

THE APPROPRIATE DISPOSAL OF RETIREMENT FUND SURPLUSES

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ABSTRACT

This paper attempts to clarify the different paradigms from which defined benefit funds are viewed, and the financial nature of the contracts implicit in their rules. Suggestions are made as to the principles that trustees might follow in applying the surpluses for the benefit of stakeholders.

KEYWORDS

Pension funds; surpluses; defined benefit; fiduciary duties

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1. INTRODUCTION

1.1 Retirement fund surplus has been the subject of a number of papers, disputes, negotiations and judgements in the last three years particularly. This paper is a contribution to that debate, which the author believes has not fully addressed actuarial concerns about the sub-optimality of restricting the distribution of surplus, nor legal and moral concerns as to the exploitative practices that have frequently led to the emergence of these surpluses.

1.2 The paper is divided in sections that consider the nature of retirement funds and the surpluses that arise, the duties of trustees and employers, and the ownership, origin and disposal of the surpluses. In this context it is argued that:

- the reasons why a fund is over-funded need to be determined;
- it is fallacious to assume that all surpluses reflect “over-contribution” by the employer;
- it can be equitable to allocate a share in the surplus to the employer; and
- it is inappropriate to take into account profits made from withdrawal and sub-inflationary pension increases in determining the rate of employer contribution to the fund because of the intrinsic unsoundness of these practices, and because these practices defeat the very purpose of defined benefit (DB) pension funds.

1.3 While it is unlikely to be the last word, it is to be hoped that it will assist lawyers, actuaries and other interested parties as to the logic underlying differences in the debate.

2. WHAT IS A RETIREMENT FUND SURPLUS?

2.1 AN ACTUARIAL CALCULATION

2.1.1 The profit earned by the church fete can be determined once the hall has been cleaned and the money banked. The profits reported by ongoing business enterprises are more difficult to determine as they necessitate placing value on the assets and liabilities of the company – the precise value of which may take some years to emerge. The profits earned by retirement funds may be even more difficult to determine as their liabilities may well stretch seventy or more years into the future.

2.1.2 The primary purpose of the actuary is, however, to ensure the financial soundness of the retirement fund, not to determine its profit. The result is that the surplus appearing on an actuarial balance sheet may merely provide an indication that, at the time of the valuation, the value of the assets of the fund exceeded that of its accrued liabilities. Neither necessarily bears any resemblance to market values.

2.1.3 This is not to say that actuaries cannot estimate the likely present value of the difference between future inflows and outflows. That part of the surplus that “belongs” to the company is clearly important to shareholders. From January 1999, companies that wish to conform to International Accounting Standards have been required to show an estimate of the value “belonging” to shareholders in their accounts.¹ Whether the method suggested is appropriate remains a matter of debate between the actuarial and accounting professions, but there is common recognition of the need to quantify the surplus in some way.

2.1.4 The surplus needs, first, to be divided into two parts.

2.2 CONTINGENCY RESERVES

2.2.1 The first is that required for future contingencies of various kinds. Retirement funds are normally required by regulators to conform to actuarial recommendations, which can be relatively conservative and so can have assets greater than those likely to be required to pay accrued benefits. This excess may be reflected as a reduction in the balance sheet value of the assets or as an increase in the value of liabilities, may be shown as explicit reserves, or may arise by virtue of the use of conservative assumptions.

2.2.2 Actuaries generally regard most of the volatility of investment markets as short-term deviations from longer-term value and attempt, in their recommendations, to avoid major changes to contributions, benefits and investment policy. Here they differ from theoretical economists who believe that current market values represent the best estimate of long-term value. Wilkie (1995) has developed models of stock market behaviour that appear to justify avoiding sharp changes in behaviour. Thomson’s (1996) South African model confirms this approach. Regardless of how the surpluses are calculated, however, the market value of the reserves held for contingencies is volatile: there may well be shortfalls from time to time.

2.3 DISTRIBUTABLE SURPLUS

The second part of the surplus (which may also be negative) requires action. If it is a shortfall, benefits must be reduced or contributions increased. South African regulations allow for up to nine years in which to make good such a shortfall. A distributable surplus (which is how this part of the surplus can be described) can lead to increased benefits, reduced contributions, or – and this is a pressing part of the debate in South Africa – to refunds in contributions.

2.4 NOT ILLUSORY

2.4.1 Justice Robert Walker has said that:²

Any impression of precision in the size of the deficit or surplus is (an actuary would be the first to emphasise) illusory, since the outcome depends not only on the financial and demographic assumptions but also on the funding method selected by the actuary as appropriate.

2.4.2 Lack of precision does not, however, make it correct to conclude, as the South African Pension Funds Adjudicator wrote in his determination in the SAPREF matter³, that:

Pension funds surpluses do not comprise tangible assets. There is nothing to “own”. A surplus arises as a result of an actuarial judgement.

2.4.3 Real surpluses (and shortfalls) do arise in retirement funds. We cannot be as certain of their exact size as we are of the profit on the church fete. Nevertheless, just as directors can declare a dividend out of their accountant’s determination of the public company’s annual profit, we can – in an analogous way – act on the actuary’s determination of the distributable surplus.

3. THE NATURE OF RETIREMENT FUNDS

Disputes over the treatment of surplus have been a source of industrial disputes and litigation over the past two decades. This can partly be explained by the financial importance of the surpluses to the parties concerned, as they have been estimated by the Financial Services Board (FSB) to be worth over R80 billion. It may also be partly explained by the lack of certainty in the laws governing their distribution. Much of the problem can perhaps be traced to the two different paradigms that govern the thinking of participants in the retirement fund industry.

3.1 THE PATERNALISTIC PARADIGM

3.1.1 The paternalistic paradigm assigns the major role to the employer in providing generous pensions for loyal staff. It is illustrated by Lee’s (1977) quotation from Charles Lamb’s *The Superannuated Man*, where the long serving employee is “astonished” by the offer of a pension. Malan (1974) writes:

A pension fund normally has a “guardian” – the employer – who accepts some responsibility to look after the fund; within limits most employers will be prepared to increase their contributions if necessary to safeguard the benefits promised ...

3.1.2 In many cases, retirement funds owe their existence to the initiative of

employers. In the context of this paradigm, it might also be argued that much of the costs have been borne by them over and above market wage rates. It was anticipated, however, that this generosity would be reciprocated by the loyalty of staff, who could be penalised if they resigned.

3.1.3 The paternalistic view is that the retirement fund benefit forms part of the employment contract, but is at least partly unrelated to wages earned. Thus Milburn-Pyle and Lennox (1990), expressing the paternalistic paradigm, argue that employer contributions to DB retirement funds are not deferred pay. In this view, the employer makes a global contribution on behalf of the group of employees for their years of service, but the benefits are allocated according to the rules, and are not necessarily related to the members' remuneration. Most DB funds, for instance, grant greater benefits to married people.

3.1.4 Viewed from this paradigm, surpluses in retirement funds clearly belong to the employers who initiated the funds and continue to underwrite their solvency.

3.1.5 It seems as if actuaries at one time unanimously held this paradigm. This is at least suggested by Hutton's (1969)⁴ rhetorical question:

To what extent is the actuary a professional advisor to his client, to the employer who sets up a pension scheme?

He apparently had in mind the temptation of paying too much attention to the interests of insurance companies and brokers, and clearly had not even considered the trustees. Such a statement would be unthinkable today, as it is clear that the actuary's clients are the retirement fund's trustees. It does not appear to have been challenged thirty years ago, although, to be fair, some funds would not have had trustees at the time. An actuarial discussion today should leave no doubt that the trustees are the actuaries' clients.

3.1.6 The official actuarial literature⁵ describes different acceptable retirement-funding rates that take a variety of approaches to the rate at which an employer should contribute, and the accrual of benefit to members. The profession, therefore, implicitly accepts this paradigm by not recognising one direct mathematical link between the cost of the benefits provided and the service rendered by the members to the employer. IAS19 gives no such latitude and requires the use of the projected unit credit method, which creates a clear mathematical link between the period of service and the benefit, and makes it clearer that the benefit is deferred pay – although the rate of accrual is different for members of differing age, marital status and salary outlook.

3.1.7 This is not to suggest that there is agreement in either the accounting or actuarial profession on how employer or employee should value the benefits: discussion of this issue would go beyond the scope of this paper. There are, however, strong feelings within the actuarial profession, illustrated in Exley, Mehta and Smith (1997) for instance, that actuaries should take a view more in line with modern financial theory and modern accounting practice.

3.2 THE SOLELY MEMBERS' FUND PARADIGM

3.2.1 A second paradigm sees contributions to retirement funds as deferred pay.⁶ The employer's contribution, even if redistributed within the group of employees on

grounds of need, is not a donation. A leading UK judgement in this respect is that of Lord Pearce⁷:

What the employer pays actually or notionally to a pensions fund is part of the total cost which he is prepared to pay in respect of the employee's service ... [In] my view the employer's contributions are earned by the employee's service just as much as those which the employee himself contributes, and I can see no justification for a difference in principle between the two contributions.

3.2.2 Employer contributions to the retirement fund can, when seen from this viewpoint, be seen as irrevocable. Surpluses arise as the fruits of the compulsory investments of a part of the members' remuneration. This means that there can be no thought of a refund of employers' contributions, and surpluses must be used to improve benefits.

