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The Edward Nugee Memorial Lectures

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Foreword

Thank you for attending this years' Edward Nugee Memorial Lectures.

This is the third year that Chambers has run this lecture series, undertaken in memory of Edward Nugee QC, to whom Chambers in large part owes its reputation in pensions law. The year leading up to them has, without a doubt, been the most eventful year for the pensions' industry for quite some time.

Outside of the Court room, pensions have enjoyed an unusually high public profile this year, driven primarily by the BHS insolvency and the consequent parliamentary and regulatory investigation. Tata steel and the government's green paper have given pensions indexation a higher profile than it might otherwise have expected to have, while there has been a considerable increase in the number of people taking advantage of the new pensions flexibilities introduced in 2015 (some 200,000 individuals took advantage of these in the second quarter of 2017, as compared to 84,000 in the equivalent quarter of 2015).

In the Court room too, there have been a number of significant cases. The RPI/CPI debate has given rise to an unusually large amount of litigation; it was the backdrop to the *BA* decision, although the significance of that case of course extends far beyond indexation, and the subject of *Barnardo's* and *Thales*. There is more to come too, with *Barnardo's* to go to the Supreme Court, and at least one further substantial case to be heard later this year. The year also saw the first, unsuccessful, attempt to judicially review the Regulator in a moral hazard case.

This years' lectures, which were given by members across the seniority spectrum in Chambers, dealt with these topical subjects, and more. The first, by Michael Furness QC and Sebastian Allen, considered the implications of the decision in *BA* for the exercise of amendment powers. Michael Tennet QC, Emily McKechnie, and James McCreath gave the second, addressing the debates around indexation, and considering the arguments advanced for and against RPI and CPI.

In the third lecture, Paul Newman QC, Jonathan Hilliard QC, Thomas Seymour, and Jamie Holmes covered various public and European aspects of pensions law, fields which are becoming increasingly prominent and which all pensions lawyers are having to become increasingly familiar with. Finally, in the fourth lecture, Emily Campbell and Michael Ashdown revealed some of the contradictions between the drive towards pensions flexibility and the existing legislative scheme.

Thank you again for your support of this years' lectures. We hope that they were and continue to be of use to you. The papers in this book repeat and expand upon the content covered in the lectures, and are intended to provide a lasting reference point for you on the topics covered. As ever, we would be delighted to discuss any points arising out of the lectures or these papers.

The Speakers

Michael Furness QC

Michael is a leading Pensions Silk specialising in occupational pensions, onshore and offshore trust litigation, tax litigation (UK and Hong Kong) and related professional negligence claims. He advises on all aspects of Pensions law and his pensions litigation practice includes regulatory litigation (FSDs and CNs), issues of interpretation of statutes and scheme rules, and claims for rectification of scheme rules. He also advises The Pensions Regulator, The Pension Protection Fund and the FSA on technical pensions issues. Michael is consistently involved in some of the biggest pensions cases, he is ranked as a leading Pensions silk in Chambers & Partners 2015 where is he described as "a highly sought-after silk", "sensationally clever" and praised for the depth of his experience and for his analytical skills. "He impresses both clients and instructing solicitors."

Sebastian Allen

Sebastian has a substantial litigious and advisory pensions practice. He has experience acting on a wide range of pensions matters and his cases have often involved significant insolvency, regulatory, employment and international aspects (including US Chapter 11 and Canadian CCAA proceedings). Sebastian has experience of pensions issues from all angles, acting regularly for trustees, members, sponsoring companies, professional advisers and regulatory bodies.

Sebastian has had particular experience of the regulatory aspects of pensions law, having worked closely with the Pensions Regulator whilst on a four-month secondment and on subsequent cases. He has, since September 2009, provided regular advice to the Pension Protection Fund following time spent with the Pension Protection Fund's in-house legal team.

James McCreath

James has a growing reputation as an up and coming junior who undertakes a range of pensions litigation and advisory work, where he is instructed on his own as sole counsel and as junior counsel as part of a larger team. He has experience acting for employers, trustees, and members, and in cases across a range of areas in pensions law, including regulatory matters. He has been recommended in Chambers & Partners 2016 for Pensions. The directories recognise his communication skills, his ability to get on top of the details of a case, and his attention to client service. He was "highly recommended" in Legal Week's 2016 'Stars at the Bar'.

