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… Winding Up Defined Benefit Pension Schemes

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Introduction

The winding up of Defined Benefit ("**DB**") pension schemes is a highly relevant topic to all DB schemes whether they are in a deficit or a surplus. However, winding up a DB scheme is full of potential pitfalls which can be easily overlooked. To that end, this article aims to provide an overview of the key stages of a winding up as well as some practical considerations that advisers may wish to keep in mind when acting for a party in a winding up.

How is Winding Up Triggered?

The winding up of a DB pension scheme is usually effected by two methods: (i) in accordance with the governing terms of the scheme, or (ii) by the Pensions Regulator ("**tPR**") exercising its power pursuant to s 11 of the Pensions Act 1995 ("**PA 1995**"). Each will be considered in turn.

<u>(i) Governing Terms of the DB Scheme</u>

The primary method of winding up a DB scheme is by relying on the provisions within the governing terms of the scheme. The terms of the scheme will usually set out events that trigger its winding up. The most common triggers are: (i) dissolution or insolvency of the employer, (ii) notice from either the employer to the trustees, or vice versa, or (iii) termination of contributions by the employer.

Another less common triggering event is the failure of the employer to comply with its duties under the scheme rules. This trigger will usually occur in response to the trustee of the scheme giving notice to the employer of the alleged failure.

In relation to the insolvency of the employer, if the trustee would be permitted under the scheme rules to wind up the scheme, then ss 38(1) and (2) PA 1995 provides that:

> *(1) If, apart from this section, the rules of a trust scheme would require the scheme to be wound up, the trustees may determine—*
>
> > *(a) that the scheme is not for the time being to be wound up but that no new members are to be admitted to it, or*
> >
> > *(b) that the scheme is not for the time being to be wound up but that no new members, except pension credit members, are to be admitted to it.*
>
> *(2) Where the trustees make a determination under subsection (1), they may also determine—*
>
> > *(a) that no further contributions are to be paid towards the scheme (other than those due to be paid before the determination is made), or*
> >
> > *(b) that no…benefits are to accrue to, or in respect of, members of the scheme*

It should also be noted that most pension scheme rules will have an express provision that replicates s 38 PA 1995 but may also cover a wider array of trigger events. One of the most important effects of a trustee triggering the s 38 PA 1995 power and continuing to run the scheme as a closed scheme is that the calculation of the employer debt under s 75 PA 1995 will be postponed. Therefore, a trustee must be satisfied that exercising the power is in the best interests of the members as a whole.

If an employer wishes to deliberately trigger the winding up of the scheme, given the discretionary power of the trustee to defer, then it is often advisable for the employer and trustee to enter into a memorandum of understanding which explains how the respective counterparties should exercise their respective discretions.

Further, it is possible for the trustee of the scheme to petition to wind up a sponsoring employer of a scheme: see *Brass Trustees Ltd v Goldstone* [2023] EWHC 1978 (Ch). In *Brass*, the trustee sought a blessing of its decision to issue winding up petitions in respect of debts owed by the sponsoring employers. Applying the *Public Trustee v Cooper* test, the Court approved the decision taken by the trustee in circumstances where the trustee must act to protect the assets of the scheme and its beneficiaries (see [66] to [69] of the judgment in *Brass*).

(ii) tPR and s 11 PA 1995

Under s 11(1) PA 1995, tPR has the power to wind up the pension scheme in the following circumstances:

> *(a) the scheme, or any part of it, ought to be replaced by a different scheme,*
>
> *(b) the scheme is no longer required, or*
>
> *(c) it is necessary in order to protect the interests of the generality of the members of the scheme that it be wound up.*

Further, tPR has powers to intervene during the course of the winding up; however, in practice tPR rarely uses either of these powers.

The Consequences of Winding Up a Pension Scheme

PPF

When a DB scheme enters a winding up after 6 April 2005, and the scheme's employer has suffered a qualifying trigger event, the trustee must undertake a Pension Protection Fund ("**PPF**") assessment period. This entails an actuary valuing the assets and liabilities of the scheme using a prescribed basis.