3.2.3 This paradigm can be justified. The paternalistic paradigm gives the employer a put option whereby it can discontinue its contributions to the retirement fund if the fund goes into a deficit, but enjoys a reduction in contributions in the event of a surplus. The second alternative is the mirror image. It gives the put to the members: they enjoy the fruits of a surplus, but the employer undertakes to make good the deficit.

3.3 A MIDDLE WAY

3.3.1 These paradigms can be caricatured as representing the interests of employers and unions respectively. To the extent that the caricature represents the truth, many actuaries continue to act as if the paternalistic paradigm was the only one within which to perform their duties.

3.3.2 This is a pity, as this behaviour appears to have undermined the status of both the profession and the retirement funds, especially the DB funds in which actuaries play a unique role. Retirement funds provide retirement and insurance benefits to groups of employees at considerable savings in distribution, administration and risk underwriting costs. They provide relatively cheap cover for those with health impairments and allow for the pooling and smoothing of investment risks. DB funds can offer a limited guarantee of investment returns by the employer – relatively inexpensively. Such guarantees are unlikely to be available in the market because of moral hazards,⁸ to which the employer is not exposed. DB funds can therefore contribute significantly to the welfare of members.

3.3.3 De Kock points out further advantages⁹:

A pension fund has advantages for both the employer and the employee. It assures the employee a financially secure old age. Employees, especially those who have to maintain others, seek employment in firms where membership of a pension fund is available. Employers are thus able to offer that advantage to attract suitable employees. The fact that long serving employees receive an adequate pension removes the moral burden that would otherwise rest on an employer to ensure that such employees do not starve when they are too old to work. The advantage is gained only when the pension fund remains financially sound. Both the employer and the employee have an interest in the continued existence of a financially secure pension fund.

3.3.4 Even if the employer took the initiative in setting up the fund, both employers and employees have to agree to continue to contribute to such arrangements. It can therefore be argued that advantages ought in some way to be shared between employer and employees. With this middle paradigm, it becomes more difficult to argue that either party has an overriding legal or moral claim on the surplus.

3.4 THE PLACE OF REGULATION

3.4.1 Adopting a different paradigm will not necessarily solve the problems of the distribution of surplus. Employees are often too weak and ineffective to participate meaningfully in the governance of their retirement funds; employers are used to exercising exclusive power over retirement funds and many find it difficult to accept restrictions on the freedom to determine pension benefits at their sole discretion. It is also possible for employers to be exploited by senior managers or powerful union leaders who can inflate their own pensions at the expense of the shareholders. Inordinately adversarial industrial bargaining can also imperil the interests of all stakeholders.

3.4.2 These circumstances provide the reasons for regulation. Employers are for instance required to keep separate funds to back their “pension promise”. Section 5 of the Pension Funds Act (1956) provides that upon the registration of a fund:

... all the assets, rights, liabilities and obligations pertaining to the business of the fund shall, notwithstanding anything contained in any law or in the memorandum, articles of association, constitution or rules of any body corporate or unincorporate having control of the business of the fund, be deemed to be the assets, rights, liabilities and obligations of the fund to the exclusion of any other person, and no person shall have any claim on the assets or rights or be responsible for any liabilities or obligations of the fund, except in so far as the claim has arisen or the responsibility has been incurred in connection with transactions relating to the business of the fund.

3.4.3 As Hunter (1998) points out:

A retirement fund is not simply a vehicle through which an employer provides retirement benefits agreed with its employees. A fund is a separate legal entity with a life of its own. If that were not the case, it would not be necessary to have trustees of the fund. But for the prohibition on the conduct of pension fund business contained in section 31 of the Pension Funds Act, pensions could be paid out of the assets of the employer. Our law does not permit this.

3.4.4 Section 2 of the Financial Institutions (Investments of Funds) Act 39 of 1984 provides that a director, official, employee or agent of a retirement fund shall observe the utmost good faith in controlling and administering a fund and that such persons:

... shall not ... make use of the funds ... in a manner calculated to gain directly or indirectly any improper advantage for himself or any other person at the expense of the [fund or a] beneficiary.

3.4.5 Finally, recent changes to the Pension Funds Act¹⁰ entitling employees to elect at least 50% of the boards of management are presumably likewise intended to ensure that employers do not use retirement funds for improper purposes.

4. HOW DO SURPLUSES ARISE?

Surpluses may arise for different reasons.

4.1 BY CHANCE

4.1.1 Strains and surpluses can arise as the result of random deviations from the actuary's assumptions. The actuary makes her best estimates of future economic and demographic events, but they inevitably turn out differently. An actuarial valuation ought¹¹ to include a summary of these deviations, and how they have affected the surplus.

4.1.2 The most important items that arise randomly, and over which the fund, the members and the employer have no control, are usually:

- investment surpluses and strains;
- surpluses and strains from growth in salaries if benefits depend on salaries at retirement; and
- death benefit strains and surpluses.

Lower mortality than expected normally gives rise to a strain. This is always the case for pensioners and sometimes the case for active members as many funds insure the entire death benefit payable.

4.1.3 Different actuaries make different assumptions as to future experience, and the size of the subsequent surpluses and strains will depend on these assumptions. The actuary of a fund for the time being, however, makes the determination of the surplus, and as long as the determination falls within the range of assumptions that actuaries may reasonably make, the ideas of other actuaries are not considered relevant for the purposes of this paper. Inconsistencies between different actuaries are, however, difficult to explain and should perhaps be addressed by the profession.

4.1.4 The actuary may change the basis of the valuation, so giving rise to a surplus or strain. To the extent that such surpluses arise from better estimates of the future, they can also be seen as arising from chance.

4.1.5 The allocation of these chance surpluses is discussed below in section 8.

4.2 BY DESIGN

4.2.1 There are three other main contributors to strain and surplus. They are:

- surpluses arising because pension increases have been less than those affordable given real investment returns;
- surpluses arising from withdrawal and transfers if the benefits paid or transferred are less than the actuarial reserve (profits reported as arising from this source may also be understated because the actuary, in determining the liabilities, has already anticipated some surplus from this source); and
- deliberate contribution by the employer of more than is necessary to pay benefits.

4.2.2 These surpluses are not the result of chance arising from the rules and practice of the scheme and are matters over which the employer, particularly, has direct influence. The employer has, more often than not, a veto over the increases granted to pensioners. It also has a significant influence on the number of people withdrawing; especially when retrenchment, or transfer of benefits to another fund, is a cause of the

withdrawal. Even withdrawals in the normal course of business are partly in the hands of employers as they depend on conditions of employment: less competitive remuneration will normally lead to higher levels of withdrawal. The employer is also currently at liberty to contribute more to the fund than recommended by the actuary.

4.2.3 Andrew (1998) suggests¹² that poor benefits do not contribute to a surplus to the extent that they have been anticipated in the actuarial valuation. The counter argument is that the fund has benefited by reducing benefits that ought to have been paid to members, and this constitutes a surplus even if it has already been utilised for other purposes. This issue is discussed in more detail in section 9.

4.3 OVER-CONTRIBUTIONS

4.3.1 As discussed in section 2.2 above, contingency reserves are sometimes part of the disclosed surplus. These reserves can be built up by contributions in excess of those required to pay benefits, or by the retention of other surpluses. This part of the surplus, therefore, consists of past over-contributions in the sense that it was not anticipated that the contributions would be necessary to pay benefits.

4.3.2 This over-contribution is to be distinguished from the argument of Milburn-Pyle and Lennox, and repeated by Andrew, that, where the employer bears the balance of costs for a retirement fund, all surpluses must arise from an over-contribution by the employer. This argument is not necessarily based within the paternalistic paradigm. It can be reconciled with the notion of deferred pay by seeing the employers' contribution as cash flows made to secure the deferred benefits.

4.3.3 It is suggested here that this view does not adequately distinguish between surpluses that arise by chance and those that arise by design. It is suggested that this is implicit in the statement by Marais JA in the Tek appeal:

The existence of a surplus in this case cannot be ascribed solely to past over-funding by the employer. The sources of that surplus are diverse. They have not been identified and isolated nor have their respective contributions to the surplus been quantified. However, on any view of the matter, the surplus must be attributable at least in part to contributions from sources other than the employer.¹³

4.3.4 Justice Warner¹⁴ explicitly mentions the inequity in giving the employer the benefit of withdrawal profits derived from the early withdrawal of its retrenched employees.

I asked whether in this case the whole surplus arose from over funding by Mettoy. I was told that no such calculation had been made to ascertain whether that was so and that such calculation would be difficult to make. It is clear that the surplus arises in part from a very successful investment of the trust fund. It appears to have arisen in part also from the reduction in the Mettoy workforce in 1982 and 1983 under Mr Hanson's plan, which resulted in departing employees receiving only "early leaver benefits" based on their salaries and years of service to date instead of benefits based on their projected final salaries for which the scheme had been funded, though not to the full extent. We know, and Mr Inglis-Jones made much of this fact in another context, that Mettoy took a contribution holiday from 1 May 1982 to 31 October 1983. One cannot, in my opinion, in construing a provision in the rules of

a “balance of cost” pension scheme relating to surplus, start from the assumption that any surplus belongs morally to the employer.

4.3.5 Employers may also voluntarily contribute more than suggested by the actuary in order to smooth the emergence of their reported profits, to fund future medical costs and, perhaps, as a tax avoidance measure.¹⁵

4.3.6 Excess contributions, made either to strengthen contingency reserves or to smooth profits, do seem to belong to those who made them – although the fiscus may also have an interest. In a DB fund where the members have no expectation of benefit increases being paid from these excessive contributions, employers appear to be entitled to a refund of distributable surplus that arises from such over-contribution.

