Bringing pensions within TUPE

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Abstract This paper analyses the application of the Acquired Rights Directive and the Transfer of Undertakings Regulations (TUPE) to occupational pension schemes in the UK, and the Government's proposals for revising the Regulations.

Keywords: *Transfer of Undertakings Regulations (TUPE)*

Introduction

Under European law, as a result of the EU Acquired Rights Directive (77/187), an employee's contract of employment transfers automatically to an employer who acquires the business in which the employee works. This effectively equates the effect of a transfer of the business with a transfer of the shares in the company for which the employee works. This principle applies directly in the UK by virtue of the Transfer of Undertaking (Protection of Employment) Regulations 1981 (SI 1981/1794) (TUPE).

However, pensions are excluded from the automatic transfer provisions both under the Acquired Rights Directive and under TUPE. Consequently, it was initially assumed that the acquiring employer had an unfettered right to decide what pension provision (if any) should be made for the transferring employees in the future. The only relevant statutory requirement related to the protection of pensions which had already accrued, and were therefore the subject of the preservation legislation which applied directly to occupational pension schemes.

Some important developments have

caused practitioners to question whether this convenient analysis is too simplistic. The following questions have, therefore, become relevant and it is the purpose of this paper to analyse them in the light of recent developments:

- Do pension obligations pass to a purchaser or other acquirer as a result of the transfer of an undertaking?
- What liabilities (if any) remain with the seller (or transferor)?
- How are the remaining uncertainties likely to be resolved?

These questions are important in the context of the sale and purchase of a business. They have also assumed particular importance in the context of privatisations and outsourcing. Both of these situations will be considered in the course of this paper.

Potentially, however, the need to analyse the scope of the exclusion for pensions may fall away in the near future, following proposals from the Government that the exclusion should be scrapped (or at least replaced).

This paper begins by reviewing the current position and then considers how the law may change in the future.

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Benefits to be provided by the receiving employer in respect of past and future service

In the context of a corporate sale and purchase or a business transfer, it is important to distinguish two elements of pension provision:

- the employees' accrued entitlements in respect of past service, and
- pension benefits which will accrue in respect of future service.

The significance of the distinction from a contractual viewpoint is this: under the contract of employment, the employee will normally have the right to continue to accrue pension benefits in respect of future service. Those contractual rights will be evidenced by the contract of employment, which will normally refer to the more detailed provisions of a member's booklet. The member's booklet will, in turn, refer to the even more detailed provisions of the Trust Deed and Rules of the scheme. The member's booklet will normally reserve the right to the employer to terminate the scheme or to amend its terms in respect of future accruals, thereby reserving the right (subject to general considerations of employment law) to vary the employee's terms and conditions regarding future pension benefits.

This must, however, be distinguished from the employee's right to receive benefits which have already accrued to him in respect of past service. Those rights are acquired under the Trust Deed and Rules of the relevant transferring employer's pension scheme and it is the responsibility of the trustees of the scheme to provide those benefits.

From a contracts of employment and TUPE standpoint, it is the accrual of benefits in respect of future service which is important, rather than the mechanism for delivering those benefits

which have already accrued. It is at this point that the nature of the corporate transaction becomes important.

If the acquisition is by way of share purchase, the contract of employment will, of course, continue intact. This means that, with regard to pensions, the employer (under its new owner) will remain under an obligation to provide pension benefits in respect of future service, in accordance with the contract of employment. However, if the acquisition is by way of the acquisition of a business or part of it, TUPE will apply, with a very different result from a pensions viewpoint.

TUPE and the transfer of a business

In principle, TUPE does not have the effect of imposing upon the acquirer the obligation to continue to provide pension benefits in respect of the employee's future service. However, the apparent exclusion of pensions from TUPE needs to be examined critically, both in terms of the current law and in the context of proposed changes which are envisaged by the Government. The exclusion of pensions from TUPE has its origins in the EU Acquired Rights Directive.

The Acquired Rights Directive

Article 3 of the EU Acquired Rights Directive establishes the 'automatic transfer principle' in the context of a business transfer. It provides for the automatic transfer of contracts of employment from transferring employer to transferee employer. This principle was enacted in English law under the Transfer of Undertakings (Protection of Employment) Regulations 1981 (SI 1981/1794) (TUPE). It is relevant to internal restructurings, corporate sales and purchases and business transfers in the

context of privatisations and outsourcing.