Michael Tennet QC

Michael's practice encompasses litigation and advice in the fields of pensions (including professional negligence), financial services and private trusts. In recent years he has appeared in many of the most high profile and complex pensions cases. This has included the litigation concerning – *The Pilots National Pension Fund, The IBM Scheme, The QinetiQ pension scheme, The Merchant Navy Ratings Pensions Fund* and *The Nortel Pensions Scheme*. Michael is also regularly instructed by the Pensions Regulator. He has a particular knowledge of the work of actuaries, both in relation to pension funds and life assurance funds and is described in Chambers & Partners, 2015 as "*A highly skilled advocate who garners accolades for his management of cases and his actuarial knowledge"*.

Emily McKechnie

Emily has wide-ranging pensions expertise. Her practice encompasses the statutory, regulatory, trusts and professional liability issues commonly encountered in relation to pension schemes. Emily is consistently recommended in the legal directories as a leading junior. The Legal 500 describe her as "*assiduous and able to translate complex ideas into simple propositions*" and someone who "*gets stuck in to the detail in a proactive and intelligent way*". Chambers & Partners commend her as "*a great advocate who is very user-friendly, bright and someone who provides excellent client service*" and "*very adept at finding practical solutions around very difficult and complex issues*".

Paul Newman QC

Paul has regularly advised some of the largest and highest value UK pension schemes and companies on various pensions' issues, often of a highly technical nature. He regularly acts for The Pensions Regulator and has been heavily involved in advising on, and appearing in cases relating to, various provisions of the Pensions Act 2004. He also has extensive experience of advising and litigating on various public sector and industry-wide pension schemes. He is consistently ranked in the legal directories such as The Legal 500 and Chambers & Partners as a leading pensions silk who is "*the counsel to go to if you want a clear opinion*". Solicitors praise him for his "*superb advice that is delivered in a way that enables clients to move swiftly to a decision*" and he is described as "*a very impressive advocate, who is extremely good on his feet and very persuasive*."

Jonathan Hilliard QC

Jonathan was appointed QC in 2016. Over the past year, he has acted successfully in IBM in the Court of Appeal, the British Airways trial, the judicial review claim in the Silent Night litigation and the strike out claim before the Upper Tribunal in Box Clever, and is due to litigate a pensions fraud trial during the next term. Aside from his Court work, he is "*widely regarded as the go-to barrister for technical pensions issues*" who "*invariably makes the right call*" (Chambers and Partners), and he frequently acts and advises on regulatory matters, corporate transactions, RPI and CPI problems, scheme closure issues, amendment problems and trustee discretion issues.

Thomas Seymour

Thomas is a highly experienced pensions practitioner, his practice being based on over 20 years' experience of acting and advising, principally in relation to occupational pension schemes, in substantive litigation in the High Court, Beddoe applications and compromises, regulatory matters and Pensions Ombudsman references. Over the years he has advised and/or represented employers, trustees and representative beneficiaries of numerous occupational pension schemes His broad Chancery practice encompasses private client, non-contentious and contentious trust litigation in the United Kingdom and overseas. Chambers & Partners, 2017 (Pensions) says *"he has a strong instinct about what the right thing is to do and he builds an intellectual case around that"; "He's incredibly thoughtful and can be relied upon to get the right answer."*

Jamie Holmes

Jamie is currently instructed alongside Jonathan Hilliard QC in the regulatory action concerning the Silentnight DB Scheme, which resulted in the recently reported decision of the Admin Court in *Grace Bay II Holdings Sarl v The Pensions Regulator* [2017] EWHC 7 (Admin); [2017] Pens L.R. 7. Through this and his experience across Chambers' practice areas, including insolvency, trusts, property and commercial cases, Jamie has a ready understanding of the impact that other areas of the law can have on pensions litigation. He has undertaken pensions work both on his own and as part of both internal and external teams of counsel. Jamie joined Chambers in 2016 following the successful completion of his pupillage with supervisors including Jonathan Hilliard QC.