4.3.7 Failure to recognise this would mean that employers would attempt to avoid the build-up of contingency reserves in the fund. This would reduce the financial security of the members and, therefore, would not be in their interest. As Justice Walker said¹⁶:

Any general exclusion of employers from surplus would tend to make employers very reluctant to contribute to their pension schemes more than the bare minimum that they could get away with. That would be unfortunate, and it would be even more unfortunate if employers were driven to abandon final salary, balance of cost schemes and were, instead, to turn to money purchase schemes which may in the long term prove less advantageous to the beneficiaries.

5. THE FIDUCIARY DUTIES OF TRUSTEES

5.1 SUMMARY

5.1.1 The duties of trustees are set out in Appendix A in some detail. They are well known to include:

- taking care of the interests of members in terms of the rules of the fund, and the Pensions Fund Act;
- acting with due care, diligence and good faith;
- avoiding conflicts of interest; and
- acting with impartiality in respect of all members and beneficiaries.

5.1.2 Trustees’ decisions are subject to judicial review according to administrative law standards. These appear to be satisfied if the decisions are reasonable, but there remains the problem of what makes a decision unreasonable. In the context of retirement funds, Murphy (1998) says the following:

Trustee decisions, to be reasonable, first must be motivated by the pursuance of a socially legitimate objective. Secondly, the means of giving effect to the decision should be proportional, in the sense of being carefully designed to achieve that objective and should be rationally connected to it. Additionally, the means should impair the rights and legitimate expectations of affected parties as little as is reasonably possible.

5.2 SOCIALLY LEGITIMATE OBJECTIVES

5.2.1 The question then becomes what constitutes socially legitimate objectives. It is suggested¹⁷ here that they should include the following:

- the nature of any contracts (explicit or implicit) involved;

- equality in both treatment and outcomes;
- desert;
- the basic needs of members; and
- the effectiveness of the institution in meeting its objectives.

5.2.2 It is suggested that trustees need to be able to justify their decisions by a reasonable argument that a failure to meet one of these objectives was necessary in order to meet one or more of the others.

5.2.3 Having considered these criteria and the claims of all parties, it must still be recognised that it is possible for different, disinterested, trustees to come to different conclusions, all of which are reasonable, fair, socially legitimate and legally sustainable.

6. AN EMPLOYER'S DUTY TOWARDS THE FUND

The duty of employers to funds they sponsor plays a crucial role in the disposal of surpluses.

6.1 GOOD FAITH

Hunter (1998) points out that:

In confirming the duty of good faith owed by an employer with discretionary powers in terms of the rules of a retirement fund both Judge Navsa¹⁸ and the Adjudicator¹⁹ have echoed the views of *Browne-Wilkinson V-C*²⁰ in which he said:

In every contract of employment there is an implied term ... that the employers will not, without reasonable and just cause, conduct themselves in a manner calculated or likely to destroy or seriously damage the relationship of confidence and trust between employer and employee. I will call this implied term "the implied obligation of good faith". In my judgement, that obligation of an employer applies as much to the exercise of his rights and powers under a pension scheme as they do to other rights and powers of an employer ... The duty of good faith requires the employer to preserve its employees' rights in the pension fund, not to destroy them ...

6.2 WHICH IMPOSES LIMITS ON SELF-INTEREST

6.2.1 Justice Walker cited that dictum with approval²¹:

The importance of an employer's duty of good faith to employees, in the context of pension schemes, stems from the seminal judgment of Sir Nicholas Browne-Wilkinson V-C in [the *Imperial case*].²² The whole of the Vice-Chancellor's judgment calls for careful study, but I will confine citation to one key passage (at 598–9):

It must be open to the company to look after its own interests, financially and otherwise, in the future operations of the scheme in deciding whether or not to give its consent. However, in my judgment the obligation of good faith does require that the company should exercise its rights (a) with a view to the efficient running of the scheme established by the fund and (b) not for the collateral purpose of forcing the members to give up their accrued rights in the existing fund subject to this scheme.

6.2.2 For Justice Vinelot, good faith requires the satisfaction of the legitimate expectations of members and pensioners. In a useful dictum, he said²³:

The employer, if it has a power of amendment [that is, to reduce or suspend contributions for a period] is entitled to exercise it in any way which will further the interests of the pension scheme to ensure that the legitimate expectations of the members and pensioners are met without, so far as possible, imposing any undue burden on the employer or building up an unnecessarily large surplus. The employer himself has an interest in maintaining a retirement fund which is satisfactory to existing and attractive to future employees, and he has an interest in ensuring that it is effectively managed, for example in seeing that the powers of investment are confined within proper limits, if necessary by amendment, and that they are properly exercised. If the assets of the scheme are so large that all legitimate expectations of the members and pensioners can be met without continued contribution by him at the rate originally provided, he can by amendment reduce or suspend contributions for a period. What he cannot do is set limits to the benefits provided for members for a collateral purpose without regard to their legitimate expectations.

6.3 EXAMPLES OF BAD FAITH

6.3.1 Some examples of breaches of the duty of good faith cited by Justice Robert Walker²⁴ are the following:

- a) withholding consent to increased benefits for members of one trade union while granting it for members of another²⁵;
- b) withholding consent for an amendment increasing benefits for the collateral purpose of putting pressure on members to abandon some of their existing rights²⁶;
- c) introducing new participating employers, and so introducing large numbers of new members of a scheme, while the principal employer itself takes a contribution holiday²⁷; and
- d) threatening to use a power to suspend contributions in order to put pressure on trustees to surrender existing powers.

6.4 GOOD FAITH NOT FIDUCIARY

Hunter (1998) says:

A duty of good faith requires that its bearer exercise its powers for the purposes for which they were conferred on it and not for any other purpose. It “does not prevent the employer from looking after its own financial interests, even where they conflict with those of the members and pensioners.”²⁸ A fiduciary duty, on the other hand, imposes upon its bearer a duty to act in the best interests of the person or persons to whom the duty is owed.

It appears that, in both South African law²⁹ and British law³⁰, the duty of an employer with discretionary powers in terms of the rules of a fund is no greater than a duty to exercise those powers in good faith.

6.5 PROPER USE OF VETO POWERS

6.5.1 Bad faith thus consists in the use of power in ways that were not originally envisaged, and for which they were not intended. One of the key questions in the surplus debate, therefore, is why the employer enjoys a power not to approve changes to the rules.

6.5.2 It is suggested that such veto powers are granted in order to prevent the trustees from unilaterally increasing benefits beyond those originally envisaged, and so

imposing additional burdens on the employer. This means that employers ought not to veto decisions by the trustees to meet members' legitimate expectations. They may, however, veto increases in benefit levels.

7. TO WHOM DOES THE SURPLUS BELONG?

7.1 ITS BENEFICIAL OWNERS

7.1.1 It is frequently said that the surplus legally belongs to the fund and not to members or employer. The surplus is, however, not an asset of the fund, but appears on the other side of its balance sheet. A pension fund may be said to have a surplus, but not to "own" one. It seems, however, that it does no violence to the meaning of words, nor any principles of law, to ask the question who beneficially owns the surplus. Lloyd (1987)³¹ reports that:

... in English law there have for centuries been two distinct kinds of owners, known as legal and equitable owners, the latter arising under what is called "a trust". The institution of a trust, ... entitles the legal title to property to be vested in a trustee or trustees, but on such terms that they hold the property on behalf of a beneficiary who owns the beneficial interest and is in effect the real owner. Yet under this arrangement the trustees have full legal ownership and the equitable title of the beneficiaries is capable of being defeated ...

7.1.2 Early South African judges were at pains to point out that our law differs from the English law of trusts. While they did recognise the "beneficial interests" of beneficiaries in trust-type arrangements, they did not like the term "beneficial ownership". Solomon J, however, acknowledged³² in confirming the rights of a particular beneficiary:

It would be better, no doubt, if the word "interest" had been used instead of "ownership" ... but the meaning is perfectly plain.

7.1.3 The concept might be seen as having been introduced into South African law with the Unity Trust Control Act³³, where a management company is required to be a "beneficial owner" of a minimum number of units in trusts it administers.

7.1.4 It is suggested that the concept of beneficial ownership is appropriate and useful in this context. As discussed in section 2, surpluses emerge in much the same way as company profits. There must similarly be a proper legal way to distribute them. The point at issue is the equitable ownership of the surplus (or deficit), and the matter is under dispute precisely because "the equitable title of the beneficiaries is capable of being defeated." This can happen to both employers' and members' rights of ownership.

7.1.5 Such expropriation of ownership rights is particularly likely if the allocation of surplus has to be "negotiated", as is frequently suggested³⁴. Negotiation may be necessary if the ownership of the surplus could not be ascertained. It represents a significant risk, however, where there are many competing stakeholders with different bargaining strengths. Trustees are obliged to balance the rights and interests of all to ensure a fair outcome. Negotiation without the protection of the weak is the most likely of all processes to see equitable title of the weak defeated.

7.2 THE RULES MIGHT INDICATE

7.2.1 Most controversy over surplus could be avoided if the fund rules were more explicit as to the treatment of surpluses and strains. While it is argued below that rules do not, as sometimes thought, form part of the employment contract, they could reduce the difficulties inherent in the conflicts of interest mentioned in section 5.2 above.

7.2.2 It is therefore suggested that the FSB amend its regulations to require the rules to spell out how a surplus ought to be distributed.

