



“WHATEVER I SAID, WHATEVER I DID, I DIDN’T MEAN IT”

Smiths Industries Pension Scheme (CAS-99766-L5X6)

By Theo Dixon

To what extent must an employer consider additional increases to pensions in payment when the Retail Price Index (“**RPI**”) exceeds the minimum increase mandated by the scheme rules? This was the question determined by the Pensions Ombudsman (“**PO**”) in *Smiths Industries Pension Scheme* (CAS-99766-L5X6), in which a member complained that the employer – Smiths Group plc (“**Smiths**”) - had failed to inflation link pensions in accordance with its previous undertakings.

Background

This case concerns the Smiths Industries Pension Scheme (the “**Scheme**”).

In early 1998, Smiths considered that it could benefit financially and operationally from merging three smaller schemes into the Scheme (as its principal scheme). However, the merging schemes all had different funding levels. Whilst it was considered unaffordable to enhance the funding of the less well funded schemes, the merger could only take place if it was in the interests of all members of the merging schemes.

For members of the incoming schemes, the benefit of the proposed merger would be the enhanced funding level protection that would apply once they became members of a larger and better funded merged scheme. For existing Scheme members, the loss of security stemming from the reduction in the Scheme funding level would have to be balanced against proposed benefit improvements for members. Benefit increases of substance were therefore considered for Scheme members.

Accordingly, in 1998 all members of the Scheme received a newsletter entitled '*Pensioner Newsletter August 1998 Special Edition*' (the "**Newsletter**") from the Trustee advising them of an improvement in the inflation protection of pensions in payment.

The Newsletter and an edition of "*Simply Pensions*" which was circulated to employees announced various benefit improvements, including "*the aim of providing annual increases in line with the Retail Prices Index (RPI) up to a maximum of 10% a year, subject to the finances of the Scheme*" (the "**Stated Aim**"). There was no other condition applied.

These benefit improvements were incorporated into the Rules by a Deed of Variation dated 22 September 1998 and were reconfirmed by a Deed of Variation dated 29 March 1999.

RPI is used as the "*Index*" for the purpose of pension increases. The relevant rule is rule 7.1, which provides for pensions in payment in excess of GMP to be increased on each 1 May by the lower of 5% and the percentage increase in the RPI published for the previous calendar year ending 31 December.

Rule 7.1 also states that if in a year the percentage increase in the Index is greater than 5% the Trustee may, at the request of Smiths, calculate the rate of increase for that year as if the 5% maximum percentage figure was 10% and that, in applying this rule, both Smiths and the Trustee will have regard to the Stated Aim.

In May 2022, the RPI rate at the preceding 31 December was calculated as 7.5%. However, an increase of 5% only was applied to pensions in payment. In May 2023 the relevant RPI rate was above 10% but increases were again limited to 5%.

On 28 September 2022 Mr Y wrote to the Trustee to complain under the Scheme's Internal Dispute Resolution Procedure. His complaint was that the annual increase applied to his Scheme pension in excess of the GMP from 1 May 2022 should have been 7.5% instead of the 5% increase that was actually awarded. He said that limiting the increase to 5% was contrary to the announcement made in 1998 that increases would be in line with RPI.

Smiths' position was that the aim to pay discretionary increases over 5% had always been a discretionary benefit rather than a contractual promise or a commitment to be paid. Rule 7.1 requires Smiths to consider the finances of the Scheme when deciding whether to award higher pension increases. When the aim of increasing pensions was communicated to members in 1998, the Scheme was fully funded on all of the relevant financial measures that applied at the time, though Smiths was still careful to reiterate that higher pension increases could only ever be provided "*subject to the finances of the Scheme*". At the most recent formal triennial actuarial valuation of the Scheme, the Trustee and Scheme actuary reported that there was a significant buy-out funding shortfall. As such, Smiths said that it was entitled not to request a greater than 5% increase to pensions in payment under rule 7.1 in light of the Scheme's finances.

Decision¹

The PO noted at [51] that he needed to consider (i) the proper interpretation of Rule 7 which was adopted following the negotiations between Smiths and the Trustee in 1998 and in particular what powers and discretion Smiths and the Trustee have under Rule 7 to grant

¹ References in square brackets are to paragraph numbers of the Determination.

increases in excess of 5% in periods of high inflation, and (ii) whether Smiths acted in accordance with its legal obligations and in particular its implied duty of good faith or fettered its discretion when deciding not to request the Trustee to grant increases in excess of 5% when RPI exceeded that figure in May 2022 and May 2023.