If the liabilities are greater than the scheme's assets using the PPF prescribed basis, then the scheme will be taken over by the PPF and the trustee will be discharged. Whereas, if the assets are greater than the liabilities, then the scheme will be returned to the trustees who will continue to administer the scheme.

Cessation of Benefit Accrual

Perhaps the most obvious consequence of winding up a pension scheme is that there will be cessation of benefit accrual: s 73A(3) PA 1995. Thus, no new employee contributions are due, and no new members may be admitted to the scheme. Likewise, usually no benefits would be due from employers, save for a s 75 debt (see further below). Any person who immediately before winding up was an active member of the scheme will become a deferred member upon winding up. However, note that employers will usually still continue to be liable for administration expenses, although the exact arrangements will be governed by the scheme rules.

Restriction on the Payment of Benefits

Section 73A(2) PA 1995 provides that:

During the winding up period, the trustees or managers of the scheme—

(a) must secure that any pensions or other benefits (other than money purchase benefits) paid to or in respect of a member are reduced, so far as necessary, to reflect the liabilities of the scheme to or in respect of the member which will be satisfied in accordance with section 73, and

(b) may, for the purposes of paragraph (a), take such steps as they consider appropriate (including steps adjusting future payments) to recover any overpayment or pay any shortfall.

Therefore, it may be that a trustee considers that the payment of benefits be restricted so as to take into account the liabilities of the scheme. Whilst the scheme is in the PPF assessment period, there are also other restrictions placed on the payment of benefits: see ss 132-139 Pensions Act 2004 ("**PA 2004**").

<u>Section 75 Debt</u>

The s 75 debt is a well-known consequence of a winding up of a scheme that is in a deficit. Under s 75 PA 1995, an employer owes a debt to the scheme if it is underfunded. A s 75 debt also applies if a sponsoring employer withdraws from a scheme and thus is not only relevant in the event of insolvency.

The size of the debt due is calculated by reference to the buyout cost, meaning the costs of securing such liabilities by purchasing immediate annuities or deferred annuities from an insurer. Given that insurers are particularly cautious when reserving for immediate and deferred annuities, this can result in schemes that are fully funded on an ongoing basis having substantial deficits by reference to their buyout costs.

Particular attention should also be paid to s 75(2) PA 1995 which permits a trustee to choose the most advantageous time when calculating the size of the s 75 debt due by the employer. In practice, the trustee will usually choose a date towards the end of the winding up process as at this stage the costs of securing the benefits will be known.

Note that there are specific rules that apply to multi-employer schemes pursuant to The Occupational Pension Schemes (Employer Debt) Regulations 2005 (the "**2005 Regulations**") (see specifically regulation 5 which modifies s 75). Whilst a detailed assessment of the 2005 Regulations is outside the scope of this article, suffice it to say that one of the distinguishing features of a multi-employer scheme is that each employer is responsible for a share of the total amount of the scheme's liabilities, including in a winding up.

Cessation of Contribution Liability

The scheme rules may provide that the contribution liability of the employer ceases on winding up. However, note that in *Pinsent Curtis v Capital Cranfield Trustees Ltd* [2005] EWCA Civ 860, the Court of Appeal held that the rules of a particular scheme may provide that the trustees can demand a lump sum contribution from an employer. In *Pinsent Curtis*, the Court of Appeal upheld the requirement in the scheme rules that permitted the trustee to require the employer to contribute a lump sum contribution, calculated on a buyout basis, in circumstances where the trustee had received notification from the sponsoring employee terminating its liability to make further contribution to the scheme.