7.2.3 The rules are, however, enabling, not prescriptive. DB scheme rules seldom provide much guidance as to how surpluses may be distributed. Hunter (1998) points out: It is argued that there is no such thing as a “contribution holiday” in a DB fund. An employer may simply cease making contributions on the advice by the actuary that the fund has sufficient assets to meet its liabilities to the members in terms of the rules. That is true. The other side of the coin is this: if, in the exercise of their fiduciary obligations the trustees decide to apply part of the surplus assets to improving benefits (by, for example, increasing pensions), the surplus which may be used to offset the employer’s contribution will be reduced. The employer has, of course, in most instances, a veto over increases in benefits, but its use of this power is restricted. Thus, the rules alone are not determinative of the benefits payable by the fund and, accordingly in a defined benefit fund, the amount that the employer may be required to contribute in order to ensure that the fund is financially sound.

7.2.4 The rules are not a legal contract. Hunter (1998) goes on to argue: The argument that retirement fund rules constitute a contract between a fund and its members ignores the most essential feature of a contract; that of consensus between parties.³⁵ Before a contract may be binding on a party, he or she must have been aware of and have agreed to all its material terms. There can be few if any cases in which a member can be said to have reached consensus with a fund concerning the provisions of its rules at the time that she joined the fund. There are no more cases in which an employee may be said to have reached consensus with her employer regarding the “pension promise”. In most cases membership of an occupational pension fund is a condition of employment, and all that the employee is told at the commencement of employment is that he or she will be obliged to contribute to the fund and that his or her employer will also make contributions to the fund on his or her behalf. To most employees, a fund must appear to be some sort of compulsory savings scheme. Many only learn of the content of the rules when they become immediately relevant, such as on early withdrawal or retirement from the fund. The law of contract is not applicable to relations between a fund and its members. What is applicable is our common law on the fiduciary duties of those who occupy positions of trust “in the wide sense”³⁶.

7.2.5 The point of this discussion is that trustees may change the benefits by amending the rules subject to legislation and normally the employer’s veto, but without the members’ approval.

7.2.6 The trustees normally have considerable discretionary powers to amend (increase) benefits. There are good reasons to leave some discretion with them. The factors that influence increases to pensions, the allocation of investment surpluses to members, the terms of transfers to and from the fund, and the determination of the employer’s contributions can be too complex to prescribe precisely in advance.

Discretion allows trustees to balance changes in interests over time and permits much lower contingency margins and reserves, thereby reducing the cost of the retirement arrangements.

7.3 REASONABLE BENEFIT EXPECTATIONS GIVE SOME CLUES

7.3.1 In exercising their discretion, trustees have to be impartial and fair to all members. Two of the more important discretions are the determination of transfer values and of increases to pensions. These have direct analogues in life assurance except that it is the declaration of bonuses and not pension increases that are of interest.

7.3.2 The use of the term “reasonable expectations” to determine fairness in the context of life assurance was introduced into British law in 1973³⁷. A working party of the Institute and Faculty of Actuaries, reported in Brindley *et al* (1993)³⁸ was unable to find any earlier origins of the concept. It was, however, accepted three years later by the South African Supreme Court³⁹, and introduced into section 14 of the Pensions Funds Act in the early nineties.

7.3.3 Reasonable benefit expectations are not limited to the rules of the fund, and may override them. They may be seen to be analogous to spoken terms of a contract as, for instance, the SA Appeal Court held⁴⁰:

A party who represents to another that he places a particular construction upon a clause in a written contract, thereby inducing the other to enter into the contract, is not entitled in an attempt to enforce the contract to set up a different construction though the latter construction may be correct in law.

7.3.4 The second report of the Brindley working party made a number of recommendations; the third report then summarised the response of the profession.

There was a very general reaction that the recommendations set out in our second report were too prescriptive. Virtually every person consulted had this reaction to some degree. At the extreme it amounted to a very firm rejection of any prescription of this kind and a feeling that the profession is better served by leaving individual actuaries to judge the situation in the particular circumstances of their own company.

They then, however, went on to report that reasonable expectations were largely considered a “non-issue”, and that “at the extreme this bordered on complacency”. It was finally recommended that there be no professional guidance on this matter.

7.3.5 Asher (1997), which attempted to create a definition of equity for the management of withdrawal benefits and pension increases, produced a very similar reaction at the annual convention of the Actuarial Society of South Africa. This reaction to explicit definitions of equity and reasonable expectations might be described as cavalier. It creates enormous difficulties in meeting the requirements that trustees be able to provide reasonable justification for their decisions, as set out in section 5 above. This confusion then serves to aggravate conflicts of interest. While reasonable benefit expectations allow for some latitude in decision-making, they could provide a framework to justify the decisions of trustees.

7.3.6 It now seems to be widely accepted that reasonable benefit expectations are created by:

- legislation and legislative practices;
- the rules of the fund, past and present;
- past practices of the fund and the need to try and maintain continuity;
- what has been indicated to members in the past by both employers and trustees; and
- practice by other funds.⁴¹

7.3.7 The expectations should also be reasonable, which is generally taken to mean as understood by an informed layman. This presumably means that benefits should be affordable and be consistent with the objectives of the fund.

7.3.8 Reasonable expectations are affected, *inter alia*, by:

- the level of disclosed contributions;
- the contingency reserves in the fund;
- the existence of a surplus, and the uses to which it was put in the past; and
- the Registrar of Pension Funds’ practice of permitting contribution holidays, but not allowing refunds of surplus.

8. ... IF IT ARISES BY CHANCE

Trustees allocating surpluses that arise by chance are constrained by the socially legitimate objectives and criteria set out in section 5.2 above. They must also conform to the rules and stakeholders’ reasonable benefit expectations. Some approaches are suggested here.

8.1 NEED

8.1.1 The needs of the poorest beneficiaries may well appeal for the distribution of part of the surplus. In a country with few social security benefits, increasing the benefits of indigent members must surely be considered when distributing surplus. Thomson (1989) outlines a method of giving the poorest pensioners greater increases.

8.1.2 The needs of an employer facing financial difficulties might also play a role. The interests of retirement fund members facing retrenchment may well be better served by either investing in, or refunding surplus to, an ailing employer.

8.1.3 Such actions are obviously open to abuse by populist majorities if they elect trustees, or by sharp employers.

8.2 DESERT

8.2.1 In life assurance a policyholder’s equitable benefit is, *prima facie*, his earned asset share⁴². The implicit argument appears to be that, while the surplus that emerges is random, those with larger asset shares would inevitably lose more if significant losses were incurred, and therefore should be compensated for the risks they take by sharing proportionally more in the surplus.

8.2.2 Retirement fund members, who expect greater benefits, have larger actuarial reserves and are exposed to greater risks. This seems appropriate as the wealthier can be expected to feel the loss of money less acutely. It would seem reasonable, therefore, to allocate surpluses and strains to members in line with the size of their benefits.

8.2.3 If the employer has contractually relieved members of risks by offering some form of guarantee, then the argument from desert justifies their participation in the surplus. The point should be made, however, that current regulation allows employers to avoid meeting these guarantees by ceasing to contribute to the fund if it is in deficit. There are forces that tie the employer to the fund for reasons based on the employment contract or labour relations, but Hunter (1998) suggests that they are not that strong:

while employers are bound by employment contracts, they are not bound to continue to employ people on the terms set out in those agreements if that is not consistent with their operational requirements. Most employers have the financial clout to bring about a change in their retirement funding obligations if they want to do so, whether by threat of retrenchment or otherwise.

It is arguable that, when an employer establishes a DB fund, the rules of the fund reflect the terms of the agreement between the employer and the fund. It is also suggested here that there is a term implied in the agreement that the employer will not cease contributing until the fund is financially sound. Regulations to require employers to make up past-service deficits are under debate. If promulgated, they will increase employers' arguments from desert when it comes to surpluses that arise in future. However, even if there were a contractual obligation to make good deficits, the employer's argument to participate in the surplus would also depend on some demonstration of its financial capacity to absorb these risks. Some employers have insufficient capital to absorb retirement fund risks and so should not be participants in DB arrangements.

8.2.4 Surplus may derive from particularly low salary increases in a depressed industry, or perhaps through agreed salary restraint to relieve a financially pressed employer. In these cases, there must be an argument for members to be considered in any distribution of surplus.

8.2.5 Andrew suggests that the employers' contributions should be separately accumulated, and that any amount not required for benefits be regarded as employers' over-contribution. Lord Pearce's argument quoted in paragraph 3.2.1 above, that there is no reason to make any distinction between employer and employee contributions, would, however, cast doubt on this argument. The exception, however, would be the genuine over-contribution discussed in section 4.2 above.

8.2.6 Andrew further argues that the members' benefits should not be less than their own contributions accumulated at a market rate of interest. Smaller benefits would imply that the employer had utilised the fund to borrow from the member at less than a market rate of interest, which would appear to be unfair. The market rate of interest should presumably be that which the employer would have paid on borrowings. If the employer has indicated that part of its contributions are made on behalf of the member, then there would be a further argument for including these contributions as part of the members'.

8.3 EQUALITY

In the absence of other strong arguments, an equitable distribution is an equal one. Surpluses are sometimes divided between members and employers equally and

occasionally equally between members. One money purchase fund divided its surplus equally amongst members because the unreliability of its membership data made it unlikely that a distribution in proportion to reserves would be any fairer.

8.4 EFFECTIVENESS

8.4.1 The present value of surpluses that may be distributed in the next twenty years has little value to an 80-year-old who may not live to receive it. The same, to a lesser extent, is true of younger members. Undistributed surplus is of little value to members.

