



CONFLICTS OF INTEREST CAN BE A RECIPE FOR DISASTER WHEN IT COMES TO MANAGING SCHEMES SET UP UNDER TRUST. PHILIP BENNETT OF SLAUGHTER AND MAY EXPLORES THE IMPLICATIONS.

COPING WITH CONFLICT

Deficits have brought into the spotlight the conflicts between the different interested parties in a funded defined benefit pension scheme set up under trust (referred to here as a 'scheme'). This article looks at the legal rules on conflicts and some ways of managing them. *Table 1* below summarises the interests and ways in which conflicts arise in a deficit situation. In considering conflicts in relation to a scheme deficit, it is first important to establish what powers relevant to the deficit the trustees and the employer respectively have under the scheme's trust deed, overriding legislation and trust law.

TRUSTEES AND SOLE CORPORATE TRUSTEES. The trustees of the scheme may be individuals, usually drawn from the senior management of the employer, some member representation from the active members and possibly the pensioners, and may include an external independent professional trustee. Decision-taking is regulated by the trust deed, trust law and overriding legislation.

The Pensions Act 1995 requires a third of the trustee body to be elected from the active members, unless alternative proposals are made by the employer and validated by the eligible members. However, it is increasingly common, for a number of reasons that

are outside the scope of this article, for the trustee to be a company whose sole function is to act as the trustee of the scheme, with its board of directors composed in the same fashion as if those directors were individual trustees. Decision-taking by the board of directors of a trustee company is regulated by its Articles of Association and the Companies Act 1985.

THE CLEAR LEGAL RULES ON CONFLICTS OF INTEREST.

- **Prohibition** – in the absence of express or implied authority, a trustee cannot act in a situation where his or her interest and duty conflict, or their duty to another person and their duty to the trust conflict.
- **Consequence of breach of prohibition** – the decision is invalid and can be set aside in a claim brought by any beneficiary. Note, the courts take this prohibition very seriously.
- **Express or implied authority to act notwithstanding the conflict** – the authority for any trustee acting in a conflict situation may be provided by: the express provisions of the scheme's documents authorising a trustee to act in a conflict situation; by legislation (there are limited circumstances in which this is of help); or by implication from the circumstances in which the trustee was appointed (a difficult area).

TABLE 1
CONFLICTS OF INTERESTS IN SCHEME AND IN DEFICIT SITUATION

Interested party	Nature of interest	Comment
1. Employer	<ul style="list-style-type: none"> ■ Attractive pension benefits to recruit and retain employees. ■ Cost of benefits. ■ Effect on employer's financial position. 	<ul style="list-style-type: none"> ■ Query taking more investment risk, reduce cost/cashflow but increase volatility. ■ Query taking less investment risk, reduced volatility and increase cost/cashflow.
2. Pensioners and deferred pensioners	<ul style="list-style-type: none"> ■ Security of pension promise. ■ Prospect of discretionary pension increases. 	<ul style="list-style-type: none"> ■ Employer to make good deficit as quickly as possible. ■ Take less investment risk (unless employer cannot pay in which case query take more investment risk).
3. Active members	<ul style="list-style-type: none"> ■ Continued accrual of future service benefits. ■ Security of pension promise. ■ Prospect of discretionary pension increases. 	<ul style="list-style-type: none"> ■ Partly 1 above and partly 2 above. ■ Depends on expected length of future employment with employer.
4. Trustees	<ul style="list-style-type: none"> ■ May be active member or pensioner. ■ May be director or employee with bonus arrangements, share options or shares in employer. 	<ul style="list-style-type: none"> ■ Need to manage the conflict.

- **In practice, conflict will often be authorised** – in practice, most well-drafted scheme documents (or sole corporate trustee company articles of association) will expressly authorise trustees (or directors) to act in a conflict of interest situation, although the need for an interest to be declared and recorded in accordance with Section 317 of the Companies Act 1985 will still apply in the case of a director of a corporate trustee.
- **Conflicts of interest** – a purely trivial or hypothetical conflict of interest may be discounted. But where a person owes duties in his or her capacity of trustee to the beneficiaries of the trust and also in the capacity as, for example, a director or employee of the employing company, that person will have a real 'duty/duty' conflict between their duties as a director or employee of the employing company to the employing company and their duties as a trustee to the beneficiaries of the scheme.
- **Sole corporate trustees** – these conflict rules also apply in similar fashion to directors of companies, including directors of a sole corporate trustee, but under company law, rather than trust law. It is, however, common for the articles of association of the company to provide that, where a director has declared his or her interest, they may nonetheless count in the quorum and vote on a matter in which he is interested. Note, if the articles are silent on the point, then the director with a conflict will be prevented from acting and the decision can generally be set aside.