Emily Campbell

Emily is a leading pensions junior with a wealth of experience in pensions litigation (including regulatory work, professional negligence and rectification claims) and she regularly advises on complex technical issues including scheme funding, the scope of powers in pension schemes and the effect of mistakes in pension scheme documents. Complementing her pensions practice, Emily has a broad private client practice. She acts in a range of contentious and non-contentious trust and estate litigation, including cases with a foreign element. She advises on a wide range of issues with an emphasis on private wealth planning, tax and the drafting of trust documentation. She is ranked in the legal directories as a Leading Junior where she is described as "*extremely bright and experienced*." "*She has an outstanding grasp of the most obscure technicalities of pensions law*." (Chambers & Partners 2015)

Michael Ashdown

Michael Ashdown has a broad pensions and private trust practice, and is regularly instructed both as sole counsel and as a junior in a larger team. His practice encompasses litigation and advice across all aspects of pensions law (including professional liability and rectification claims) and private trusts (often offshore or with an international element). Michael is also lecturer in law at Somerville College, Oxford.

LECTURE 1

A fresh look at the exercise of amendment powers:

British Airways plc v Airways Pension Scheme Trustee Limited

Michael Furness QC and Sebastian Allen

Introduction

1. This paper looks at the familiar topic of restrictions on the power of amendment.

2. It might reasonably be thought that there are not many stones left unturned on this subject. Pensions lawyers are certainly well acquainted with cases concerning fetters on reducing benefits – the role of *Courage* provisos[1], section 67 of the Pensions Act 1995, estoppels and the duty of trust and confidence. Recent decisions in the Court of Appeal in *Bradbury v BBC* and *IBM UK Holdings Ltd v Dalgleish* continue the line of authority on this issue.

3. This paper looks at the issue from the rather different perspective of whether there are any restrictions on the use of amendment powers to *increase* members' benefits.

4. The paper has been prompted by the recent decision of Mr Justice Morgan in the *British Airways* case,[2] in which the employer ("**BA**") was challenging the series of decisions taken by the trustees of its pension scheme to exercise a unilateral amendment power to grant members increases in their benefits, against the interests and express wishes of BA as the sponsoring employer. The particular challenge made by BA on which this paper is focused was that the decisions taken to increase benefits against the interests and wishes of the employer were inconsistent with the purposes of a pension scheme.

5. It has been described as "trite law" in *Courage* that an amendment power can only be used for the purposes for which it has been conferred and that this means that it must be used to further the purposes of an occupational pension scheme.

6. The important issue left unanswered in *Courage* is what the purposes of an occupational pension scheme actually are, in furtherance of which the amendment power must be exercised. It is this issue that came before Mr Justice Morgan for determination in the *British Airways* case. It is perhaps surprising that this rather fundamental aspect of the *Courage*

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[1] *Re Courage Group's Pension Scheme* [1987] 1 All ER 528 (Millett J)

[2] *British Airways v Airways Pension Scheme Trustee Ltd* [2017] EWHC 1191 (Ch)

analysis remained previously untested for such a long time given that *Courage,* which is now more than 30 years old, is one of the most widely cited cases in pensions law. It remains to be seen, however, whether, as explained below, the answer Mr Justice Morgan provided to this 30 year old problem raises more questions than it actually answers.

7. This paper looks at the issues in the British Airways case in five sections:

   7.1. the background facts to the British Airways case;

   7.2. the orthodox challenges to the exercise of discretionary powers;

   7.3. the law on improper purposes;

   7.4. the benevolent argument; and

   7.5. the purposes of an occupational pension scheme.

The background facts to the *British Airways* case

8. BA operates two main defined benefit occupational pension schemes: the Airways Pension Scheme ("**APS**") and the New Airways Pension Scheme ("**NAPS**").

9. The combined deficit of those schemes as at their Triennial Valuation dated of 31 March 2012 was £3.4 billion on a technical provisions basis and £10.6 billion on a solvency basis.