Article 3(3) of the Directive contains an exception to the 'automatic transfer principle' in the case of 'employees' rights for old age, invalidity or survivors' benefits under supplementary company ... pension schemes'. This exception is reflected in Regulation 7(1) of TUPE, which provides that the automatic transfer of the contract of employment will not apply to so much of its terms as relate to an occupational pension scheme.

However, the basis upon which the UK has excluded the automatic transfer of pension rights has been challenged in the courts. The main basis of challenge was that the UK legislation does not meet the requirements of Article 3 of the Acquired Rights Directive, in that the Directive requires Member States to 'adopt the measures necessary to protect the interests of employees and of persons no longer employed in the transferor's business ... in respect of rights conferring on them immediate and prospective entitlement to old age benefits ...'. This paper will examine this issue in more detail later.

The Transfer of Undertakings (Protection of Employment) Regulations 1981

Regulation 5 of TUPE provides for the automatic transfer of contracts of employment on the transfer of a business. However, Regulation 7(1) then excludes occupational pension schemes in the following terms:

- '(1) Regulations 5 and 6 above shall not apply:
 - (a) to so much of a contract of employment or collective agreement as relates to an occupational pension scheme within the meaning of the Social Security Pensions Act 1975 or

the Social Security Pensions (Northern Ireland) Order 1975; or

- (b) to any rights, powers, duties or liabilities under or in connection with any such contract or subsisting by virtue of any such agreement and relating to such a scheme or otherwise arising in connection with that person's employment and relating to such a scheme.
- (2) For the purposes of paragraph (1) above any provisions of an occupational pension scheme which do not relate to benefits for old age, invalidity or survivors shall be treated as not being part of the scheme.'

Does Regulation 7 work? Case law on the position of the receiving employer

Past and future service

It is generally accepted that neither TUPE nor the Acquired Rights Directive requires the receiving employer to provide pension benefits in respect of past service. However, there has been considerable debate about the obligations of the transferring and receiving employers regarding pension benefits for future service. Various claims were brought in an attempt to impose an obligation on the receiving employer.

The Warrener case

Some Industrial Tribunals found it hard to accept that the acquiring employer should incur no obligation at all with regard to the future pension provision. In *Warrener v. Walden Engineering Co Limited* [1992] OPLR 1 and *Perry v. Intec Colleges Limited* [1993] IRLR 56, industrial tribunals used fairly contrived arguments to conclude that the obligation to provide pension benefits in respect of future service should pass automatically to the receiving employer.

However, in June 1993, the Warrener

appeal was heard by the Employment Appeal Tribunal (EAT). The EAT overturned the decision of the Industrial Tribunal and concluded that pension rights do not automatically become enforceable by an employee against the acquirer of the business in which he works. This decision was subsequently confirmed by the Adams case.

The Adams case

On 15th May, 1997, the Court of Appeal delivered its judgment in the case of *Adams & Ors v. Lancashire CC & BET Catering Services Limited* [1997] PLR 145, [1977] IRLR 436. The Adams case related to dinner ladies who became employed by BET as a result of a contracting-out arrangement by Lancashire County Council. The dinner ladies had been members of the Local Government Pension Scheme. However, they were not eligible to join the BET pension scheme, under the terms of that scheme. BET did not offer membership of its scheme to transferred employees earning less than £15,000 per annum, thereby excluding all of the part-time dinner ladies.

The dinner ladies' claim against both BET and Lancashire County Council was rejected in the High Court. They appealed to the Court of Appeal. In their claim against BET, the plaintiffs raised two arguments. They argued that the exclusion in Regulation 7 of TUPE, on its true construction, applied only to pensions which had accrued in respect of pensionable service prior to the business transfer. On that analysis, pension rights in respect of future service would transfer under Regulation 5 of TUPE. The Court of Appeal could find no support for this view in the construction of Regulation 7.

