 2022).

With regards to different classes of members, trustees have a duty to treat beneficiaries fairly and impartially. However, trustees are not obliged to treat each class of beneficiary equally.[19] Following *Edge,* as long as trustees exercise the power for the purpose it was given, taking all relevant matters into account, and disregarding any irrelevant matters, their decision to seemingly favour certain classes cannot be criticised.[20] Trustees should be mindful of this when applying a surplus. Depending on the circumstances, there may be clear justification for enhancing benefits for some classes but not all. For instance, in the case of a winding-up, the fate of different beneficiaries, particularly those with poor employment prospects, should be given due weight.[21] It could also be argued that since the primary purpose of a pension scheme is to provide benefits to members, such members should have more of a right to a surplus over any secondary beneficiaries, whose entitlements are contingent (i.e., spouses or children upon the death of a member).[22]

The Relevance of Trust Law

At this juncture, it is important to discuss the role and duties of trustees. Where the scheme rules are silent as to how a surplus should be dealt with, the courts rely upon general trust law principles.[23] Under common law, trustees are fiduciaries and therefore have an overriding duty to act in the interests of scheme beneficiaries.[24] A trustee's discretion to apply a surplus is therefore constrained by its duty to act in the best interests of its beneficiaries.[25] There may be cases where acting to the financial disadvantage of a beneficiary may actually be for their benefit, but this is rare.[26] The main beneficiary under a scheme is the member. Therefore, a trustee must not accede to employer demands to the detriment of members, and thereby breach its own trustee duties.[27]

It seems, therefore, that the issue of competing interests in surplus cases can be resolved by reverting to overarching trust law principles which invariably tend to favour members' interests.[28] Although members do not have a legal right to surplus *per se*, trustees have a continuing responsibility to represent and protect their interests when negotiating with employers.[29] It seems that employers' interests can and should be considered by trustees, but perhaps only to the extent to which they are not inconsistent with the interests of the members. It could be argued, therefore, that a discussion as to whether certain stakeholders should be preferred over others is in fact moot, owing to the governing principles of trust law in this context. However, if the scheme rules permit for a refund of surplus to employers, then they too could be considered as beneficiaries. In light of this, so long as members' benefits are fully secured, it is arguable that their interests need not necessarily take precedence.

Conclusion

Ultimately, whether some stakeholders should be preferred over others in the context of a surplus is not a matter that can be definitively decided. It is completely dependent on the scheme at issue rather than some entitlement, albeit a historic one, under trust law.

[19] Jonathan Hilliard KC and Emily McKechnie, 'Pension trustees' duties of care and skill' (unknown) Wilberforce Chambers.

[20] n 5.

[21] n 18.

[22] Specialist News Analysis, 'Pension trusts: the position of spouses and dependants' (2002) Association of Pension Lawyers.

[23] n 2.

[24] Faith Dickson, 'Pension scheme trustees: understanding their dilemma' (2008) Sacker & Partners LLP.

[25] n 2.

[26] n 19.

[27] Tim Sewell, 'Pension Schemes' (2023) 31(1) Encyclopaedia of Forms and Precedents.

[28] n 3.

[29] ibid.

Instead, all that trustees can reasonably do is to try to find some harmony between the relative interests of all interested parties. These will never be perfectly aligned and therefore, there will always be an opportunity cost. The key to navigating this balancing act is to ensure that trustees engage in open communication with stakeholders and consider all relevant factors. What is relevant will depend on the prevailing circumstances at the time as well as the historical context of the scheme. Provided trustees act properly within the ambit of their discretion, their decision cannot be impugned.

"Please also briefly discuss the treatment of defined benefit scheme surpluses in the United Kingdom with a particular focus on recent case law."

The treatment of defined benefit scheme surpluses in the United Kingdom (**UK**) is subject to the rules of the scheme and therefore varies widely. This can be seen in the inconsistency of the caselaw on this subject, wherein the courts have approved a range of different approaches.

Firstly, it is important to note the legislative context of surpluses in the UK. Surplus payments to employers in ongoing schemes are highly regulated, with legislation imposing a tax of 25% on such payments.[30] Section 37 and Section 251 of the Pensions Act 1995 restrict when surplus payments can be made to employers in order to protect members.[31]

It is worth noting that the Department for Work and Pensions (**DWP**) published a consultation this year on proposals to introduce a statutory override in relation to surpluses.[32] The deadline for responses has since passed and the DWP's consultation response is awaited.[33]

A key Ombudsman decision recently permitted a trustee to return a £12 million surplus to an employer.[34] It was held that as long as trustees follow the correct process, take account of all relevant factors, and make a reasonable decision, their decision cannot be overruled.[35] The Ombudsman repeatedly commended how well documented the process was and the fact that actuarial and legal advice was sought by the trustees.[36] This case mirrors the guidance from the earlier decision of *Edge,* in which it was held to be permissible to exclude pensioners from benefit enhancements as their benefits had been improved in the past and were index-linked.[37]