10. The litigation concerned the older and more mature scheme – APS.

11. APS was originally set up as a public sector scheme in 1948 pursuant to s.20 of the Civil Aviation Act 1946 with three statutory employers, BOAC, BEAC and BSAAC. The Minister for Aviation had wide powers over the scheme to make regulations and under Regulation 7 of the Airways Corporation (General Staff) Regulations 1948/2361, no amendment made by the original Management Trustees under the power of amendment conferred upon them would have effect unless confirmed in regulations by the Minister. When the scheme was privatised in 1987, BA became the sponsoring employer and all references to the Minister for Aviation – including the role reserved for the Minister for Aviation in approving amendments – were removed from the scheme.

12. The Management Trustees of APS were required under its trust deed to be made up of six Member Nominated Trustees ("**MNTs**") and six Employer Nominated Trustees ("**ENTs**").

13. APS has always provided particularly generous pension benefits, with accrual rates of 1/50th - 1/56th of final salary for each year of service and a normal retirement age of 55 or 60

depending on employment status. APS closed to new members with effect from 31 March 1984 and NAPS was established for employees joining BA after that date.

14. Under Rule 15 of the APS rules, pension increases were linked directly to the Pension Increase (Review Orders) or "PIROs" published each year by the Secretary of State.

15. The Trustees also had a power under Rule 15 to change the pension increase index in the specific situation where PIROs ceased to exist or where it became necessary to review the rate of increases to ensure that pensions increased by reference to an "*appropriate national index or indices reflecting fluctuations in the cost of living*."

16. Whilst PIROs have historically been linked to RPI, one of the changes brought about by the coalition Government in 2010 was to change PIROs so that they would in the future be linked to CPI. This did not change the benefit entitlements of APS members: members had been entitled to inflation protection by reference to PIROs and they continued to be entitled to inflation protection by reference to PIROs. In practice, however, it meant that members would be receiving CPI increases for the foreseeable future rather than RPI increases.

17. This change in Government policy did not go down well with many of the members of APS and it did not go down well with some of the Trustees – particularly the MNTs.

18. It prompted a campaign pursued by members and by certain MNTs to put pressure on BA and the ENTs to reverse the effect of the change in Government policy on members of APS. The actions undertaken as part of that campaign – which included the lobbying of MPs, the election of MNTs on a manifesto of restoring RPI increases, the instigation of more than 1,000 IDRP complaints and the initiation of Pension Ombudsman complaints and Small Claims Court litigation – are set out in the judgment of Mr Justice Morgan and make interesting reading for any disgruntled pension scheme member looking to put pressure on employers and trustees.[3]

19. The Trustees as a collective body ultimately decided three things in response to the change from RPI to CPI:

    19.1. First, they decided that they had a collective objective of "restoring" RPI increases for members.

[3] See [148] – [348] of the Judgment of Mr Justice Morgan.

19.2. Secondly, they decided that they could not exercise their existing power under Rule 15 to change the index to RPI because CPI was an appropriate national index to protect pension benefits from the cost of inflation.

19.3. Thirdly, they decided that they could instead increase the benefits of members because they had a unilateral power of amendment which – shorn of the ministerial approval requirement - could be exercised by the Trustees to give members pension increases above their existing entitlement to CPI.

20. That amendment power was contained in Clause 18 in the following terms:

"*The provisions of the Trust Deed may be amended or added to in any way by means of a supplemental deed executed by such two Management Trustees as may be appointed by the Management Trustees to execute the same. Furthermore the Rules may be amended to or added to in any way and in particular by the addition of rules relating to specific occupational categories of staff. No such amendment or addition to the provisions of the Trust Deed or to the Rules shall take effect unless the same has been approved by a resolution of the Management Trustees in favour of which at least two thirds of the Management Trustees for the time being shall have voted PROVIDED THAT no amendment or addition shall be made which:*

- *would have the effect of changing the purposes of the Scheme, or*
- *would result in the return to an Employer of their contributions or any part thereof, or*
- *would operate in any way to diminish or prejudicially affect the present or future rights of any then existing member or pensioner, or*
- *would be contrary to the principle embodied in Clause 12 of these presents that the Management Trustees shall consist of an equal number of representatives of the employers and the members respectively*".