Amendment Power

Likewise, depending on how the governing rules of the scheme are drafted, the amendment power may no longer be able to be exercised by the trustee. This is because as a matter of general trust law, general powers are restricted in the event of winding up unless they are expressly said to continue: see *Thrells v Lomas* [1993] 1 WLR 456. The rationale behind the general approach of trust law is that because the trustee's duties are solely to collect and protect the available assets of the scheme and then distribute them accordingly (see below), the more general powers cease in winding up.

Appointment of an Independent Trustee by tPR

Last but not least, tPR may consider the appointment of an independent trustee where an insolvency practitioner has been appointed in relation to the employer: see s 23 PA 1995.

Distribution of Assets in Winding Up

The statutory priority rules for the distribution of assets in the winding up of a DB scheme are set out in ss 73 PA(3) and (4) 1995 (which applies to schemes being wound up on or after 6 April 2005):[1]

> *(3) The assets of the scheme must be applied first towards satisfying the amounts of the liabilities mentioned in subsection (4) and, if the assets are insufficient to satisfy those amounts in full, then—*
>
> > *(a) the assets must be applied first towards satisfying the amounts of the liabilities mentioned in earlier paragraphs of subsection (4) before the amounts of the liabilities mentioned in later paragraphs, and*
> > *(b) where the amounts of the liabilities mentioned in one of those paragraphs cannot be satisfied in full, those amounts must be satisfied in the same proportions.*
>
> *(4) The liabilities referred to in subsection (3) are—*
>
> > *(a) where—*
> >
> > > *(i) the trustees or managers of the scheme are entitled to benefits under a relevant pre-1997 contract of insurance entered into in relation to the scheme, and*
> > >
> > > *(ii) either that contract may not be surrendered or the amount payable on surrender does not exceed the liability secured by the contract,*
> > > *the liability so secured;*
> >
> > *(b) any liability for pensions or other benefits to the extent that the amount of the liability does not exceed the corresponding PPF liability, other than a liability within paragraph (a);*

[1] Section 73(2) PA 1995 exempts money purchase schemes or prescribed schemes from the priority rules.

(c) any liability for pensions or other benefits which, in the opinion of the trustees or managers, are derived from the payment by any member of voluntary contributions, other than a liability within paragraph (a) or (b);

(d) any other liability in respect of pensions or other benefits.

Note that if the scheme rules provide that the scheme expenses are paid before benefits are secured (which in practice often occurs) then, in those circumstances, the expenses will be paid before applying the statutory rules of priority. Whereas, if the scheme rules are silent on the order of payment of expenses, then those expenses will not be paid ahead of the usual statutory priority rules. If the latter scenario applies, the trustee will usually seek an order for winding up from tPR which contains specific provisions dealing with expenses, as a trustee is unlikely to wish to continue with the winding up without taking professional advice and would want those fees to be provided for out of the assets of the scheme rather than their personal assets.

If the scheme is in a deficit such that it cannot meet all its liabilities, then there will be a proportionate reduction in the benefits that are paid out.

In terms of the methods that a trustee may use to secure the scheme's benefits, the following are the most common methods used:

- Purchase of annuities for members.
- Transfer payments to other arrangements.
- Commuting benefits for a cash sum.

Purchase of Annuities for Members

The first principal method which a trustee may use to secure members' benefits is to purchase an annuity from an insurance company – commonly referred to as a bulk buyout. Trustees often receive better value if they purchase insurance over a bulk of liabilities with a single annuity from a single provider. It is usually advisable for trustees to shop around to find the best quotation from an insurance company.

Further, any annuity purchased must meet the statutory requirements set out in regulation 8 of The Occupational Pension Schemes (Winding Up) Regulations (the "**Winding Up Regulations 1996**"). Regulation 6(2)(a) of the Winding Up Regulations 1996 provides that a trustee must give notification in writing to the members if they propose to discharge a liability of the scheme, which extends to the purchase of an annuity to secure members' benefits.