The plaintiffs argued, in the alternative, that the exclusion in Regulation 7 went

beyond the scope of the exclusion in Article 3(3) of the Acquired Rights Directive. Again, the plaintiffs argued that the exclusion of pension benefits under Article 3(3) related only to accrued benefits. They supported this contention by referring to the second part of Article 3(3), which referred to the need for Member States to legislate to protect the interests of employees in respect of their accrued rights. They argued that the requirement to legislate in respect of accrued benefits on a national basis and the exclusion of pensions from protection under Article 3(3) should be read together (with the consequential application of the restriction only to accrued benefits).

Again, the Court of Appeal did not agree with this interpretation of Article 3(3). It found no inconsistency in construing the exclusion in Article 3(3) so that it applied to both accrued pension benefits and benefits in respect of future service. Although this created a gap in protection, by reference to future service entitlements, the Court of Appeal was not persuaded that this should cause it to change its view. It is, of course, conceivable that the European Court of Justice could take a different view if the question were to be referred to them, but no further appeal was lodged in the Adams case.

What is the Regulation 7 exclusion intended to cover?

When Regulation 7 first came into force, it excluded the provisions of occupational pension scheme generally from transferring under TUPE. The exemption covered all benefits provided under an occupational pension scheme and all contractual entitlements arising in connection with an occupational pension scheme.

The term 'occupational pension scheme' is defined quite widely. The

definition is now found in Section 1 of the Pension Schemes Act 1993, which provides as follows:

“Occupational pension scheme” means any scheme or arrangement which is comprised in one or more instruments or agreements and which has, or is capable of having, effect in relation to one or more descriptions or categories of employments so as to provide benefits, in the form of pensions or otherwise, payable on termination of service, on death or retirement, to or in respect of earners with qualifying service in an employment of any such description or category.’

The wide-ranging nature of this exemption gave rise to concerns that it extended the exemption beyond that which was contemplated in Article 3(3) of the EU Acquired Rights Directive. As a result, the Trade Union Reform and Employment Rights Act 1993 introduced regulation 7(2) with effect from 30th August, 1993. This resulted in the exclusion from TUPE being restricted to those provisions of an occupational pension scheme which relate to ‘benefits for old age, invalidity or survivors’.

What benefits fall outside Regulation 7(2)?

As a result of restricting the application of the exclusion in Regulation 7, some features of pension arrangements now fall outside the exclusion and therefore transfer automatically. Although benefits payable under tax-approved occupational pension schemes in the private sector all tend to fall within the exclusion, some benefits provided in public sector schemes do not.

For example, the Principal Civil Service Pension Scheme provides certain benefits which are payable on redundancy rather than upon retirement. They may therefore fall outside the

definition of ‘benefits for old age, invalidity or survivors’. These benefits may consequently transfer automatically under Regulation 5, but cannot be replicated in a tax-approved occupational pension scheme in the private sector. As a result, the new employer in the private sector will normally have to enter into a contractual arrangement with the employee to provide the benefit outside the terms of the employer’s occupational pension scheme.

Regulation 7(2): The Frankling and Beckmans cases

The scope of the exclusion in Regulation 7(2) has now been considered in two cases, with inconsistent results. It was first considered by the Employment Appeal Tribunal in *Frankling v. BPS Public Sector Limited* (EAT/442/98) IRLR [1999] 212. The case related to redundancy payments and pension enhancements under the NHS Superannuation Scheme upon reaching a specified age. The question which the EAT had to consider was whether these benefits related to old age (and hence were excluded from transfer under Regulation 5).

The facts of the case were that the payroll function of Eastbourne Hospitals NHS Trust was outsourced to BPS Public Sector Limited, a private sector company. The employees were transferred to BPS, but BPS subsequently moved its payroll department to Glasgow and the employees were made redundant.

Section 46 of the Whitley Council terms and conditions provides that employees over age 50 and five years’ service should receive a cash payment and special early retirement terms if they are made redundant. These provisions were incorporated into the NHS Superannuation Scheme by the NHS Superannuation and Compensation Regulations.

The EAT concluded, from a technical viewpoint, that there was no direct contractual promise from the employer to make the payments, given that the benefits were payable under the NHS Superannuation and Compensation Regulations and were therefore statutory in nature. However, the EAT went on to consider what the effect of Regulation 7(2) would have been if a contractual promise had existed.