21. There were accordingly four main elements to the amendment power in Clause 18: (i) the Trustees could change the Trust Deed or Rules "*in any way*"; (ii) it was a unilateral power and did not require BA's consent to be exercised; (iii) it required a resolution of 2/3 of the Trustees to be passed and (iv) there were a number of provisos restricting the use of the amendment power, including that no amendment will have the effect of changing the purposes of the Scheme.

22. The Trustees decided to exercise that power to introduce an amendment to Rule 15 to include the following additional words:

"PROVIDED FURTHER THAT the Management Trustees may at their discretion, and shall in any event at least once in any one year period, review the annual rate of pension payable or prospectively payable under Rules 8, 9, 10, 11, 12, 13 and 34 and shall have the power, following such a review, by resolution to apply discretionary increases in addition to those set out in these Rules, subject to taking such professional advice as appropriate. This discretion cannot be exercised unless at least two thirds of the Management Trustees for the time being vote in favour of the resolution".

23. In other words, the Trustees decided to grant themselves a specific discretion that they did not previously have under the APS trust deed and rules to grant additional pension increases above the pension increases to which members were already entitled by reference to PIROs.

24. An important feature of the case in terms of how the arguments developed and in terms of its wider significance is that the Trustees accepted throughout that this discretion permitted them to increase the benefits payable to members. The Trustees already had a power under Rule 15 to change the index where it became necessary to protect members' existing benefits from inflation. This was not about preserving the value of existing benefits but about giving members better benefits than the benefits to which they were previously entitled.

25. This was a development to which BA objected for a number of reasons – including the fact that:

    25.1. APS was already in very substantial deficit and could not afford to fund the existing benefits that had been promised to members let alone enhanced benefits.

    25.2. APS members were already receiving better pensions than NAPS members – who had agreed to a number benefit reductions in consultation with the Trade Unions on account of BA's pension funding difficulties.

    25.3. Current employees of BA had been forced to suffer a period of pay freezes as part of a series of cuts BA had been required to make to the business over a number of years and it was politically unpalatable for pensioners to be awarded enhanced benefits in such a financial climate.

25.4. BA had no business case for increasing APS pensioner benefits, particularly in the context of the capital investment that BA considered it needed to make over coming years.

26. The cost to BA of restoring RPI increases – if the Trustees exercised the discretionary power they had conferred upon themselves to achieve their stated objective to "restore" RPI – would have been to add approximately £800m to the liabilities of the Scheme

27. The new discretionary power was exercised in 2013 in a series of overlapping decisions taken in February 2013, June 2013 and November 2013. It was ultimately held by Mr Justice Morgan that only the November 2013 decision was a final and binding decision and so this is treated as the relevant decision for the purposes of this paper.

28. The decision was to apply an additional 0.2% increase to pensions – which was half the gap between CPI and RPI in that year.

29. There were consequently two main decisions of the Trustees being challenged in the proceedings brought by BA:

29.1. the decision to exercise Clause 18 amendment power to introduce the discretionary power; and

29.2. the exercise of that discretionary power to grant the increased pension.

30. It was accepted throughout that Clause 18 was on its face a wide unilateral amendment power vested in the Trustees. The main question in the litigation was whether that simply meant that, provided the Trustees comply with the terms of Clause 18, they could do whatever they wanted in exercising that power or whether there were restrictions outside the four corners of the words of Clause 18 itself on how that discretion could be exercised by reference to the purposes of the scheme.

The orthodox grounds for challenging the exercise of discretionary powers

31. The orthodoxy on the constraints on the exercise of discretionary powers is still the position summarised by Lord Walker in *Pitt v Holt* [2013] UKSC 26.

32. Lord Walker agreed with Lloyd LJ in the Court of Appeal in identifying three broad categories of challenge to the exercise of discretionary powers at [60]:

32.1. **Excessive execution** – i.e. a decision that goes beyond the scope of the power, with the consequence that it is void.

32.2. **Fraud on a power** – i.e. a decision that is ostensibly within the scope of the power but where the power has been exercised for an improper purpose, with the consequence that the decision is void.

32.3. **Inadequate deliberation** – i.e. a flaw in the way in which the decision has been taken, such as taking into account irrelevant or failing to take into account relevant considerations, with the consequence that the decision is voidable.