8.4.2 The employer (which can be assumed to be an ongoing organisation) can, however, enjoy the benefits of surpluses that will be distributed in future. They are effectively included in the present value of its shares, and IAS19 will require that they be included in its balance sheet.

8.4.3 It can therefore be argued that the value of the future surplus to the employer is likely to be more than its value to members. Both parties will then be better off if the employer is entitled to future surpluses that arise by chance.

8.5 HORIZONTAL AND VERTICAL EQUITY

8.5.1 Reasonable decisions also need to conform to Aristotle's principles of horizontal and vertical equity. Horizontal equity requires that like parties are treated alike: in constitutional terms that there is no unreasonable discrimination. Surplus ought not to be used arbitrarily to reward some employees at the expense of others.

8.5.2 The relatively common practice of using the surplus to give managers higher benefits would surely fall foul of this requirement unless it can be shown that the surpluses would otherwise have been utilised to reduce the employer's contributions, and that the employer has agreed to increase the benefits. If trustees who are also managers have increased their own benefits then this appears to the author to be a clear breach of their fiduciary duties to both the fund and the company. It would appear that such actions are legally voidable. Retirement fund trustees, or the employer's directors, could then recover the overpaid benefits.

8.5.3 Vertical equity requires that the differences in the treatment of dissimilar parties are reasonable relative to their differences. It seems to require that there be no significant discontinuities in the allocation of surpluses. It would be inequitable, for instance, to increase lump-sum benefits dramatically in any year without considering compensation for those receiving benefits in earlier years, or to give (say) 50% increases to those over 80 and nothing to those younger.

9. ... IF IT ARISES BY DESIGN

9.1 PENSION INCREASES LESS THAN INFLATION

9.1.1 Funds set up before 1973 can be distinguished from those set up later. Inflation was relatively low until the early seventies, but then rose and remained in double digits in South Africa for twenty years. Pension funds were relatively slow in beginning to adjust pensions appropriately. Some pensioners' living standards were reduced

significantly, while some pension funds accumulated significant surpluses, which were partly used to increase benefits for active members and partly for contribution holidays. Some of the details and commentary on these developments are set out in Walker (1990), who lists four papers given to the Actuarial Society of South Africa in the eighties.

9.1.2 In the low inflationary environment preceding 1973, it was not prudent to use annual rates of discount more than a nominal 3% to 5% in calculating the liability to be held for pensioners. In such an environment, members obviously expect their pensions to retain their real value. This would seem to be a “reasonable benefit expectation”. It can also be met without additional cost if nominal investment returns increase with inflation.

9.1.3 It seems likely that some trustees did abuse their fiduciary responsibilities in allocating the unwarranted inflationary surpluses that arose in the late seventies and eighties. Some appear to have increased their own benefits, while others appear to have failed to distinguish between their fiduciary duties to the fund and to their employer, and have allowed the latter to take contribution holidays or other unwarranted advantages from the surplus.

9.1.4 It would be extremely difficult to set about unravelling all the injustices of the past thirty years. Existing pensioners do seem, however, to have a prior moral and legal claim on all surpluses arising from investment returns to bring their future pensions up to the real value they had on their retirement. So much is common cause with Milburn-Pyle and Lennox, Andrew and legislation on the refund of surpluses originally proposed in 1997.

9.1.5 Where the surplus is considerable, and there is evidence that the poor increases to pensions were an important contributory factor, a strong case exists for some retrospective compensation to pensioners and their heirs.

9.1.6 Funds set up in inflationary times may be seen in a different light. It might be argued that funds set up since 1973 might legitimately have created reasonable benefit expectations that pensions will not increase in line with inflation. Some financially astute members may expect no increases at all.

9.1.7 There are two problems with this argument. As low inflation may return within the space of a year or two, it is never prudent to anticipate annual investment returns in excess of 5% when discounting pensions unless the benefits can immediately be matched by fixed interest investments. Assuming a rate of interest higher than 5% is clearly imprudent. Nominal rates of interest in most countries were at lower levels than this for over two centuries before 1950, and have now returned to these lower levels. Various UK life offices have recently increased their reserves by billions in order to meet annuity guarantees that require higher rates of interest. It is therefore suggested that funds that use higher interest rates and cannot match their liabilities should be taking active steps, including the use of any surpluses, to strengthen their reserves. They will otherwise not be able to survive a change to a low inflationary environment. There is a risk of even lower interest rates. Japanese nominal interest rates are now below 2%, although real rates are over 3% thanks to deflation. Retirement funds must be prepared to respond to such circumstances if they arise in South Africa.

9.1.8 The second problem with a policy of sub-inflationary increases is that it is inconsistent with the objectives of pension funds, and inherently unreasonable. If a pension fund is intended to provide for a member's standard of living in retirement, it cannot do so if it offers no protection against inflation. It cannot even be countered that the need to protect against inflation can be left to a member. There are no financial instruments available for pensioners to provide themselves with protection against unexpected future increases in inflation.

9.1.9 It is suggested, therefore, that members could reasonably expect that investment returns in excess of 5% be used to compensate them for reductions in the purchasing power of their pensions.

9.1.10 The SANLAM surveys⁴³ show that most funds do now increase their pensions in line with inflation. One could argue that it is now the industry practice. It would seem, therefore, that in the absence of explicit statements to the contrary, members' reasonable benefit expectations are for pensions to increase in line with inflation.

9.1.11 In the light of the above, it seems clear that the Registrar of Pension Funds should not accept actuarial valuations where post-retirement interest rates exceed 5%. The actuarial professional guidelines might also be amended.

9.1.12 That much is relatively easy, but it is difficult to legislate that investment surpluses that can be said to arise from the pensioners' share of the assets should be used to fund inflationary increases. Andrew suggests a code of conduct that may help. It is suggested here that professional actuarial guidance should require valuation reports to include a note as to what increases can be afforded. The extent to which pensions have reduced below their initial purchasing power should also be shown, and a recommendation made to the trustees of what increases are affordable.

9.2 WITHDRAWAL BENEFITS

9.2.1 The same arguments can apply to cash withdrawal benefits that are given in lieu of deferred pensions. It seems to the author that some employers, trustees and actuaries have colluded to exploit early leavers by not allowing for inflation in the deferred pension.

9.2.2 The arguments are, however, somewhat weaker when applied to provident funds and pension funds that do not offer deferred pensions, but have also given penal withdrawal benefits. Viewed from the paternalistic paradigm, paternalistic generosity is normally limited to loyal employees who have served until retirement. Those who leave early are given their own contributions plus a low rate of interest, the withdrawal benefit being considerably lower than the present value of their retirement benefits (or actuarial reserve). This is the penalty for their disloyalty. The penalty becomes very significant once employees have built up significant future benefits in the retirement fund. In some instances, it can be several times the annual salary or up to two-thirds of a member's potential pension. The retirement fund therefore provides both carrot and stick for employers wishing to encourage long service.

9.2.3 It seems clear today that a mechanism that penalises "disloyal" staff to this

extent is unacceptable. It is arguably an unfair labour practice, and seems untenable in a constitutional dispensation that guarantees freedom of employment.

9.2.4 This penalty on early leavers can be justified in other ways. The profits when a member withdraws, in that they are normally used to reduce employer contributions, provide the employers with some compensation for their investment in training of departing employees.⁴⁴ This justification would only apply in the first few years of employment. It cannot explain the growing penalty that is normally applied, or the fact that it does not diminish as retirement approaches.

9.2.5 In Asher (1987), it was argued that poor withdrawal benefits are socially unacceptable in that they contribute significantly to financial insecurity, make personal financial planning impossible, and severely limit labour mobility. In terms of the socially legitimate objectives outlined in section 5.2, these are arguments from effectiveness. Low withdrawal benefits also conflict with:

- the criterion of desert, in that they differ from the actuarial reserve;
- reasonable benefit expectations to the extent that the benefits are intended to provide for retirement rather than as long service awards;
- horizontal equity, in that there is unjustifiable discrimination on grounds of age and against women who are more likely to withdraw at an early age to raise children; and
- vertical equity, in that the sharp difference in treatment of early leavers close to retirement from those at retirement cannot be justified.

9.2.6 They are also unreasonable in that they actively undermine members' attempts at achieving a retirement pension. No financial instruments are available for the member to insure against the possible losses she might suffer on withdrawal.

9.2.7 The discussion of the 1987 paper reflected the view of the time that equity was not a relevant issue, and that it would be inappropriate for government to intervene in the employment contract to which a new employee freely agrees. Milburn-Pyle and Lennox acknowledge the unfairness, but take the same view. Andrew suggests that the question should be left to labour law.

9.2.8 It is suggested (the arguments of Appendix A make the point in more detail) that trustees do have the responsibility to take such steps as may be available to them to amend such discriminatory rules. Changes to the pension fund regulations that would require funds to calculate the benefits given to members transferring into the fund on broadly the same basis as those withdrawing, would help speed up this process.

9.2.9 A minimum requirement of (say) 5 service years could be allowed to recoup training costs, or such new legislation might legitimately be accused of making new employment more difficult.

9.3 ON TRANSFER

9.3.1 This matter is dealt with in some depth by Gluckman and Kamionsky (1997) but requires some mention in this context.

9.3.2 It is clear that transferring members deserve the trustee's full fiduciary forethought. As Lord Justice Dillon has said⁴⁵:

If [the members of the board] decide to make a transfer they have to consider whether they

are acting fairly as between those who will become members of the associated scheme and those who will remain members of the Fisons pension scheme ... they will ... in each case need to feel satisfied that the amount to be transferred is fair each way. In each case the transferring members and the members who remain are among the trustees' beneficiaries.