THE LESS CLEAR LEGAL RULES. Assuming that the trustee is authorised to act in a conflict situation, the trustee still has to comply with additional rules imposed under trust law to avoid

potential liability for breach of trust. Although these rules can be stated clearly, their application to the facts of the situation is more difficult.

- **Conflict of interest authorised but still a duty to act in best interests of beneficiaries** – where a trustee has a conflict of interest, that trustee must nonetheless act in the best interests of the beneficiaries of the trust. They cannot contract out of this rule; and they should assume the same rules apply to the director of a sole corporate trustee, although the legal position is more complex.
- **Duty to hold balance fairly** – where there are different and competing interests (see *Table 1*) of the different classes of beneficiaries, then the trustees are required to hold the balance fairly between those conflicting interests.
- **Who are the beneficiaries?** – the primary beneficiaries will be the members of the scheme (whether active members, deferred members or those in receipt of pension). The interests of future members may also be required to be considered.
- **Employer as residual beneficiary** – most pension trust deeds will provide for any surplus that arises on winding-up to be repaid to the employer, so the employer is also the residual beneficiary.
- **Burden of proof** – a useful rule of thumb to adopt is to assume that, where a trustee or a director has a conflict of interest that is material to the decision in question, then, even though authorised to act in that conflict situation, the burden of proof should be assumed to lie with the conflicted trustee or director to show that, notwithstanding the conflict, the trustee or director was acting in the best interest of the beneficiaries.

CASE STUDY

Two into one won't go

As has been noted by others, 2002/2003 was stormy for pensions; for many funds, their sponsoring company was also suffering from the prevailing economic environment. For at least one FTSE-100 company, the (new) CFO quickly found himself in an untenable position. As a trustee, although not chairman of the trustees, he found himself acutely aware of the advantages of persuading the sponsoring company to make additional contributions to reduce the deficit he had inherited. As CFO, he was similarly aware that the resulting deterioration in cashflow would almost certainly place the company's credit rating under more pressure than it would otherwise have been. In practice, he was clearly the trustee most aware of the risk of the credit rating being downgraded anyway and therefore of the increased credit risk that would fall on the fund. As trustee, it was even legitimate to ask whether the fund should be buying credit protection to hedge this risk, which certainly would not have been in the company's interest at a time when it was thinking of tapping the debt capital markets. Had this question actually been asked, it would have made the situation even more complex, since the company would have had to give its approval to the changes to the trust deed that would have been necessary to permit this. For a relatively short period of time a great deal of rationalisation went into why it made sense to continue in both roles ('everybody does it', 'resignation would look worse', 'lines of communication would deteriorate' and

the like). Eventually, a slightly different question was asked, would anybody in his or her right frame of mind take on both roles, understanding full well the issues? The answer was resoundingly that they would not and a communication plan was developed for explaining the reasons for his resignation to the trustees.

There was a sequel to this story. Now free of his trustee role, the CFO needed to consult the company's actuarial advisers as to courses of action that might be available with regard to the level of contributions. It immediately transpired that the company did not have an independent actuarial adviser at all – to the extent that it had ever sought advice previously, it had been from the scheme actuary on an informal basis. This was the very person who, a few days before, had been explaining to the trustees why they might want to ask the company for additional contributions. In this situation, something else was clearly required. The solution was in two parts. First, within the firm of which the scheme actuary was a principal, an effective Chinese wall was built and a separate principal appointed to deal with company issues. This was considered to be more cost effective than appointing a completely independent firm to deal with all issues on behalf of the company. Second, for issues that were considered particularly sensitive, a completely independent firm was appointed to deal with questions specifically referred to them.

'WHEN MANAGING CONFLICTS, THERE MAY BE CASES WHERE THERE WILL NEED TO BE A NEGOTIATION BETWEEN THE TRUSTEES AND THE EMPLOYER'

- **Acute conflicts** – there can be cases where the conflict is so acute that it is advisable for the trustee or director to stand aside from the decision because the burden of proof rule of thumb becomes too onerous. If all of the trustees or directors have acute conflicts, it may be that the best way to proceed would be to appoint an independent trustee to make the decision (or to apply to the court to approve the decision – usually as a course of action of last resort).
- **Consequence of not acting in best interests of beneficiaries** – if a trustee does not act in the best interests of the beneficiaries, that trustee is liable to make good the loss to the trust flowing from that breach of duty. This is subject to any exculpation or indemnification provisions in the trust deed which might apply if the trustee has acted in good faith, although this could be difficult to demonstrate. Such an exculpation or indemnification provision will be set aside by Section 33 of the Pensions Act 1995, where the breach of duty relates to the trustee's investment function.