The EAT considered that terms such as those found in Section 46 fell within the scope of benefits for old age, invalidity or survivors (and hence within the exclusion in Regulation 7). It took the view that the provisions of a pension scheme do not cease to relate to benefits for old age merely because the employee has taken early retirement. Old age was not to be used in the sense of 65 years of age and over. Morison J commented as follows:

‘Accordingly, although the benefits falling due to redundant employees were triggered by redundancy, the benefits retain their character as retirement benefits although accelerated and enhanced.’

The Frankling case is being appealed. Leave to appeal was granted in February 1999, but the case has not yet been heard by the Court of Appeal.

Doubt was cast upon the views expressed by the EAT in the Frankling case when Mr Justice Penry-Davey commented on similar provisions in the case of *Beckmann v. Dynamco*. The High Court concluded that the entitlement of employees aged over 50 with five years’ service to receive a cash payment and special early retirement terms if made redundant constituted a redundancy payment, and not an old age benefit. Consequently, the obligations did not fall under the exclusion in Regulation 7 and transferred automatically to the new employer. This case, in which the High

Court delivered judgement on 21st January 2000, has now been referred to the European Court of Justice.

The continuing liability of the transferring employer

There are two technical arguments that some liability may remain with the transferring employer if the acquirer fails to make adequate pension provision in respect of future service.

It is possible that an employee who rejects employment with the new employer altogether, perhaps on the grounds that inadequate pension provision is to be made, may be able to claim that he has been constructively dismissed as a result of a repudiatory breach of contract. Such a claim could encompass both wrongful dismissal and unfair dismissal. The Court of Appeal approved this proposition in the context of wrongful dismissal in *The University of Oxford v. Humphreys and the Associated Examining Board* (ILRL 21/2/2000). This case does not relate to pensions, but it entailed a detrimental change in the employee’s terms and conditions of employment. It could therefore be applied to pensions by analogy. The case (in which judgement was delivered on 20th December 1999) is now subject to appeal to the House of Lords.

The argument in the Oxford University case is dependent upon the employee refusing to accept employment with the new employer. However, as follows, a more technical argument exists in support of the proposition that the employee may transfer to the new employer and still bring a claim against the transferring employer. The transfer of an undertaking would normally terminate the contract of employment. However, Regulation 5 of TUPE provides expressly that, ‘a relevant transfer shall not operate so as to terminate the contract of

employment'. It is this provision which encapsulates the main thrust of TUPE. Regulation 5(2) then proceeds to refer to the automatic transfer of the transferor employer's rights and liabilities with regard to the employees.

As noted above, Regulation 7(1) provides that Regulation 5 does not apply to 'so much of a contract of employment ... as relates to an occupational pension scheme'. Consequently, it is argued, if Regulation 5 cannot apply to pensions, the effect of the transfer is to terminate the contract of employment, at least insofar as it relates to pensions (because Regulation 5 cannot therefore save it). If so, the employee may treat this as a termination of his contractual rights, leading therefore, to a possible claim against the transferor employer for constructive unfair dismissal or for damages.

This argument appears particularly contrived. The Government did, however, take the position on privatisations and contractings-out that the relevant public body, as transferor, must ensure that the interests of the employees with regard to pensions are safeguarded. This led the Government to apply a universal test of 'broad comparability' to the transferee's proposed pension benefits in privatisations and contractings-out of services.

The Adams case now suggests that no liability will remain with the transferor, whatever pension arrangements are put in place by the transferee. The point was not considered in detail by the Court of Appeal. However, in the High Court, Walker J took the view that it cannot have been the intention of Article 3(1) to effect 'the artificial prolongation of the old employer's obligations'. Although the argument based upon the interplay between Regulations 5 and 7 of TUPE was not rehearsed in either judgment, it seems most unlikely that an employee

who transfers to the transferee could bring a successful claim against the transferor on the grounds that the transferee has failed to establish appropriate pension arrangements.

If the employee is to be able to bring a claim against the transferring employer, it appears unlikely that he will be able to do so unless he adopts the course of action of Mr Humphreys in the Oxford University case and refuses to join the new employer altogether.