In addition, there are further restrictions placed on the purchase of an annuity where the trustees are securing contracted-out benefits: see ss 19 and 37A of the Pension Schemes Act 1993 ("**PSA 1993**"). It should be noted that contracting-out on the salary-related basis was abolished from 6 April 2016; however, restrictions still apply to guaranteed minimum pensions ("**GMPs**") (s 19 PSA 1993) and to s 9(2B) rights which replaced GMPs (s 37A PSA 1993).

Transfer Payments to other Arrangements

The trustee may also decide to secure the liabilities of the scheme by organising individual transfers out of the scheme for members, so long as members' consent is sought beforehand. Many scheme rules provide the trustee with this express power, although it is also given to trustees under s 74(3) PA 1995 in relation to schemes that started to be wound up after 5 April 1997.

It should also be noted that if the transfer is not deemed to be a "*recognised transfer*" under the Finance Act 2004 ("**FA 2004**"), then HMRC will levy an unauthorised payment charge on the transfer.

Commuting Benefits for a Cash Sum

If there are members in the scheme that have only small pension entitlements and have not started receiving the benefits, then the trustee may commute their benefits by paying a lump sum to the member, so long as it conforms with the relevant rules in FA 2004 and does not contravene the trivial commutation rules in respect of formerly contracted-out schemes or prohibitions on assignment and forfeiture.

Further, regulation 8(6) of the Winding Up Regulations 1996 sets out the lump sums which are permitted:

For the purposes of section 74(3)(e) (liabilities treated as discharged where the trustees have provided for them to be discharged by the payment of a cash sum in circumstances where prescribed requirements are met), the circumstances which are prescribed are—

(a) where the payment is a contribution refund under Chapter 2 of Part 4ZA of the 1993 Act; or

(b) where the payment—

(i) of a lump sum—

(aa) that is a trivial commutation lump sum, an uncrystallised funds pension lump sum or a winding up lump sum for the purposes of Part 1 of Schedule 29 to the Finance Act 2004 is made to a member; or

(bb) is made by a registered pension scheme (within the meaning given in section 150(2) of the Finance Act 2004 (meaning of "pension scheme")), is a payment that is described in Part 2 of the Registered Pension Schemes (Authorised Payments) Regulations 2009 and is made to or in respect of a member; and

(ii) does not contravene any trivial commutation restriction that applies in the circumstances in question.

<u>Outcome of Securing Members' Benefits</u>

If the trustee successfully secures the members' benefits using one of the above methods, the trustee will then be discharged from liability pay the benefits: see s 74(3) PA 1995. Further, benefits may be secured in tranches, provided that the terms of the scheme provide for this approach or by an implied power depending on the facts and rules of the specific scheme. In *Sarjeant v Rigid Group Ltd* [2013] EWCA Civ 1714, Patten LJ held that as a matter of construction and implication, the scheme rules did permit staggering of secured liabilities. The Court held that where there are no provisions in the rules of the scheme which suggest that securing liabilities in tranches is not permitted, the powers implied in terms of effecting a buyout should be those that give the trustee the "*maximum flexibility*" in carrying out their duties (at [32]).

Distribution of Surplus

The starting point for the distribution of any surplus in the winding up of a scheme is the scheme rules. Usually, the surplus is repaid to the employer although in some circumstances the trustee will have a power or be under a duty to augment benefits for members before repaying the surplus to the employer.

Before the surplus is repaid to the employer, the following conditions need to be met (see s 76(3) PA 1995):

The requirements of this subsection are that—

> *(a) the liabilities of the scheme have been fully discharged,*
>
> *(b) where there is any power under the scheme, after the discharge of those liabilities, to distribute assets to any person other than the employer, the power has been exercised or a decision has been made not to exercise it,*
> *… and*
>
> *(d) notice has been given in accordance with prescribed requirements to the members of the scheme of the proposal to exercise the power.*

However, in limited circumstances the surplus may be repaid to the employer where s 76 is not complied with: see regulation 3 of The Registered Pension Schemes (Authorised Surplus Payments) Regulations 2006 (the "**Authorised Surplus Regulations 2006**"). Regulation 3 provides as follows:

(1) A payment made by an occupational pension scheme to a sponsoring employer which does not satisfy paragraph (2) or (3) of regulation 2 is an authorised surplus payment if it satisfies the following conditions.

