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Introduction

Defined benefit pension schemes are often associated with higher risks for employers due to the likelihood of having to fund scheme deficits. Many employers have in fact chosen the defined contribution (DC) model for the provision of pension benefits as a way to mitigate these risks. However, a study conducted by Mercer in 2022 showed that bond yields had swung in favour of DB pension schemes. At that time, there was in fact a significant surplus of approximately €1 billion in Irish DB pension schemes.[1] This is compared to a deficit of approximately €4.5 billion in December 2016.[2] As a result of this turn of events, the question now centres around how to deal with these surplus assets in DB pension schemes as they reach maturity or are wound up.

There are numerous stakeholders involved in pension schemes and their interests must be borne in mind in considering how to deal with surplus assets. However, the degree to which varying interests are taken into account is a balance trustees must strike. The first part of this paper delves into this precise balancing act which trustees must strike in order to deal with competing claims on pension scheme surplus in Ireland, while the second part of this paper looks at the approach in the United Kingdom (UK).

1. 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 order to assess this question, trustees must take into account the purpose of a pension scheme in providing benefits for the various classes of members. Trustees and their advisors must first consider the trust deed and rules of the relevant pension scheme and then take into account the legislative provisions as well as case law.

1.1. Purpose of a pension scheme

Pension schemes are designed to provide income for retired members in the form of lump sum and/or regular payments. Pension schemes can also provide an income for dependants in the event of a member's death. The government encourages private pension contributions which supplement the state pension, and as a result there are tax incentives provided for contributions to DB and DC pension schemes. Pension schemes are often seen as an employer's way of rewarding employees by providing them with retirement benefits. In the past, DB pension schemes were a popular choice for employers looking to provide pensions for their employees. This is no longer the case due to the increased risk and cost for employers associated with this type of pension scheme. The preferred option for pension provision now is through a DC pension scheme, which is often housed in a master trust. Both scheme types fulfil the purpose of providing benefits for members, however the key distinction between DB and DC pension schemes is the fact that in DB pension schemes, the employer usually bears the risk of ensuring that the standard of the fund is maintained at the agreed level. For those DB schemes which remain, where a surplus occurs there are a number of options available to trustees in dealing with such surplus, including: leaving surplus funds in the scheme, reducing contributions, transferring surplus assets to another scheme, augmenting member benefits or refunding surplus funds to the sponsoring employer. However, as pension schemes were not designed to make a profit, they can be ill equipped for dealing with surplus assets.

1.2. Balancing competing rights to surplus

Taking the purpose of a pension scheme into account, once members needs are met, trustees must look at, the trust deed and rules, legislation and case law in order to assess their options in dealing with surplus assets.

1.2.1. Trust Deed and Rules

A trustees primary duty in administering the trusts of a scheme is to act in the best interests of the scheme members. This will often require trustees to consider the financial interests of members given that this is the purpose for which a scheme is set up.[3] However, this does not preclude them from taking

[1] Mercer, '*€1bn swing to surplus estimated in Irish defined benefit pension schemes*', 27 July 2022 (available here).
[2] Ibid.
[3] Cowan v Scargill [1985] 1 Ch 270.

other stakeholders' interests into account when a surplus occurs. The *Element Six*[4] case states that in addition to a duty to act in good faith, trustees are required to "*take all relevant matters into account; trustees must exclude irrelevant matters; trustees must direct themselves properly in law and in interpreting the provisions of a trust deed and rules.*" The UK case of *Edge v Pensions Ombudsman*[5] highlights that if trustees follow these principles, "*they cannot be criticised if they reach a decision which appears to prefer the claims of one interest - whether that of employers, current employees or pensioners - over others. The preference will be the result of a proper exercise of the discretionary power".*

Therefore, trustees have a duty to consider the impact of their decision on each category of stakeholder including active and deferred members, employers, dependants and pensioners. However, they do not have to attach equal weight to that impact on each category of stakeholder. Trustees and their legal advisors will need to carefully consider any requirements under the trust deed and rules on how best to deal with surplus scheme assets. This is particularly relevant where the scheme is in windup.

Any powers relating to surplus assets contained in the trust deed and rules will typically be at the discretion of the trustees and/or the sponsoring employer. Trustees should pay particular attention to any power of amendment or restriction on paying funds to a scheme employer.[6] Any amendment which purports to deal with surplus scheme assets must be dealt with in accordance with the scheme trust deed and rules as they stood at that time and the intention behind such an amendment must be clear.[7] The courts will not interfere in a trustees decision but rather they will ensure that proper procedures have been followed.

