In good faith

When does a discretion become a right? **Peter Esam**, Travers Smith, considers the outcome of the *Prudential* case

Employers and trustees have often wondered whether there are circumstances where a longstanding discretionary practice in a pension scheme might become entrenched as a right. Could members argue that even if a benefit is stated in the rules to be granted at the employer's discretion, the employer would be prevented from changing its practice?

This issue has become more topical, because in many schemes employers have recently reviewed longstanding practices of granting discretionary pension increases or enhanced early retirement. A recent case, concerning the Prudential scheme, has cleared up many of these issues.

Prudential, one of the UK's largest insurers, has won a case in the High Court over the change in its practice of granting discretionary pension increases. The High Court (Mr Justice Newey) ruled that Prudential was entitled to change the basis on which discretionary pension increases were awarded to its defined benefit (DB) members and had not breached its duty of good faith (sometimes called the mutual duty of trust and confidence) by doing so.

The case focused on a decision by Prudential in November 2005 that pension increases for pre-April 1997 service (which, under the rules, were entirely at the discretion of Prudential) would continue to be based on inflation but – significantly – would be capped at 2.5% a year. Prudential had historically protected pensions more or less fully against inflation.

The trustee (who had sought directions from the court) was neutral on the main issues, so the case against Prudential was argued by representative beneficiaries. The beneficiaries brought a variety of arguments including: that Prudential had breached its duty of good faith by changing its policy in respect of pension increases, and that Prudential was estopped from changing the policy.

Each argument was contended in respect of pensions deriving from additional voluntary contributions (AVCs) and transfers in as well as standard pensions.

The facts of the case

History of discretionary increases Pensions under the scheme had been increased since at least 1951. During the case, evidence was produced of increases in 1951, 1953, 1955 and 1959. And from 1961 onwards, pension increases were awarded annually and on a sliding scale basis (rather than in line with inflation). The sliding scale basis operated such that the oldest pensioners enjoyed the highest increases, for example 10% in 1967, while those pensioners who had retired since the end of 1965 (ie the most recently retired) had no pension increase at all.

In the 1970s, when inflation was unusually high, no pensions were entirely protected from the effect of inflation. For instance in 1975, when the Retail Prices Index (RPI) rose by 24.2%, pensions were increased across the board by only 7.5%. In subsequent years, however, Prudential made attempts to restore pensions' purchasing power by employing "catch-up" exercises. An example which illustrates this was in 1979 when those who had retired by 1972 had their pensions increased by 30%, even though RPI had gone up by only 13.4%; and in the same year everyone who had retired by the end of 1976 enjoyed an increase above that 13.4% figure. By 1992, the increases had resulted in pensions from 1 July 1991 being equal to at least 100% of their real value (taking account of inflation) at commencement for more than 97% of pensioners.

Between 1991 and 1996, pensions were increased in line with RPI increases but subject to the figures being rounded to

In a nutshell

- Prudential has won a High Court case over the change in its practice of granting discretionary pension increases
- representative beneficiaries argued that Prudential had breached its duty of good faith
- an employer may stop granting increases if the decision is properly considered and is not irrational or perverse.

the nearest half per cent which, overall, resulted in increases marginally in excess of inflation. In 1997 – when the statutory provisions came into force requiring pensions attributable to service after that date to be increased by a minimum amount each year – the rounding practice was discontinued. From 1997 until 2005, the pension increase for each year matched exactly the rise in RPI in the year to the preceding 30 September.

Member communications The court saw communications to members dating back to 1979 which related to pension increases. The communications (including from *Prunews*, a historic staff newspaper) examined in court show Prudential was proud of its record on discretionary pension increases, while generally diligent about conveying to its members that the increases were just that – discretionary. For example, a 1996 *Members' Booklet* said: *The Company will normally try to cushion retired staff against the effect of inflation, but does not guarantee to do so, particularly in times of high inflation*.

2005 and subsequent pension increases Historically the scheme had been well funded and valuations had shown large surpluses. In 1990, Prudential's contributions were reduced to the minimum level permitted under the scheme rules of 12.5% of members' salaries and this was maintained until 2006. Augmentations were funded from 1992 to 2005 without additional employer contributions being required.

In common with many other schemes, however, Prudential's pension scheme had mainly invested in equities, so after falls in the stock market the scheme's funding deteriorated. Accordingly in 2004, the trustee board resolved to set up an asset allocation and value assumptions working party, which first convened in December 2004. Its minutes show that the working party viewed the discretionary benefits as a key factor in developing the investment strategy of the fund and that Prudential was aware that members had strong expectations that pension increases would be granted indefinitely.

At a meeting on 7 November 2005, the board of Prudential decided that future discretionary increases would be in line with RPI increases subject to a 2.5% a year cap. The increases could be suspended if the scheme's funding deteriorated materially, but higher increases could be paid if the scheme's funding could support them.

In **January 2006**, actuarial advisers provided a note to the trustee and Prudential on the funding position of the scheme, which confirmed that the fund could support a pension increase of 2.5% or 2.7% (the latter figure reflecting the change in RPI) and the medium term effect of either increase on the fund would be marginal. Despite objections from the trustee, Prudential awarded increases of 2.5%.

In **2007**, with the rise in RPI at 3.6%, Prudential set the increase at 2.75% to share with pensioners the improved funding position of the scheme (through an increase slightly above 2.5%). In **2008**, RPI had increased by 3.9% and the increases were 2.5%. In **2009**, when RPI had risen by 5%, the increases stayed at 2.5%. And in **2010** when RPI had fallen by 1.4%, no increase was awarded.

The decision

Although counsel for the beneficiaries cited cases which referred to fairness, Mr Justice Newey held that the obligation of good faith to which Prudential was subject did not constitute a requirement to reach a "reasonable" or "fair" decision when exercising an ostensibly unfettered power under the scheme rules. Prudential had not breached its duty of good faith (or of trust and confidence). This conclusion also applied to increases to pensions deriving from AVCs and transfers in, despite the fact that conversion terms for these had been based on the assumption that uncapped RPI increases would continue.

A crucial point to note was that the employer's power to award discretionary pension increases was not fiduciary. Accordingly, Prudential was entitled to consider its own interests when making decisions. A decision would need to be defined as irrational or perverse to constitute a breach of the duty of good faith. Investment returns had declined, longevity had increased and the scheme's solvency had deteriorated, all of which influenced Prudential's decision. Furthermore, critically, the discretion was not subject to any restriction under the scheme rules.

A decision by an employer in a pensions context which is irrational or perverse might breach the duty of good faith. The employer must employ a genuine and rational approach to an exercise of discretion. A failure of process, if sufficiently significant, may, once known to members, be likely to undermine trust and confidence and thus breach the good faith obligation.

On the other hand, an irrational decision by an employer on a trivial matter might not destroy or seriously damage the relationship between employer and members and thus constitute no breach of the obligation.

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The beneficiaries' estoppel argument also failed. The evidence did not demonstrate any promise (let alone a clear or unequivocal one) to give uncapped increases. Nor was there any evidence that anyone had relied on receiving uncapped increases.

Following Browne-Wilkinson V-C's extension of the employer's implied obligation of good faith into the pensions context in the *Imperial Tobacco* case in 1991, we now have a better picture of how it applies to discretionary decisions under an occupational pension scheme. This decision may seem harsh to a member whose service is all or mostly pre-April 1997. But it is clear that (subject to any qualification in the scheme rules) if a power to increase pensions is discretionary, even if historically it has almost always been exercised, an employer may stop granting increases if the decision is properly considered and is not irrational or perverse.

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