MANAGEMENT OF CONFLICTS. There may be cases where there will need to be a negotiation between the trustees and the employer. An example would be how quickly the deficit in the pension scheme should be made good. Where the trustees have the power to fix the employer contribution rate, they may have a starting position of seeking immediate cash payment for the whole of the deficit or may require a charge over the employer's assets (or a bank guarantee or a requirement that the employer maintain a particular credit rating), in return for allowing the deficit to be made good over time. There are a number of permutations here and the position will be influenced by, among other things, the size of the deficit relative to the financial strength of the employer.

- **Separate advisers** – to manage the conflict process, trustees and employers should consider, in relation to the conflict in question, whether they need separate legal advisers and, depending on the circumstances, actuarial advisers. They will normally seek legal advice on this point.
- **The finance director cannot be on both sides of the fence** – if the finance director is leading the negotiations in relation to managing the deficit on behalf of the employer, he or she cannot also act as the chairman of the trustee body considering how to deal with the deficit from the point of view of the scheme and its beneficiaries. It is a perhaps self-evident, but often overlooked point, that you cannot have a negotiation with yourself.
- **Chinese walls** – if there is to be a negotiation, it will be necessary, in addition to the trustees and the employer having separate legal advisers, to establish Chinese walls. This process must be a genuine process. For example, the board of the employer may be able to establish a board committee that excludes anyone who is a member of the trustee body, and the trustee body may, itself, if authorised to do so by the scheme's trust deed, be able to establish a committee of the trustee body, excluding anyone who is involved

from the employer perspective. Information flows (including emails) have to be managed carefully to make sure the Chinese walls are not breached.

- **Liability of excluded trustee/director of trustee company for decision in which they took no part** – at the risk of oversimplification, the general rule under trust law, is that a trustee is not liable for the acts or defaults of his or her co-trustees – this assumes that the trustee has power to act by majority decision, as is commonly the case, and that the trustee did not otherwise knowingly participate in the breach. The position is more complex if a unanimous decision is required from all of the trustees. In such a situation, the trustee in question may well need to resign. However, if the trustee who is on the employer's side of the Chinese wall has knowingly procured a breach of duty by the trustees on the pension scheme side of the Chinese wall, the working assumption should be that the trustee concerned would likewise be liable for breach of duty. The rules are similar for a director of a trustee company.
- **Position does turn on its facts** – I would, however, emphasise that the appropriate method of managing the conflict of interest will depend on the particular facts. For example, the deficit may be small relative to the size of the sponsoring employer, who may prefer to make an immediate cash contribution to remove the deficit, but may wish the trustee to adopt a 100% bond investment policy. In such a situation, although there is a deficit, the proposed solution will usually resolve the conflict and separate legal advisers are unlikely to be needed.

SO WHAT MESSAGES SHOULD THE READER TAKE AWAY FROM THIS ARTICLE? In my view, the messages to take away from this article are:

- **Do not leave it too late before seeking legal advice** – a lawyer seeking to set aside a decision of trustees will look at whether it is possible to challenge the decision on conflict of interest grounds. If you do not have express power to act in a conflict position under your trust deed (articles of association for a trustee company), you will be struggling badly. Pensions is an increasingly litigious area of business.
- **Do follow proper processes** – assuming you have express authority to act in a conflict situation, you should take steps to follow the proper processes for managing the conflicts. A number of these have been outlined earlier in this article. But, remember, each case will turn on its own facts.
- **Watch out for the acute conflicts** – in acute conflicts, it may be necessary to stand aside and, if all of the trustees have a conflict, to appoint an independent trustee to take the decision (or, as a last resort, apply to the court to sanction the decision that is to be taken). It may seem excessive at the time, but if the conflicted decision is set aside, you will have lost control of the process and there are likely to be adverse consequences for the employer's reputation.
- **Do not forget the pensioner action group** – when the pensioner action group asks questions at the AGM about the security of the company's pension fund, having followed a properly and carefully documented process for dealing with conflicts of interest in relation to the deficit is helpful!

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