1.2.2. Legislation

Trustees must also take into account any legislative requirements in dealing with scheme surplus. The Pensions Act 1990 (as amended) does not explicitly provide a mechanism for deciding which stakeholders should be preferred in circumstances where there are surplus assets in a pension scheme. However, where a surplus occurs and excess assets are refunded to the sponsoring employer, such assets may be taxed as a trading expense as per Revenue's Pensions Manual[8]. In addition, in circumstances where a pension scheme surplus is in excess of 10% of the scheme's assets this should be notified to Revenue.[9]

Where a DB scheme is in wind up, the Pensions Act Protected Disclosure Regulations[10] should also be borne in mind. An information and consultation requirement arises where trustees in the context of a wind up, propose to exercise any discretion "*as to the payment of any of the resources"* of a scheme to an employer. The refund of a scheme surplus to an employer on the scheme windup could fall within this requirement if the rules are drafted in such a way as to give the trustees discretion as to how to apportion such surplus. As a result, before exercising any discretion on the refund of scheme surplus assets to an employer, the trustees should provide members with a notice setting out the relevant details required under Regulation 16 and allow for a one-month period during which observations may be made.[11]

1.2.3. Case Law

Finally, we look to case law to consider how the courts have dealt with this topic. The UK case law has proven persuasive before the Irish courts and as a result is relevant in our interpretation of pension scheme rules surrounding surplus assets. It is settled law that surplus scheme assets are not in any particular way beneficially owned by either an employer or scheme members. The purpose of employer contributions is to fund the benefits payable under a DB pension scheme. As stated in *Re Courage*, *"surplus arise from what, with hindsight, can be recognised as past overfunding".*[12] Neuberger J clarified in *Barclay's Bank v Holmes* that, " *it cannot sensibly be contended that a member of a pension scheme*

[4] Greene v Coady [2014] IEHC 38 (hereinafter *Element Six* case)
[5] [2000] Ch. 602.
[6] Hillsdown Holdings plc v Pensions Ombudsman [1996] Pens LR 427.
[7] BIC UK Ltd v Burgess, Chambonnet and Everitt [2019] EWCA Civ 806.
[8] Section 782, Taxes Consolidation Act 1997 (as amended); Chapter 15, Revenue Pensions Manual.
[9] Chapter 5, Revenue Pensions Manual.
[10] Occupational Pension Schemes (Disclosure of Information) Regulations, 2006 [S.I. No. 301 of 2006], as amended.
[11] Regulation 16, Occupational Pension Schemes (Disclosure of Information) Regulations, 2006 [S.I. No. 301 of 2006], as amended.
[12] Re Courage Groups Pensions Scheme [1987] 1 WL 495, considered by the Irish High Court in Element Six case supra note 4.

has any 'right', let alone an 'accrued right', to or in relation to surplus ".[13] Although members may not have an inherent right to augmented benefits, neither do employers have such a right to a refund of surplus assets. As a result, trustees must exercise any discretion under the trust deed and rules by considering the interests of all of the stakeholders in a pension scheme including members, pensioners, employers, dependants and beneficiaries.

In reaching their decision on how to deal with surplus scheme assets, trustees are expected to consider the following[14]:

- source of surplus;
- size of surplus;
- financial position of employer;
- reasonable expectations of scheme members;
- member's needs; and
- previous funding patterns.

The Irish High Court confirmed in the *Element Six* case[15] that it is a matter for the trustees to decide the weight they place on each of these factors. The courts will not intervene in the decision-making process of the trustees unless it is a decision which no reasonable board of trustees would make.[16]

2. Treatment of surplus in the UK

The principles for dealing with surplus scheme assets in the UK are similar to the Irish approach. The Irish courts have been influenced by the decisions in the UK and as a result they have proved to be a useful guide in interpreting the parameters of scheme requirements in distributing surplus assets.

2.1. UK Legislation

Legislation in the UK specifically regulates the return of surplus scheme assets to an employer in circumstances which fall under s.37 of the UK Pension Act 1995 and s. 251 of UK Pensions Act 2004. The issue with this is the fact that in order to exert any discretion under s.37, scheme trustees must be satisfied that it is in the interest of members to return a surplus to an employer. In addition, trustees must also follow the UK Occupational Pension Schemes (Payments to Employer) Regulations 2006. The combined effect of these provisions has made it very difficult for trustees to deal with surplus assets in well-funded pension schemes.

In order to return a surplus payment to an employer in the UK without incurring surplus charges, it must fall within the definition of an authorised surplus payment under the Registered Pension Schemes (Authorised Surplus Payments) Regulations 2006. This may, however, attract an authorised surplus payments charge under s. 207 of the UK Finance Act 2004.