So far as the PO was required to consider relevant legal principles, he noted at [56] to [63] that:

- a. Construction of a document involves ascertaining the meaning which a document conveys to a reasonable person having all the background knowledge as would reasonably have been available to the parties in the situation in which they were at the time of the contract.
- b. The context of pension trust deeds is one which is inherently antipathetic to the recognition, by way of departure from plain language, of some common understanding between the principal employer and the trustee.
- c. In light of recent authorities, the PO considered that in interpreting the increase rule he should give significant weight to textual analysis, by concentrating on the plain meaning of the words which the draftsman has chosen to use and attaching less weight to the background factual matrix than might be appropriate in certain commercial contracts. The circumstances in which the amendments to the increase rule were entered into do, however, provide some helpful context to why the rule was adopted. Further, Rule 7.1 cannot be interpreted without sight of the 1998 Announcement which effectively is incorporated by reference to the increase rules and in effect sets out the purpose of the rule which was to provide some enhanced inflation protection for members benefits when RPI exceeds 5% subject to the finances of the scheme.

Taking the relevant principles of interpretation into account, the PO considered that under Rule 7.1 the Trustee did not have a unilateral discretion to grant increases in excess of 5% in years where the rate of inflation exceeds 10%. Only Smiths could request such an increase (at [64]).

In deciding whether to request an increase in excess of 5%, Smiths was obliged to have regard to the Stated Aim subject to the finances of the Scheme (at [65]). Smith's discretion to request an increase was therefore not completely unfettered. Similarly, in deciding whether to agree to any request made by Smiths for an increase above 5%, the Trustee was obliged to consider the Stated Aim subject to the finances of the Scheme (at [66]).

The PO concluded at [67] that the expression "*subject to the finances of the scheme*" is widely drafted and does not specify an actuarial basis (ongoing technical funding basis or buy-out basis) by reference to which the finances of the scheme are to be determined, or specify that the manner in which the finances of the scheme are assessed cannot change. However, the PO stated that Smiths must genuinely consider whether to make a request to the Trustee to grant increases in excess of 5% each time inflation exceeds 5%.

Having concluded that Smiths had a constrained discretion whether to request an increase above the 5% minimum, the PO went on to consider whether Smiths validly exercised that power in declining to make a request in 2022 and 2023. The PO held that Smiths was entitled not to request an above 5% increase for the following reasons.

First, on the facts Smiths did have regard to the finances of the Scheme and the Stated Aim when making its decision not to request an increase to pensions in payment above 5% (at [73]). Whilst Smiths gave greater weight to the Scheme's significant funding shortfall on a buy-out funding basis than to the Stated Aim, it was entitled to do so and it was not for the PO to make his own decision based on the available evidence providing the discretion was exercised in accordance with the wording of the applicable rule (at [74]).

Second, Smiths did not exercise its discretion in breach of its duty not to conduct itself in a manner calculated to destroy or seriously damage the relationship of trust and confidence between employer and employee (the “**Imperial Duty**”). The PO stated that the Imperial Duty does not require the employer to act to an objective standard of reasonableness or reach a decision which is ‘fair’ between the parties (at [77]). Members’ expectations are just one factor to be considered when exercising a non-fiduciary power (at [79]). The Imperial Duty was not breached in the present case because:

- a. Smiths decided not to propose to the Trustee to increase pensions in payment above 10% in May 2022 and May 2023 due to the finances of the Scheme and other relevant factors; not paying increases over 5% would shorten the time to reach the long-term funding target by 2 years. The discretion was therefore exercised for a proper purpose (at [82]).
- b. Smiths took relevant factors into account in reaching its decision and ignored irrelevant factors. In particular, Smiths considered: (i) the finances of the Scheme, (ii) the objective of strengthening the financial security of the Scheme for all members, (iii) enhancing the resilience of the Scheme against the changing macro-economic conditions, and (iv) past increases to pensions in payment which had been based on RPI. The fact that Mr Y formed an expectation of increases up to 10% based on the Newsletter was simply one factor to consider; Smiths had considered the wording of the Newsletter in reaching its decision (at [83] and [87]).
- c. Smiths reached its decision based on evidence, relevant factors, and having taken advice. There was no indication that the decision was irrational or perverse (at [88]).

Conclusion

This case demonstrates the emphasis placed on textual analysis, and the plain meaning of words used, when construing pension scheme documents. On the one hand, Mr Y can perhaps feel hard done by, given that he was personally involved in discussions concerning changes to rule 7.1 in 1998. His assertion that the “*aim*” that Smiths would pay for increases above 5% in line with RPI was intended to require Smiths “*to take actions that would make the payment of such increases likely*” (at [19]) most likely reflects his contemporaneous discussions with the Trustee. The Stated Aim must have been intended to give greater assurance to members that pensions in payment would be increased in line with RPI when the Scheme was in surplus. On the other hand, the wording of Rule 7.1 is clear; it is for Smiths to decide whether a request should be made to the Trustee to increase pensions in payment above the 5% minimum and, other than the requirement to take into account the Stated Aim, that discretion is a broad one. To avoid a similar outcome in other cases, parties should ensure that the intended effects of any variation are clearly incorporated into the wording of the amendment.

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Published May 2025

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