Condition A
The rules of the scheme permit such a payment to be made.

Condition B
The rules of the scheme contain a limit, calculated other than by reference to the size of the member's fund, on the maximum amount of benefits that may be paid to, or in respect of, members of the scheme.

Condition C
If the scheme is being wound up, the liabilities of the scheme have been fully discharged including any tax that may be due and there is a surplus of assets over liabilities.

Condition D
If the scheme is not being wound up, the requirements set out in section 37 of the 1995 Act would have been met if the scheme had been one to which the section applied.
This paragraph is subject to paragraph (2).

(2) A payment made by an occupational pension scheme to a sponsoring employer solely in respect of the death of a member is an authorised surplus payment if it satisfies the conditions in paragraph (1) and—

(a) in a case where the deceased member's fund was an alternatively secured pension fund, it satisfies conditions E and F, and

(b) in other cases, it satisfies condition F.

Condition E
The scheme administrator has been unable to identify any dependants of the deceased member.

Condition F
The member was not connected to the sponsoring employer at the date of his death.

There are certain tax consequences if the surplus is repaid to the employer. This is because "*authorised surplus payments*" attract tax treatment under FA 2004. First, a refund of surplus will qualify if it satisfies the requirements in s 76(3) (see s 177 FA 2004) and regulation 2 of the Authorised Surplus Regulations 2006. Even if the refund falls outside of the requirements in s 76(3), there is scope for it to be deemed an authorised surplus payment pursuant to regulation 3 of the Authorised Surplus Regulations 2006. Second, if the payment is an authorised surplus payment, then it will attract a tax change of 25 per cent which is payable by the scheme administrator (see s 207 FA 2004).

If the scheme rules are silent on what should happen with the surplus, then the traditional view was that the surplus would revert to the Crown as *bona vacantia*. However, the prevailing view is that the surplus will be held on resulting trust for the employer and members, referable to their share of contributions: *Air Jamaica v Charlton* [1999] UKPC 20. The author concurs which this approach. However, it should be noted that *Air Jamacia* was a Privy Council decision thus some practitioners believe could be limited to the facts of that case. In *abrdn (SLSPS) Pension Trustee Co Ltd, Petitioner* [2023] CSIH 31 (a Scottish decision), the Inner House of the Court of Session referred to *Air Jamacia* as support for the approach that a resulting trust arose over the surplus in favour of the original contributor of the funds where there had been a failure or completion of the trust purposes. When all benefits had been secured for the scheme's members, then it was held that the trust purposes would be complete, thus the surplus would no longer be held on trust (see [33]). Further, it was held that the surplus should be distributed to the employers as they had not funded the scheme to produce a surplus, but rather to cover any deficit which had been avoided (see [34]-[35]).

Finally, for present purposes it should also be noted that in *Re Courage Group's Pension Schemes* [1987] 1 All ER 528, whilst the members of the various schemes did not have a legal right to participate in the surpluses, they were entitled to have the surpluses dealt with by consultation and negotiation between themselves and the employers, as the latter had a continuing responsibility towards them (see p 545).

It is also open for tPR, on an application being made by the trustee of the scheme, to make a modification order in respect of a registered pension scheme that is being wound up: see s 69(1) PA 1995. This is little known, yet important, power that tPR has at its disposal.

For example, in the recent Determination Notice in *The Littlewoods Pensions Trust Limited* (tPR case ref: C212251039), the trustee applied for a modification order to distribute a surplus to the principal employer. The rules of the scheme provided that a surplus should be distributed to provide a "just and equitable increase in the benefits of persons entitled to benefits" under the scheme but any such distribution was subject to employer consent. The employer refused to give consent, and there was no alternative provision for distribution under the scheme and the trustee was expressly precluded form amending the terms of the scheme to introduce a power to return a surplus to the principal employer. Having considered the case, tPR made the order sought and permitted the surplus to be returned to the employer.