33. This taxonomy was adopted by Mr Justice Morgan in the *British Airways* case at [350] – [352] of his Judgment, albeit he referred to the fraud on a power cases as an "abuse of power", picking up on the language of Lord Sumption in *Eclairs Group Ltd v JKX Oil & Gas plc*.[4]

34. BA was challenging the decisions of the Trustees on all three grounds on the basis that:

34.1. The decisions were an excessive execution because they contravened the explicit restriction in the objects clause against making a "*benevolent or compassionate payment*".

34.2. The decisions were an abuse of power because they were made for the improper purpose of setting the remuneration of the employer rather than delivering that remuneration.

34.3. The decisions involved an inadequate deliberation by the MNTs because the determination of the MNTs to grant pension increases "come what may" resulted in them taking into account irrelevant factors and failing to take into account relevant factors, in breach of their fiduciary duties.

35. Mr Justice Morgan rejected the challenge on all three grounds but gave permission to appeal to the Court of Appeal on Grounds 1 and 2.

36. This paper looks only at Grounds 1 and 2 of the challenge brought by BA because these are the challenges that related most directly to the proper purposes issue.

The law on improper purposes in the context of pension schemes

The proper purpose rule

37. It is a well-established rule applicable to the exercise of powers that they must not be exercised other than for the purposes for which they have been conferred.

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4 [2015] UKSC 71, [2016] 3 All ER 641, [2016] 1 BCLC 1.

38. The classic statement of the proper purposes rule is from Lord Westbury LC in *Duke of Portland v Topham* (1864) 11 HL Cas 32, in which he stated the rule as follows:

> "*that the donee, the appointor under the power, shall, at the time of the exercise of that power, and for any purpose for which it is used, act with good faith and sincerity, and with an entire and single view to the real purpose and object of the power, and not for the purpose of accomplishing or carrying into effect any bye or sinister object (I mean sinister in the sense of its being beyond the purpose and intent of the power) which he may desire to effect in the exercise of the power."*

39. Whilst the proper purposes rule has historically been referred to as the doctrine of a "fraud on the power", it has nothing to do with fraud. As explained by Lord Parker in *Vatcher v Paull*,[5] it:

> *"does not necessarily denote any conduct on the part of the appointor amounting to fraud in the common law meaning of the term or any conduct which could be properly termed dishonest or immoral. It merely means that the power has been exercised for a purpose, or with an intention, beyond the scope of or not justified by the instrument creating the power."*

40. In *Equitable Life Assurance Society v Hyman* [2002] 1 AC 408, Lord Cooke expressed the principle at p.460F as being that:

> "*no legal discretion, however widely worded…can be exercised for purposes contrary to those of the instrument by which it is conferred".*

41. In Underhill and Hayton: Law Relating to Trusts and Trustees 19th Ed 2016, the principle is expressed that a trustee:

> "*(d) must exercise his discretion only within the scope of the terms of the relevant power and, then, only for the purposes for which the discretions were conferred on him by the settlor and not perverse to any sensible expectation of the settlor*".

In the context of a pension scheme the "settlor" is the employer and it is the employer's purposes as donor of the power that count.

42. The principle has developed in both a trustee context and in the context of the exercise of powers of directors.

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5 [1915] AC 372, PC at 378. Cited by Lord Sumption in *Eclairs* at [15].

43. Two classic company law cases in this area are ***Hogg v Cramphorn*** [1967] 1 Ch. 254 and ***Howard Smith v Ampol Petroleum Ltd*** [1974] AC 821 where the courts held that it was not a proper purpose for directors to exercise their power to issue shares in order to block a takeover bid.

44. The recent authority on the doctrine in a company law context is the decision of the Supreme Court is ***Eclairs***.

45. In ***Eclairs***, the Supreme Court struck down a decision by a board of directors in exercising a power conferred by the company's articles to suspend voting rights of some shareholders. That power was given for the purpose of compelling shareholders to disclose interests in their shares if the board had served a statutory disclosure notice under section 793 of the Companies Act 2006, and as a sanction for failure to make such a disclosure (see Lord Sumption at para [32]).