Privatisation and contracting out: Broad comparability

In spite of the Adams case, the Government and public sector employers still insist, presumably now for political and HR reasons, that the transferee must provide broadly comparable pension benefits in respect of future service. This insistence has been confirmed in a Statement of Practice entitled 'A Fair Deal for Staff Pensions', issued by the Chief Secretary to the Treasury, Alan Milburn, on 14th June, 1999. It relates specifically to transfers from Government Departments and Agencies, but it is likely that other public sector employers will follow suit. In substance, the Statement of Practice does little more than formalise the practice which has been adopted by successive governments for several years.

No precise definition of 'broad comparability' has been advanced by the Government. However, the criteria which the Government and the Government Actuary's Department apply relate both to the benefits which are to be provided by the acquirer's scheme, and to the structure of the acquirer's scheme insofar as it may affect the scheme's ability to deliver those promised benefits.

As noted above, in the majority of privatisations and contractings-out, the new employer is required to make

'broadly comparable' provisions both for benefits accruing in respect of future service and for benefits which have already accrued, on the basis that the employees will be 'kept whole' in terms of their pension expectations.

If, as is almost always the case, the new employer is to provide benefits in respect of past service, it is necessary for a transfer payment to be paid from the public sector scheme to the new employer's scheme. In some cases, public sector schemes are funded schemes (in the sense of having a separately identifiable fund set aside to pay the promised benefits), in which case the transfer payment will be paid from existing funds. In other cases, such as PCSPS, the scheme is not pre-funded and the payment is made directly by the Treasury.

In either case, the Government and the scheme concerned will propose a basis of calculating the transfer payment, which is normally determined by the Government Actuary's Department. It is then for the new employer's actuary to advise the new employer upon the adequacy of the proposed transfer payment.

The public sector employer, of course, needs to be confident that the acquirer's pension scheme will actually deliver the promised benefits, particularly if public money is paid to it by way of a transfer payment. In order to do this, it will normally attempt to impose certain obligations and restrictions upon the acquirer relating to the trust deeds and rules of its pension scheme before it will issue a certificate of broad comparability. For those private sector schemes which regularly accept public sector transfers, the Government Actuary's Department will issue a 'passport' to confirm that the scheme satisfies its requirements.

Finally, as noted above, public sector pension schemes, such as PCSPS, often contain features which are not found in

private sector pension schemes. In particular, the early retirement, redundancy and early leaver provisions go beyond those which are permitted in tax-approved private sector pension schemes. Consequently, these provisions will normally need to be replicated outside the acquirer's pension scheme.

The impact of interim arrangements in a sale and purchase

The employment law position regarding pensions is sometimes complicated by the fact that there may be a need to put in place an interim arrangement following a corporate sale. In many sales, the buyer will not acquire the seller's pension scheme. Consequently, the buyer will need to establish either a new pension scheme or the new section of its pension scheme for the transferring employees. In either case, the buyer is unlikely to be able to establish the new pension arrangement immediately on completion of the purchase.

As a result, in many purchases, the seller will agree to the employees continuing to accrue benefits under the seller's scheme for a period of time after completion, in return for which the buyer contributes to the seller's scheme. The Pension Schemes Office of the Inland Revenue will not allow unrelated companies to participate in the same scheme indefinitely, but continued participation for up to 12 months is allowed. Typically, employees will remain in the seller's scheme for between three and six months after completion of the sale, on the assumption that this can be agreed between the seller, the buyer and the trustees of the seller's pension scheme.

This has an effect upon the position under TUPE. If the employees continue to participate in the seller's scheme after completion, this means that they will

begin working for the buyer on the same terms and conditions regarding pensions. Consequently, if the buyer wishes to preserve its ability to change the pension arrangements without regard to the terms which the employees enjoyed under the seller's scheme, it is important that the buyer should notify the employees, at the time of the purchase, that it is intending to make a future change to the employees' pension arrangements as a result of the TUPE transfer.

The future: The Government's 1997 consultative document

In December 1997, the Government issued a consultation paper on the workings of both the Acquired Rights Directive and TUPE. In it, the Government canvassed views on the possibility of removing the exclusion in respect of pensions. The specific suggestion made in the paper was that receiving employers would be required to provide comparable (but not necessarily identical) pension benefits.