9.3.3 Surpluses or shortfalls are created on transfer if the transfer value does not represent the present value of the members' reasonable benefit expectations. The actuary of the transferor fund is responsible for certifying that the reasonable benefit expectations of transferring members have been met. A surplus can therefore only arise if the actuary has failed to fulfil this responsibility.

9.3.4 The transferor actuary will, in almost all instances, base the transfer values on the actuarial reserves calculated on the same basis as used in the previous valuation. Problems may arise if the method and assumptions used to calculate the reserves are imprudent, or fail to take all considerations into account. In particular:

- It is argued above that nominal post-retirement interest rates of more than 5% are imprudent.
- Members being transferred may need some compensation for the loss of the protection offered by the contingency reserves frequently included in an actuarial balance sheet.
- It can also be argued that actuarial bases, which anticipate mortality profits on the death of members, and on early withdrawal, are inequitable and undervalue the members' reasonable benefit expectations. The latter follows from the arguments of the previous section. The former follows from the argument that it is invidious for employers to in any way benefit from an employee's death. (It can be argued that a retirement fund's insurable interest in its members is limited to the excess of the death benefits over the actuarial reserve. The practice of anticipating a release of actuarial reserves on death is thus merely a ruse to increase commissions on insurance premiums and artificially reduce the fund's total liabilities.)
- This value must be compatible with market rates of interest and asset values that apply at the time of transfer. If not, members will be unable to purchase assets that permit them to maintain the expected value of their benefits.

9.4 CONFLICTING INTERESTS

9.4.1 Managers who are also trustees, face significant conflicts of interest and duty over decisions that affect these artificially created surpluses. It is trite to point out that, when making decisions in these areas, the employer's managers – if they are doing their job properly – must take the effect on the company's contribution to the retirement fund into account. They have conflicting fiduciary duties to members and shareholders, and may have conflicting interests as beneficiaries, as employees and sometimes as shareholders or holders of share options.

9.4.2 As discussed in more detail in Appendix A2, this situation is undesirable even where managers who also function as trustees, act with the utmost propriety. Under these circumstances, it is not surprising that the allocation of surpluses is a matter of particular controversy. It is suggested here that the poor benefits that lead to these artificial surpluses are always inappropriate and represent a failure in fund design and

fiduciary responsibility. Their elimination would significantly reduce, if not eliminate, these conflicts of interests and duties.

10. WHY SURPLUSES SHOULD BE DISTRIBUTED

The withholding of distributable surpluses in retirement funds is not desirable.

10.1 MEMBERS WANT IT

10.1.1 If the equitable ownership is with members, then it is entirely proper that it be allocated accordingly. Failure to do so will mean that some members will receive smaller benefits than those to which they are entitled in equity if not in law.

10.1.2 It is true that no contingency reserves can guarantee solvency; insisting on an allocation of distributable surplus will reduce the members' security to some extent. Holding excessive contingency reserves does, however, have an unnecessary cost.

10.2 EMPLOYERS WANT IT

10.2.1 It has been suggested that employers may allow excessive surpluses to be built up in order to smooth the flow of their profits or to defer tax. Many foreign jurisdictions require the distribution of excessive surpluses in order to prevent such tax deferral. The loss to the fiscus from such tax deferral is now less important in South Africa where there is a small difference between the taxation of companies and retirement funds. Tax flows to the fiscus will, however, accrue earlier if surplus is distributed.

10.2.2 Various recent changes to theory and practice have reduced the benefits of retaining excessive surpluses. IAS19 will remove some of the benefits of smoothing, while modern financial theory deprecates the accumulation of unnecessary capital reserves. These reasons, and the need to account for employers' post-retirement medical aid subsidies, appear to underlie the recent requests by employers for refunds of the surplus equitably belonging to them. The ability to access distributable surplus more readily (i.e. not through contribution holidays but by direct transfer of assets) will also increase their value in the hands of the employers.

10.2.3 Thus, if appropriate controls can be introduced to prevent employers from accessing surpluses that do not equitably belong to them, then direct refunds of surplus would appear to be desirable.

10.3 IT IS THE TRUSTEES' DUTY

It is one of the responsibilities of the trustees to consider the distribution of surplus. This is evident from *Thrells v Lomas* (1993)⁴⁶ in which it is stated:

When a scheme so permits, members have a reasonable expectation that if the scheme funds permit, ... if there is a surplus after providing for the estimated liabilities, or in a winding up, for the actual liabilities, the trustee will exercise that power to the extent that is fair and equitable in all the circumstances, having regard to the purpose for which the power was conferred. The power is an integral part of the scheme. It assumes the existence of a surplus. A trustee should not decline to exercise the power solely on the ground that the employer was under no legal obligation to provide the surplus.

Regular distribution exercises are necessary for good governance. It is suggested that trustees apply their minds to the issue whenever they receive a valuation report.

11. IF SURPLUS HAS ALREADY BEEN DISTRIBUTED?

11.1 The arguments listed above are not necessarily limited to existing surpluses. In the case of pensions, both in payment and deferred, it has been argued that failing to give inflationary increases represents a failure to meet reasonable benefit expectations, and that these are protected by law. The author is aware of cases where pensioners have been dispossessed of part of the real value of their pensions, and other parties have benefited.

11.2 In other cases, members withdrawing or transferring to other funds may also have been given less than their reasonable expectations and the resulting surpluses have been used for other purposes.

11.3 Pijper⁴⁷ points, for instance, to the increase in the accrual rates for active members from 60ths to 40ths in the seventies and eighties. It may be that many trustees, who would have been long-serving employees, benefited disproportionately from such increases. More serious breaches of their fiduciary duty occur when senior managers, involved in the management of the fund, grant themselves exceptional increases.

11.4 Shareholders may have benefited from contribution holidays, or from merging under-funded retirement funds with those with large surpluses.

11.5 It is not suggested here that special legislation be required to remedy any unwarranted historical expropriation of the surplus. What this author would like to see is a re-invigoration of the ancient laws governing fiduciary duty – and fraud. They could be an adequate legal basis for the restitution of past wrongs. Trustees, members and pensioners are free to pursue such cases with the Pensions Adjudicator and the Courts, where it is hoped they will find compensation. It is hoped that they will not shrink from doing so.

12. CONCLUSION

12.1 To fulfil their obligations, trustees should procure from the fund's actuary an analysis of the financial history of the fund. The period analysed would depend on the incidence of significant transactions and the costs. Special consideration should be given to the effect on surplus of:

- withdrawal benefits;
- the extent to which pension increases have not kept up with the consumer price index or have not been consistent with the rate of the fund's return on the relevant investments;
- the transfer of a significant number of members out of the fund or out of the DB arrangement within the fund; or
- the retrenchment of a significant number of members.

12.2 Of course, it is impossible to unscramble the egg and to determine, on any scientific basis, the extent to which one factor contributed to the surplus. Nonetheless, the actuary should be able to suggest one or more bases for the appropriate division of the surplus with reference to the various factors mentioned in this paper. Such division might require a recovery of past misallocations.

12.3 It is suggested that the employer would be acting in bad faith if it used its powers to veto thoughtful trustee decisions of this sort.

12.4 Where no significant part of the surplus has been artificially manufactured, and the employer demonstrably bears the economic risks, it seems appropriate for the trustees, in the exercise of their fiduciary duties, to grant employers the benefit of the distributable surplus. Where contingency reserves are adequate, a lump-sum payment would seem acceptable.

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NOTES

- 1 IAS19 – Employee Benefits (1998).
- 2 In a cluster of cases involving National Grid PLC and National Power PLC in the Chancery Division of the High Court on 10 June 1997 at 9. Hunter (1998) points out that “judgements of the Chancery Division (an equity division) of the British High Court are not ‘persuasive’ in the sense that they do not require the degree of respect that an obiter dictum statement of a division of the South African High Court would require. Nonetheless, they are worthy of consideration, particularly in the field of pensions law in which equitable considerations apply.”
- 3 Group of SAPREF Pensioners v SAPREF Pension fund and another; a determination under case number PFA/KZN/25/98 dated 31 August 1998.
- 4 In a discussion reported in the Transactions of the Actuarial Society of SA, vol I.I at 7.
- 5 See professional guidance note GN26 published by the Institute and Faculty of Actuaries.
- 6 See chapter one of Hunter (1993) and the cases cited in it.
- 7 In the House of Lords in Parry v Cleaver (1969) 1 555 at 558 (HL).
- 8 DB funds effectively guarantee that investment returns will match salary increases. These guarantees cannot be offered in the market, as employers might conspire with employees to increase salaries just before retirement.
- 9 In Van Coppenhagen v Shell and BPSA Petroleum Refineries (Pty) Ltd (1991) 12 ILJ 620 (IC) at 626.
- 10 Section 7A, in force since 15 December 1998.
- 11 Professional Guidance Note (PGN) 201 paragraph 8 of the Actuarial Society of South Africa.
- 12 At 325.
- 13 See Tek Corporation Provident Fund & 10 others v Lorentz 1999 (4) SA 884 (SCA) paragraph (19).
- 14 In Mettoy Pension Trustees Limited v Evans (1991) 2 All ER 513 (ChD) at 550–551.
- 15 Andrew makes the point at 324.
- 16 In the National Grid cases at 46.