Practical Considerations

This final section endeavours to set out eight practical considerations that advisers should have in mind when a DB scheme is wound up.

- It may seem prosaic, but the first consideration is to identify the contact details for all existing members of the scheme. The trustee should consider using the Department of Work and Pensions' member tracing service to aid in the identification of all contact details.

- Second, the trustee should reconcile the data relating to members' benefits so that the trustee can accurately calculate any entitlements still outstanding.

- Third, the trustee should consider the contracted-out liabilities that the scheme has accrued, including GMP equalisation requirements following *Lloyds Banking Group Pensions Trustees Ltd v Lloyds Bank plc* [2018] EWHC 2839 (Ch). If the scheme is solvent upon winding up, it is often prudent and economically feasible to level up any GMPs between men and women.

- The fourth consideration concerns protecting the trustee from personal liability for any unsecured benefits or missing beneficiaries. There are two methods often adopted: (i) obtaining insurance - although see *Kemble v Hicks* [1999] Pens LR 287 where Rimer J held that the cost of insurance of the money purchase scheme could not be met from the assets of the final salary scheme as the funds should be kept separate; (ii) the trustee may also advertise the winding up and resulting distribution in the Gazette to avoid liability (see s 27 Trustee Act 1925 ("**TA 1925**")) – although in *AON Pension Trustees Ltd v MCP Pension Trustees Ltd* [2010] EWCA Civ 377 it was held that notice did not supersede knowledge such that a forgetful trustee could not avoid liability by stating that they had given notice and received no responses, despite having knowledge of a beneficiary that it had not provided for pursuant to s 27 TA 1925 (see [17] – [18]).

- Fifth, there should be reporting to members when the winding up is triggered and at subsequent stages of the winding up process: see regulations 24 to 25 of The Occupational and Personal Pension Schemes (Disclosure of Information) Regulations 2013 (the "**Disclosure of Information Regulations**").

- Sixth, the trustee must comply with its record keeping requirements pursuant to s 49 PA 1995 and regulation 13 of the Disclosure of Information Regulations including records of trustee meetings and books and records relating to any prescribed transaction.

- Seventh, there is a statutory requirement for trustees to submit progress reports to tPR. When a scheme is wound up after 1 October 2007 then the trustee must make a progress report within two years after the day the winding-up began, including the following information (see s 72A PA 1995 and regulations 9 and 10 Winding Up Regulations 1996):

    - The scheme name.
    - The date winding-up began.
    - The number allotted to the scheme by the Registrar of Occupational and Personal Pension Schemes for the purposes of the register kept under s 6 PSA 1993.
    - a statement as to the nature of the benefits provided by the scheme.
    - Whether an independent trustee has been appointed.
    - The contact details for the scheme actuary if one is appointed.
    - The name of any third party scheme administrator.

- An estimate of the concluding date of the winding up.
- A statement as to what steps in the winding up have been completed, what steps remain, and when the remaining steps are expected to be completed.
- A statement as to whether any particular difficulties are hindering or delaying completion of the winding up.

Note that tPR can intervene in the winding up where (i) the scheme is being wound up and the employer in the scheme is subject to an insolvency procedure, and (ii) during the course of a winding up of a scheme, tPR determines to give directions as they consider appropriate e.g. where tPR considers that the trustee is not taking all steps that ought to be taken by a reasonable trustee (see ss 71A and 72B PA 1995).[2]

- Lastly, the trustee (assuming they are the scheme administrator for tax purposes) should notify HMRC of the conclusion of the winding up within 3 months.

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[2] Note that tPR has issued guidance for schemes in winding up: see regulation 4 of the Registered Pension Schemes (Provision of Information) Regulations 2006.