Approaches to applying a pension increase underpin (FDR v Dutton)

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Pensions analysis: How should an underpin operate in relation to increases to pensions in payment for an occupational pension scheme? Simon Atkinson, barrister at Wilberforce Chambers, points out that in the current world of prevailing scheme deficits and struggling employers, the Court of Appeal's decision in FDR Ltd to apply a cumulative approach is surely to be welcomed.

Original news

FDR Limited v Dutton and others [2017] EWCA Civ 200, [2017] All ER (D) 186 (Mar)

The Court of Appeal, Civil Division, allowed the employer's appeal concerning the interaction of old and new rules in respect of the FDR pension scheme. Under the old rules, pensioners had been entitled to annual increases in their pensions of 3% compound. Since 1991, when new rules were introduced, the rate of increase was changed. Three approaches were at play and the lower court had ruled that one of the approaches proposed by the trustees, the most expensive to the scheme, was the correct one. The Court of Appeal disagreed and held that the terms of a proviso to the power of amendment in the old rules were such that any change in the rules had to not prejudicially affect any pension in payment or any accrued pension rights. It held, among other things, that the modified cumulative approach, preferred by the employer, preserved that right and enabled a pensioner to take the benefits of the new rules if, in any given year, that produced a better outcome for her.

What was the background to this case?

The FDR scheme's governing documentation contained a power vested in the employer to authorise the trustees to amend the deed and rules. As is usual, the power of amendment was subject to a proviso preventing its exercise in a way that prejudicially affected the accrued rights of members.

In June 1991, the trustees purported to amend the FDR scheme's rules so as to change the rate at which pensions in payment would be increased. The rules at the time provided that the amount of a pension in payment would 'be increased at each anniversary of the date of [the pension's] institution by 3 per cent compound'. By a deed dated 20 June 1991, however, this rule was amended so that the amount of a pension in payment would 'be increased by the lesser of 5% of that amount or such percentage of that amount as represents any increase in the government's Index of Retail Prices since the immediately preceding anniversary date' (ie 5% limited price indexation (LPI)).

As the amended rule purported to apply to all pensionable service, both prospective and retrospective, it violated the proviso contained in the power of amendment. The amended rule violated the proviso because in those years when the retail price index (RPI) was below 3%, members with pre-20 June 1991 pensionable service would receive increases less than that to which they had been entitled prior to the amendment.

What issues were raised?

The case raised the following issue—how did the proviso operate so as to protect the rights of members with pre-20 June 1991 pensionable service? Both the trustees and the employer agreed that an underpin had to apply. The parties were, however, in disagreement as to how the underpin should operate.

The trustees' principal case was that an annual 3% underpin should apply. Such an underpin would apply in the following way. Any pre-20 June 1991 element of a pension to be paid to a member in a given year was to be determined by taking the higher of:

- the value of that element of the member's pension paid in the year immediately prior to the increase taking effect by 3% LPI, and
- the value of that element of the member's pension paid in the year immediately prior to the increase taking effect by 5% LPI

The employer's case was that a modified cumulative 3% underpin should apply (modified because a 0% floor had been inserted to ensure that pensions never decreased year on year in value). Such an underpin would apply in the following way. Any pre-20 June 1991 element of a pension to be paid to a member in a given year was to be determined by taking the higher of:

- the value of that element of the member's pension as at the date of retirement increased year on year by 3% pa compound up to and including the year in which the increase was to take effect, and
- the value of that element of the member's pension as at the date of retirement increased year on year by 5% LPI pa compound up to and including the year in which the increase was to take effect, subject to a 0% floor

The main methodological difference between an annual and cumulative approach was that the employer's approach involved running two separate calculations, one which applied a 3% pa compound increase to the pension paid from the date of retirement up to and including the date of the increase and one which applied a 5% LPI pa compound increase to the pension paid from the date of retirement up to and including the date of the increase, and then in paying the higher of the two values to the member.

The trustees also advanced an alternative approach which in essence provided for a mix of an annual and cumulative underpin.

While both approaches resulted in an increase in liabilities, the employer's modified cumulative approach resulted in a considerably lower increase to those liabilities than the trustees' annual and alternative approaches.

What arguments were made by the parties?

The trustees' main argument was that the annual approach best preserved the right that had existed prior to the rule change in 1991. The annual approach, it was said, gave effect to the requirement in both the old and new rules that the pension in payment be increased each year by the amount specified by the rule in question.

The employer's principal argument was that the annual approach gave a pensioner more than he or she would have been entitled to if the old rules had remained in force. This was because in any given year when the 3% underpin applied (ie in any year when RPI was running below 3%), then the pension payable to a member would be increased by 3%. That pension, however, would in previous years have been increased by more than 3% (ie in those years when RPI was running above 3%), with the result that members' pensions would be greater than they would have received had they always been entitled to 3% increases (and indeed would be greater than they would have received had they always been entitled to 5% LPI increases).

The modified cumulative approach, however, ensured that a member would never receive less than he or she would have been entitled to under the old rules while at the same time ensuring that the pension in payment was only ever one that had been increased by either 3% pa compound or 5% LPI compound, but never increased by both.

What did the court decide and why?

Asplin J at first instance had preferred the trustees' annual approach. The Court of Appeal unanimously reversed that decision.

The Court of Appeal held that the proviso operated to preserve a member's existing rights. That right was to a 3% pa increase which crucially applied to a pension that had itself in past years only been increased by 3% and no higher figure. The employer's modified cumulative approach, while in any given year might result in an increase of less than 3%, would crucially never be less in value than the member would have received under the old rules had no change been effected.

What practical points can be drawn for employers, trustees and advisers?

Sponsoring employers of pension schemes will welcome this judgment, not merely for the outcome itself, but also for the endorsement of the 'minimum interference' principle explained in *Foster Wheeler Ltd v Hanley* [2009] EWCA Civ 651, [2017] All ER (D) 186 (Mar). The modified cumulative approach ensured that members received at least what they would have received under the old rules but at the minimum cost to the employer. In the current world of prevailing scheme deficits and struggling employers, this is an approach surely to be welcomed.

Simon has a busy and diverse practice. He appears regularly in the High Court and County Court, both in his own right and as part of a larger team. Simon's practice encompasses all of chambers' areas of work, though his principal interests are in property, trusts (including charities), probate and estates, and pensions work. He is instructed in both domestic and international matters, and has particular experience in disputes with a Middle Eastern element, including Dubai International Finance Centre litigation. In FDR Ltd v Dutton, Simon was junior counsel for the successful appellant (led by Paul Newman QC).

Interviewed by Kate Beaumont.

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