- 17 Following the arguments in Asher (1997) as to the achievement of equity.
- 18 In his judgement in the Tek Provident Fund matter.
- 19 In his determination in the SAPREF Pension Fund matter.
- 20 In *Imperial Group Pension Trust Ltd v Imperial Tobacco Ltd* (1991) 2 All ER 597 (ChD) at 606.
- 21 In the National Grid cases at 37.
- 22 *Imperial Group Pensions Trust Ltd v Imperial Tobacco* (1991) 1 WLR 589. That decision has been referred to with approval by the Court of Appeal in *Stannard v Fisons Pensions Trust* (1991) PLR 225, 234 (paragraph 49), by the Court of Appeal in *New Zealand in UEB Industries v Brabant* (1992) 1 NZLR 294, 297 and many times by courts of the first instance.
- 23 In his judgement in the case of *British Coal v British Coal Superannuation Scheme* (1995) 1 All ER 912 (ChD) at 926 e–h.
- 24 In the National Grid judgement.
- 25 See the Imperial Tobacco case.
- 26 See the Imperial Tobacco case.
- 27 See *Hillsdown Holdings Plc v The Pensions Ombudsman* (1997) 1 AER 862 at 890.
- 28 Sir Robert Walker in the National Grid cases at 38.
- 29 See the Tek judgement at 229J.
- 30 See the National Grid judgement at 37 to 40.
- 31 At 323.
- 32 *Adam v Jhavady* (1926) AD 147 at 153.
- 33 18 of 1947, section 9.
- 34 Not least in *Tek Corporation Provident Fund & Others v Lorenz* (1999) 4 SA 884 (SCA).
- 35 cf *NIMED Medical Aid Society v Seipp and others NNO* (1989) 2 SA 166 at 170I–J, and *Simpson v Selfmed Medical Scheme and another* (1992) (1) SA 855 at 862G–I.
- 36 That is, who are not trustees but who do hold positions of trust. These are positions such as those of an attorney in relation to his or her client, an agent in relation to the principal, and a director in relation to the company.
- 37 Insurance Companies Amendment Act 1973, section 12(1).
- 38 In a series of three reports published by the Institute and Faculty of Actuaries as a booklet.
- 39 By Boshoff J in *Ex-parte Liberty Life Association and Another* 1976 (1) SA 58 (W).
- 40 *Sampson v Union and Rhodesia Wholesale (Bloem)* (1929) at 468.
- 41 See Smaller et al Appendices 1 and 3, and the report of the Working Party.
- 42 See Smaller SL et al in Appendix 3. The earned asset share is his premiums accumulated with investment earnings, less the cost of claims and expenses that can equitably be allocated to him. The earned asset share ought to be approximately equal to the actuarial reserve in order to ensure that the benefits are “earned” by the premiums.
- 43 Retirement Benefits in South Africa. Bi-annual surveys.
- 44 See Polachek and Siebert (1993) at 265.
- 45 *Stannard v Fisons Pension Trust Ltd* (1992) IRLR 27 at 29.
- 46 1 WLR 456 (Ch) at 456.
- 47 In the discussion of Asher (1987).
- 48 In *Robinson v Randfontein Estates Gold Mining Co Ltd* (1921) AD 168 at 177.

- 49 At 464–465.
- 50 See *Howard v Herrigel* 1991 2 SA 660 (A) at 678.
- 51 See *Percival v Wright* (1902) 2 (Ch) 421, *Pergamon Press Ltd v Maxwell* (1970) 2 All ER 809. See, however, *LAWSA Vol 4 (Part 2) (First Reissue)* at paragraph 119 for a discussion of circumstances in which directors may be said to owe a fiduciary duty to the company's shareholders. Such circumstances include those in which a company is essentially a family business or when the directors are engaged in the sale of the shares of the company to an outside bidder.
- 52 In *Edge v Pensions Ombudsman* (1998) 2 All ER 547 (ChD) at 570–571.
- 53 *Turner v Jockey Club of SA* (1974) 3 SA 633 A, *Theron en Andere v Ring van Wellington van die NG Sendingkerk in SA en Andere* 1976 (2) SA 1 A, *Hira and Another v Booyesen and Another* (1992) 4 SA 69 A at 84E, *Jockey Club of SA v Forbes* (1993) (1) SA 649 A at 654H–I but cf the recent unreported judgement of *Wunsh J in SA Association of Retired Persons v Transnet Limited* (unreported WLD 98/4432).
- 54 In his judgement in *Dawnlaan Beleggings (Edms) Bpk v Johannesburg Stock Exchange and Others* (1983) 3 SA 344 W at 364H to 365B.
- 55 At 364H.
- 56 As held by *Wunsh J in SA Association of Retired Persons v Transnet Limited* (unreported WLD 98/4432) when considering the Board of a medical aid scheme.
- 57 *Murphy, J* (1998) See pages 2 and 3.
- 58 *CW van der Merwe and others v The Southern Life Association Limited and another*.
- 59 *Caffin & Dooling v African Oxygen Limited Pension Fund*, case number PFA/WE/14/98 decided on 30 March 1998.
- 60 In *Roman v Williams* NO (1998) 1 SA 270 C.
- 61 At 284.

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APPENDIX A

THE FIDUCIARY DUTIES OF TRUSTEES

A.1 THE PENSIONS FUND ACT

A.1.1 The Pension Funds Act sets out some of the duties of trustees of retirement funds. Section 7C(1) provides that:

The object of a board shall be to direct, control and oversee the operations of a fund in accordance with the applicable laws and the rules of the fund.

A.1.2 Section 7C(2) provides that:

In pursuing its object, the board shall –

take all reasonable steps to ensure that the interests of members in terms of the rules of the fund and the provisions of this Act are protected at all times especially in the event of an amalgamation or transfer of any business contemplated in section 14, splitting of a fund, termination or reduction in contributions to a fund by an employer, increase in contributions of members and withdrawal of an employer who participates in a fund;

act with due care, diligence and good faith;

avoid conflicts of interest;

act with impartiality in respect of all members and beneficiaries.

A.1.3 Hunter (1998) points out that these provisions:

are nothing more than the codification of the most basic of the common law fiduciary duties of trustees. They are not, however, a comprehensive list.

A.2 DUTY TO AVOID CONFLICTING INTERESTS

A.2.1 The position in South African law was set out some time ago in a judgement of Innes CJ,⁴⁸:

When one man stands to another in a position of confidence involving a duty to protect the interests of that other, he is not allowed to make a secret profit at the other's expense or place himself in a position where his interests conflict with his duty. The principle underlies an extensive field of legal relationship. A guardian to his ward, a solicitor to his client, an agent to his principal, afford examples of persons occupying such a position ... [T]he doctrine prevents a [fiduciary] from properly entering into any transaction which would cause his interests and his duty to clash ...

A.2.2 This creates particular problems with retirement fund trustees who are usually members, or senior officials of the employer. Decisions that involve an increase in benefits to some or all members frequently place them in a position where interest and duty clash.

A.2.3 The only way to conform to this law would be to have independent trustees or an arbitrator make these decisions. Brassey (1998), amongst others, suggests that there is “a growing recognition that the law's stance is unrealistic.” His argument is based on Ford and Austin (1992), an Australian text that discusses the role of nominee directors who owe allegiance to the shareholders that appoint them rather than the company as a

whole. They argue⁴⁹ that:

Nominee directors who, without being puppets, have extraneous loyalties will not be in breach of duties if, in the board's deliberations, they consider the interests of somebody other than the company as a whole.... Where (1) the company's constitutive documents authorise that consideration; or (2) it is in the interests of the company as a whole that the extraneous interests should be considered; or (3) the directors in good faith reasonably conclude that those interests are compatible with the interest of the company as a whole.

A.2.4 The Australian origin of the text is relevant because of the lower standards applied in Australian, and South African, corporate governance. It is, for instance, common in both countries for holding companies to nominate directors to sit on the board of subsidiaries, where their interests in the holding company may conflict with their duty to (minority) shareholders in the subsidiary. This is less common elsewhere, and can be used to explain the lower investment ratings of the Australian and South African stock markets.

A.2.5 That the law is currently honoured largely in the breach is clear: almost all boards of trustees allow interested trustees to vote on benefit improvements. This appears true not only in South Africa but in most of the world. It does, however, have a greater impact in countries like South Africa where rates of inflation are high.

A.2.6 The argument appears to boil down to the contention that allowing trustees to make decisions where they are personally interested in the outcome must be acceptable because everybody does it. Arranging it otherwise would be too expensive.

A.2.7 The simple rebuttal of this argument is that it is the contention of the scoundrel: "Everybody is doing it." It is the same as arguing that the million thefts reported each year in South Africa make the laws of property unrealistic. The requirement to avoid conflicts of interest and duty is an ancient legal doctrine that lies at the centre of all commercial organisation. It follows from recognition of human frailness in the face of temptation. Undermining it undermines all contracts of agency, all delegation, all trusteeship, all professionalism.

A.2.8 The conflicts of interest faced by employer trustees particularly have fuelled suspicion about their motives in dealing with surplus. Given the costs of administering retirement funds, the use of disinterested trustees or arbitrators for these discretionary decisions is small. What is required is an acceptance of the wisdom of the law. Regulation is urgently required to ensure that the rules leave relatively little discretion to trustees, and that only those not personally interested in the outcome are allowed to make decisions.

A.3 DUTIES TO THE FUND OR TO THE MEMBERS?

A.3.1 Hunter (2000) debates the question whether the trustees owe a fiduciary duty to the fund or to the members.