Due to the increase in surplus assets in schemes in the UK, the government is considering introducing express legislation which allows for the return of such surplus to employers. It is thought that this is in the hope that these funds will then be reinvested into the economy.[17]

As a result of the difficulties in managing DB pension schemes surplus, trustees are considering the ways in which surplus can be avoided. These mechanisms require specific tax advice based on the schemes position and include: escrow accounts, guarantees, partnerships and reservoir trusts.[18]

2.2. Case law on the interpretation of pension documentation

The starting point in dealing with a question of scheme surplus will always be looking at the trust deed and rules. The UK case law shows that where the scheme rules are concerned in general they either:

[13] [2000] EWHC Ch 457.
[14] Thrells v Lomas [1993] 1 WLR 456.
[15] Element Six case supra note 4.
[16] Edge v Pensions Ombudsman [2000] Ch. 602 as endorsed in the Irish High Court in Element Six case supra note 4.
[17] DWP Consultation Paper, "Options for Defined Benefit Schemes", 23 February 2024.
[18] Emma Game, Senior Counsel, Tax, Slaughter and May, Presentation at Association of Pension Lawyers Conference, 21 June 2024.

confer a discretionary power on the trustees to apportion surplus with or without employer consent, give the employer discretion to apportion surplus or, are silent on the matter of the division of surplus scheme assets.

2.2.1. Trustee Discretion

The leading UK case of *Thrells v Lomas*[19] clarifies that where scheme rules provide for the augmentation of member benefits before the remaining surplus, if any, is refunded to the employers,

> *"… the power ranks ahead of the provision that any remaining balance of the scheme funds should be paid to the company. When a scheme so provides, members have a reasonable expectation that if the scheme funds permit, namely, if there is a surplus after providing for the estimated liabilities, or in a winding up, the actual liabilities, the trustee will exercise that power to the extent that is fair and equitable in all the circumstances, having particular regard to the purpose for which the power was conferred. The power is an integral part of the scheme."*

The case of *Alexander Forbes Trustee Services v. Halliwell* [20] clarifies that in dealing with such power of augmentation, the scheme trustees need not only consider the needs of members but also other stakeholders, including employers. The UK Pensions Ombudsman has recently followed this approach by rejecting a member's complaint in relation to refunding a scheme surplus to the scheme employers.[21] The Ombudsman clarified that in deciding how to deal with pension surplus, as long as trustees follow proper procedures and consider relevant factors to make a reasonable decision they will not be in breach of their duties. In this instance, the trustees had decided to refund a scheme surplus to the employers. Although this does not set a precedent for case law, the Ombudsman did clarify that even where another board of trustees may have decided differently this did not render either decision unreasonable or perverse. The key in analysing whether trustees have fulfilled their duties is in looking at the process followed in accordance with the scheme trust deed and rules.

2.2.2. Employer Discretion

The case of *Imperial Group Trust v Imperial Tobacco Ltd*[22] established that, in circumstances where the scheme employer has discretion to consent to the apportionment of surplus assets, they must act in good faith. This standard was considered in the case of *IBM United Kingdom Holdings Ltd v Dalgleish*[23]. in which the court held that the appropriate test was that of the rational decision-maker. An employer's discretionary power is not necessarily considered to be a fiduciary responsibility. As summarised in *UC Rusal Alumina Jamaica Limited v Miller* [24]

> *"First, it is common ground that [an employer] would have to act bona fide. Second, that does not merely mean that it must act honestly; it must avoid irrational or arbitrary behaviour and must not exercise its power to give or refuse consent for extraneous reasons".*

Therefore, it is not expected that an employer in exerting such a discretion would disregard their own interests, but rather that they would also consider the interests of members and other stakeholders before coming to a definitive decision.[25]

2.2.3. Trust Deeds are Silent

There have also been cases where the trust deeds are silent on the matter of apportioning surplus assets. A recent Scottish case provides some clarity on the treatment of surplus where the governing deeds of a pension scheme are silent on the issue. The court decided that it was reasonable under the circumstances for the trustees to treat the remaining surplus of the fund to be the subject of a resulting trust in favour of the employers. However, this decision was specific to this set of circumstances where

[19] [1993] 1 WLR 456.
[20] [2003] EWHC 1685 (Ch).
[21] Mr S v The Water Companies (Pension Fund) Trustee Company, CAS-92093-N4D9.
[22] HC [1991] 1 WLR 589.
[23] [2017] EWCA Civ 1212.
[24] [2014] UKPC 39.
[25] National Grid Co plc v Mays [2001] 1 WLR 864.

the trust deed was silent on how to deal with surplus scheme assets and the scheme was largely non-contributory for members.[26] The more common approach is that adopted in *Thrells v Lomas*[27].

Conclusion

It is clear from the above analysis that pension schemes were not designed to house surplus scheme assets, as their main purpose is to provide benefits to their members. It has become apparent through the case law in both Ireland and the UK that no one class of stakeholders holds ownership over surplus scheme assets unless provided for explicitly in the trust deed and rules. As a result, in deciding how to balance competing interests in relation to surplus assets, trustees must take care to consider all relevant factors in their decision. As long as trustees reach a reasonable conclusion in deciding how to apportion surplus assets in a DB scheme, the courts will not overrule their decision even if another board of trustees would reach a different conclusion. Although the process may differ, this approach is consistent in both Ireland and the UK.

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[26] Petition of abrdn (SLSPS) Pension Trustee Company Limited for Directions [2023] CSIH 31; See also Air Jamaica v Charlton [1999], PC 1 WLR 1399.
[27] [1993] 1 WLR 456.