Amendment to the Acquired Rights Directive

In a European context, the Government has now paved the way for a change in legislation by securing Member States' agreement to a revision of the Acquired Rights Directive. The new Directive, approved in June 1998, makes it clear that Member States have the option to include the automatic transfer of pension rights within the coverage of their national legislation. The full text of Article 3(4) of the Acquired Rights Directive now contains a very inelegant double negative and reads as follows:

- '4.(a) Unless Member States provide otherwise, paragraphs 1 and 3 shall not apply in relation to employees' rights

to old-age, invalidity or survivors' benefits under supplementary company or inter-company pension schemes outside the statutory social security schemes in Member States.

- (b) Even where they do not provide in accordance with subparagraph (a) that paragraphs 1 and 3 apply in relation to such rights, Member States shall adopt the measures necessary to protect the interests of employees and of persons no longer employed in the transferor's business at the time of the transfer in respect of rights conferring on them immediate or prospective entitlement to old age benefits, including survivors' benefits, under supplementary schemes referred to in subparagraph (a).'

The reference to paragraphs 1 and 3 is a reference to automatic transfer. The recent amendments are underlined.

As noted above, the UK satisfies the requirements of paragraph (b) by protecting the benefits of early leavers under the preservation legislation first introduced in the Social Security Act 1973 and now contained in the Pension Schemes Act 1993.

The Green Paper: Partnership in Pensions

In December 1998, the Government issued a consultation document or Green Paper entitled Partnership in Pensions. This document made a number of proposals for revising the provision of pensions, notably the introduction of stakeholder pension schemes. Some provisions (including those relating to stakeholder pension schemes) are included in the Welfare Reform and Pensions Bill, which has been enacted this Summer. The Green Paper indicated that it is the Government's intention to amend TUPE in order to apply to occupational pension rights.

As the sponsoring department for proposed changes in TUPE, the Department of Trade and Industry is taking the lead in reviewing the pensions aspects of TUPE. It has formed a joint working group which includes the DSS and representatives of various pensions industry bodies.

The DTI has prepared a submission to the Minister recommending that a further consultation process should be undertaken in order to canvass reaction to various specific options for mandating the transfer of pension benefits. The intention is that consultation will begin shortly, and the process will enable representations to be made by the pensions industry as a whole. The likely outcome is that pension benefits for future service will be brought within the scope of TUPE, but that employers will be given some latitude to vary pension provision, while satisfying a test like that of 'broad comparability' discussed earlier.

Employers are naturally keen to ensure that they should be given some latitude in these circumstances. The reason is that it is often difficult for an acquiring employer to replicate a transferring employer's scheme precisely. A large and mature pension scheme (including public sector schemes) will often have a complexity of benefit structure which simply cannot be reproduced economically in a smaller scheme. It may not be practical to expect an acquiring employer (particularly a smaller employer) to establish a new scheme (or a section within its existing scheme) which mirrors precisely the provisions of the transferor's scheme. Indeed, in some cases, the acquiring employer may wish to introduce a money purchase arrangement. It remains to be seen whether a test of 'broad comparability' will be devised which is capable of accommodating anything other than a final salary arrangement, given the

difficulty which a money purchase arrangement would face in satisfying any requirement which relates to the provision of a specific level of benefits.

Summary of the current position under TUPE

The present legal and practical position under UK law is therefore as follows. The exclusion of pensions from TUPE is effective to ensure that future pension rights are not automatically enforceable against the new employer. This is even the case when the transfer of the business takes place as a result of an internal corporate reorganisation as opposed to a sale.

However, from an employer's perspective, care needs to be taken in communicating with employees to ensure that legally enforceable rights and expectations are not conferred upon employees regarding their future pension benefits. An employee may well be able to bring a claim against the new employer if the employer has been injudicious about giving general assurances in respect of future terms and conditions.

There is no legal basis, according to the Adams case, for any liability to remain with the transferor if the receiving employer fails to provide adequate pension benefits for future service. However, the University of Oxford case may have cast some doubt on this.

It is, of course, possible that a case may be referred to the European Court of Justice on these issues and that the ECJ may take a different approach from the Court of Appeal. However, the Government is now proposing to amend TUPE to provide for the automatic transfer of future pension rights under contracts of employment (but with the likelihood that acquiring employers will be allowed some latitude to provide only broadly comparable benefits).