Just as directors owe their fiduciary duties to the company and not its shareholders, trustees owe their fiduciary duties to the fund⁵⁰ and, in most cases, not its members⁵¹.... In the fulfilment of their [fiduciary duties] in most cases trustees will act in the interest of the members, but they may not do so to the prejudice of the fund. ... Section 7C of the Pension

Funds Act is often cited as statutory authority for the proposition that trustees owe a fiduciary duty to the members of the fund but in fact it only requires that the trustees take all reasonable steps to protect the interests of the members. It does not require them to act in their best interests. The significance of the debate is this: if the fiduciary duty is to the fund, then the trustees may take account of the interests of the employer when making decisions concerning matters such as surplus allocations. If the duty is to the members, then the trustees may only take the employer's interests into account if that is required in order to protect and promote the interests of the members; if, for example, it was necessary to conclude a deal with the employer in order to procure a benefit for the members....

In my opinion it is arguable, but by no means certain, that the employment context of the relationships between the fund, its trustees, its members and contributing employers may be such that a direct fiduciary duty between trustees and members may be said to exist.

A.3.2 There are differences between companies and retirement funds that distinguish between the roles of directors and trustees. The objects of a company relate to its business; shareholders have a residual right to the profits. The objects of a retirement fund are, however, to pay benefits; the interests of the beneficiaries are central to the action of the trustees. Companies can exist without shareholders; a retirement fund without a member would be meaningless. It seems therefore that there must be a direct fiduciary responsibility to members.

A.3.3 Sir Richard Scott V-C held, however, that trustees are permitted to consider the employer's interests⁵²:

[T]he proposition that the trustees were not entitled, when deciding how to reduce the £29.9m surplus, to take account of the position of the employers is one with which I emphatically disagree. The employers play a critical part in this pension scheme.

Ms. Gill submitted that ... the trustees' role was to try to promote the interests of the members to the exclusion of the employers, who were in a position to look after themselves. If the trustees had chosen to adopt such a starkly confrontational role as is suggested by the submission, they would have been entitled to do so. But their failure to do so does not, in my judgment, take them outside the spectrum of possible stances that a reasonable body of trustees could properly adopt....

In my judgment the trustees, in deciding how to reduce the surplus, had no duty to be impartial between members in service and member pensioners. They were entitled to prefer the former. They were entitled to recommend a package, which included reductions in the future contributions that the employers would have to pay.

A.3.4 It is not clear that this necessarily applies in South Africa. Employers in Britain have a clear right to a refund of surplus, once members' rights have been protected. Trustees there must therefore give recognition to the employers' wish to use it for the benefit of active members rather than pensioners. Recognising the interests of the employer in this instance would not imply a failure to act in the interests of the member.

A.4 FIDUCIARY DUTIES GO BEYOND THE RULES

A.4.1 Hunter (1998) says:

What constitutes a fiduciary duty may change from time to time as society's attitudes change

in the context of changes to the environment in which powers are exercised.

On the one hand the trustees must ensure that the existing interests of the members are protected. On the other they must take positive steps to advance the interests of the members. They cannot escape that duty by saying that they are bound by the rules of the fund. Section 7D(f) of the Pensions Fund Act specifically provides for the duties of a board to, *inter alia*: ensure that the rules and the operation and administration of the fund comply with this Act, the Financial Institutions (Investment of Funds) Act, 1984 (Act No 39 of 1984), and all other applicable laws.

A.4.2 This suggests that the trustees are obliged to change inappropriate rules, and presumably repeal those that are unreasonable or unfairly discriminatory. It means also that they are bound to serve the interests of members if these conflict with those of employers, as the employers are not beneficiaries of the fund. They have a lesser duty – that of good faith – to the employer.

A.5 DECISIONS SUBJECT TO JUDICIAL REVIEW

Hunter (1998) says:

... it is trite law that domestic tribunals constituted by private parties by agreement are expected to comply with the standards of bounded rationality in exercising adjudicative powers.⁵³ In recent years our courts have recognised that the adjudicative decisions of private bodies which exercise a “public power” (in the absence of agreement between those private bodies and persons subject to their power) are also subject to judicial review along administrative law grounds. Judge Goldstone held⁵⁴ that the Supreme Court had the power to review the decisions of the Johannesburg Stock Exchange although there was no contractual relationship between the applicant and the JSE and although the JSE, while licensed by the state, was not “strictly speaking” a statutory body⁵⁵.

There may be some debate as to whether the board of a retirement fund constitutes a domestic tribunal⁵⁶. Even if the Supreme Court is found to have no jurisdiction to impose administrative fairness, it does appear that the Adjudicator sees it as falling within his powers. One of the types of “complaint” contemplated in the Pension Funds Act is a complaint relating to the administration of the fund, the investment of its fund or the interpretation and application of its rules, alleging *inter alia*:

... that the complainant has sustained or may sustain prejudice in consequence of the maladministration of the fund by the fund or any person, whether by act or omission.

The Pension Funds Adjudicator appears to be satisfied that the language used in the definition of “complaint” indicates that Parliament intended that the decisions of retirement fund trustees be subjected to review along administrative law lines. This means that the task of the Pension Funds Adjudicator must be viewed, *inter alia*, as – “... one which aims at curbing arbitrary practices by ensuring fairness, impartiality and rationality in decision-making.”⁵⁷

A.6 ADMINISTRATIVE LAW STANDARDS

The common law standards applicable to decision-making by statutory bodies have been codified in the Constitution. Hunter (1998) defines them:

A.6.1 Members have a right to lawful administrative action where any of his or her rights or interests is affected or threatened:

This right is reflected in the definition of “complaint” in the Pension Funds Act. In terms of the new Chapter VA of the Pension Funds Act, persons who fall within the definition of “complainant” may refer a “complaint” as defined to the Adjudicator for his investigation. A complaint must be one relating to the administration of the fund, the investment of its fund or the interpretation and application of its rules and alleging *inter alia*:

... that a decision of the fund or any person purportedly taken in terms of the rules was in excess of the powers of that fund or person, or an improper exercise of its powers.

For example, if the trustees of a fund decide to transfer a share of its surplus assets to a provident fund for the benefit of former members of the retirement fund, and there is no provision in its rules either expressly allowing it to transfer assets in those circumstances or giving it general powers to “take such actions as it deems appropriate in order to give effect to the objects of the fund”, the trustees’ decision would have been taken in excess of their powers and the powers of the fund and could legitimately form the subject of a complaint. If, on the other hand, the rules of the fund give the trustees the power to transfer assets in such circumstances, but they refuse even to consider whether they should do so, their refusal to consider the matter could constitute an improper exercise of their powers because they have failed to apply their minds to a matter to which they should have been applied in the exercise of their fiduciary duties.

A.6.2 Member have a right to procedurally fair administrative action where any of his or her rights or legitimate expectations is affected or threatened.

The Adjudicator, in a number of his determinations to date, has enforced this right. For example, he has held that trustees are obliged to consult with persons whose rights may be affected by their decisions and, in order that such persons may be meaningfully consulted, that they be furnished with relevant information. In his determination in a case⁵⁸ involving the distribution of death benefits in terms of section 37C of the Pension Funds Act, the Adjudicator held that:

Given that the fund’s decision will impact significantly upon the rights and property of the dependants, the fund ought properly to investigate the circumstances of the dependants and should give each an opportunity to be heard. The nature, content and extent of such hearing will depend upon the circumstances of each particular case. Where there are disputes of fact and credibility, the resolution of which may result in payment of significant amounts of money, the fund may well be expected to hold an oral hearing to properly ventilate the issues before making a finding.

In another case,⁵⁹ the Adjudicator said that the duty to disclose adequate relevant information is particularly strong when an individual faces an impending decision, which may have adverse implications for him or her. In that case he refused to grant an order that the fund furnish the complainants with the minutes of the trustees’ meetings. This was because the request for it had been phrased in broad terms and the complainants had not made out a case that any of the minutes were reasonably required for the protection or exercise of any of their rights.

This principle should be borne in mind whenever the distribution of a retirement fund surplus is contemplated. The determination of the Adjudicator in the SAPREF Pension Fund matter provides an example. It may not be feasible to consult all the members, but representatives of the stakeholders or groups of stakeholders in the fund should be consulted before the trustees make their decision.

Other administrative law standards contemplated by the right to procedurally fair administrative action include the requirements that trustees:
apply their minds to relevant issues;
for the purpose of exercising their discretionary powers, take into account only relevant considerations and disregard irrelevant considerations; and
take their decisions in good faith.

A.6.3 Members have a right to be furnished with reasons in writing for administrative action, which affects any of his or her rights or interests unless the reasons for such action have been made public.

This right is self-explanatory. Without being given reasons for a decision, a person whose rights or interests are affected by it is not in a position to say whether the decision was taken in compliance with the trustees' obligations.

A.6.4 Members have a right have a right to administrative action that is justifiable in relation to the reasons given for it where any of his or her rights is affected or threatened.

The Adjudicator has referred in a number of his determinations to a recent decision of Van Deventer J.⁶⁰ The judge stated that the effect of the constitutional right to reasonable administrative action means that judicial review of administrative decisions is no longer limited to a review of their procedural fairness. In addition it requires the courts to scrutinise the decisions to determine whether there is proportionality between means and end. He says⁶¹:

Administrative action, in order to prove justifiable in relation to the reasons given for it, must be objectively tested against the three requirements of suitability, necessity and proportionality which requirements involve a test of reasonableness. Gross unreasonableness is no longer a requirement for review.