UK caselaw has also held that if the scheme rules are silent as to applying a surplus and if there is no resulting trust, the surplus may pass to the Crown under the principle of bona vacantia.[38] In *Davis v Richards & Wallington Industries,* any surplus arising from employer contributions was held to be on a resulting trust for employers, whereas the surplus that arose from member contributions and transferred funds was subject to the principle of bona vacantia.[39]

It should be noted that whether resulting trusts can actually arise in the context of surpluses remains to be an unsettled matter in UK caselaw. However, the *Air Jamaica*[40] approach, which states that the surplus

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[30] Finance Act 2004, s 177.

[31] Practical Law Pensions, 'Dealing with a surplus in a defined benefit pension scheme: key cases' (unknown).

[32] Practical Law Pensions, 'DB schemes: DWP consults on surplus changes and creation of PPF consolidator' (2024).

[33] ibid.

[34] *Water Companies Pension Scheme – Bristol Water plc Section* (CAS-92093-N4D9).

[35] ibid.

[36] ibid.

[37] *Edge v Pensions Ombudsman* [2000] Ch602.

[38] n 3.

[39] *Davis v Richards & Wallington* [1990] 1 WLR 1511.

[40] *Air Jamaica Ltd v Charlton* [1999] 1 WLR 1399.

attributable to employers' contributions should be held on resulting trust for them, was recently supported in Scotland.[41]

In *National Grid,* the Court stated that the solution to the surplus distribution problem *"lies within the terms of the scheme itself."* [42] This position continues to prevail, as seen in the recent case of *Entrust* in which it was held that based on an interpretation of the scheme rules, rather than an antiquated entitlement under trust law, members were not entitled to a share of the surplus.[43] In *Merchant Navy Ratings,* it was held that 'the best interests of beneficiaries' approach should not be viewed as a stand-alone duty - the key is the purpose of the scheme. [44]

In *Re Courage,* it was held that a surplus could entitle employers to a contributions holiday, but that this does not equally entitle them to a surplus refund.[45] In *National Grid,* the House of Lords concluded that using a surplus to discharge accrued liabilities did not amount to a repayment to the employer.[46] *Stevens v Bell* later held that trustees may allocate surplus to reserves and upheld a thirty-year contributions holiday.[47]

In *NBPF Pension Trustees*, trustees were permitted to use part of the surplus to purchase run-off insurance.[48] They were also permitted to pay a lump sum to members, rather than augment benefits, and to exclude untraced and dissenting beneficiaries from distribution.[49] In *Halliwell*, it was confirmed that awarding limited price indexation benefit increases to members, with the remaining surplus being divided equally among members and employers, was reasonable.[50]

It has also been held that a surplus may be used to pay contributions to a defined contribution scheme.[51] In *Harding v Joy,* transferring two thirds of a surplus to another scheme was held to be permissible.[52]

Despite the prescriptive legislation regarding payments of surplus to employers, the treatment of scheme surpluses in the UK has been varied. This is to be expected as the result is dependent upon the rules of the scheme. The caselaw supports the opinion that provided trustees act properly, by considering all relevant factors, their decision will be upheld by the Court.

Trustees' decisions on distribution of surplus is an important issue. Careful consideration must be given to all stakeholders as well as the individual parameters of the scheme, thereby reducing the risk of subsequent complaint or litigation.

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[41] *Petition for Direction of abrdn (SLSPS) Pension Trustee Company Limited* [2023] CSIH 31.

[42] *National Grid Co plc v Mayes* [1999] All ER (D) 126.

[43] *Entrust Pension Ltd v Prospect Hospice Ltd* [2012] EWHC 1666 (Ch).

[44] *Merchant Navy Ratings Pension Fund; Merchant Navy Ratings Pension Trustees Ltd v Stena Line Ltd* [2015] EWHC 448 (Ch).

[45] *Re Courage Group's Pension Schemes* [1987] 1 All ER 528.

[46] *National Grid Co plc v Mayes* [2001] UKHL 20.

[47] *Stevens v Bell* [2002] EWCA Civ 672.

[48] *NBPF Pension Trustees Ltd v Warnock-Smith* [2008] EWHC 455 (Ch).

[49] ibid.

[50] *Alexander Forbes Trustee Services Ltd v Halliwell* [2003] EWHC 1685 (Ch).

[51] *Barclays Bank Plc v Holmes & Ors* [2001] OPLR 37.

[52] *Petition of Peter Harding & Others for Directions and Answers for Joy Manufacturing Holdings Limited* [1999] P16/11/97.