46. There were seven directors on the board of the company, of whom six gave evidence. The judge's findings were that of those six:

> one exercised the power for the purpose of compelling compliance with the notice;
>
> one exercised the power both for that reason, and also because he thought it was in the interests of the company generally that the power be exercised and that the shareholders be prevented from voting and
>
> four exercised the power because they thought it was in the interests of the company generally that the power be exercised and that the shareholders be prevented from voting, although they also had in mind the proper purpose as well.

The Supreme Court were of the view that the purpose entertained by the four was improper, and therefore the decision to exercise the power was struck down.

47. However, the real interest in the case stemmed from the trial judge's further finding that even if the four had not entertained the improper purpose, they would nevertheless have still exercised the power for the proper purpose (see paragraph [26] of Lord Sumption's judgment). However, because the directors had not pleaded their case in this way, the judge refused to allow them to run that argument, and there was no appeal from that decision.

48. Lord Sumption began his judgment with some general observations about the proper purpose rule. He stated at [15] that:

"*The important point for present purposes is that the proper purpose rule is not concerned with excess of power by doing an act which is beyond the scope of the instrument creating it as a matter of construction or implication. It is concerned with abuse of power, by doing acts which are within its scope but done for an improper reason. It follows that the test is necessarily subjective*".

49. Lord Sumption listed various factors to consider where the power is silent as to purpose:

    49.1. an inference from the mischief of the provision which it itself deduced from its express terms;

    49.2. an analysis of their effect; and

    49.3. the courts understanding of the business context.

50. According to Lord Sumption at [30]:

    "*The rule is not a term of the contract and does not necessarily depend on any limitation on the scope of the power as a matter of construction. The proper purpose rule is a principle by which equity controls the exercise of a fiduciary's powers in respects which are not necessarily determined by the instrument*".

51. The exercise is not wholly dissimilar to but appears to be wider than a process of construction.

52. It is not, however, easy to distinguish the two, reflecting the fact that the boundary between implied limitations on the scope of the power as a matter of construction and the limitation against abuses of the power is often an obscure one. Indeed in many of the leading cases, such as <u>*Equitable Life*</u> and <u>*Courage*</u>, the Court has treated the requirement to act for a proper purpose interchangeably as both an implied limitation on the scope of the power and as an independent equitable principle.

53. The overlap is explained quite helpfully by Nolan in his article "Controlling Fiduciary Power" (2009) 68 CLJ 293 where he considers the distinction between construction and improper purposes:

    "*But what, precisely, is this distinction?*

    Construction is concerned with words: attributing meaning to words, however strictly or loosely, and whatever the context, is the key to construction. By contrast, the proper purposes doctrine looks to the particular ends intended to be achieved through certain particular acts and determines whether such ends are contemplated (and therefore authorised) by the power in question.

Naturally, there can be a degree of overlap between questions of construction and the proper purposes doctrine: the facts of cases are often ambiguous or can sensibly bear more than one interpretation. For example, it may be possible to view the purported exercise of a power of appointment as something not authorised by the words of the power, because in substance the trustees conferred benefit on someone outside the class of beneficiaries, or as something within the express language of the power, because the appointment was formally to an object of the power, but made for an improper purpose because the recipient was to hand on the benefit to a non-object. Similarly, when directors of an insurance company purportedly used their discretion under the company's articles of association to reduce final bonuses payable under insurance policies issued subject to those articles, the directors' action was held to be invalid either by reason of an implied limitation on the relevant article, which is a matter of construction, or because they had abused the power conferred by the relevant article. More generally, the scope of directors' actual authority is impliedly limited in that it is to be used for the "purposes of the company as set out in [its] memorandum of association". That too could be regarded as a canon of construction or as an application of the proper purposes doctrine."

54. In practice, it does not matter whether a restriction is imposed as an implied term or as abuse of the power because, as the law currently stands, the remedy for excessive execution and abuse of power are the same: the exercise of the power is void.[6]

The issue of multiple purposes

55. In ***Eclairs*** Lord Sumption dealt with a further issue of potential relevance to pension schemes, namely how to deal with the situation in which the person exercising the power entertains more than one purpose, some of which are proper and some of which are not.

56. This consideration was prompted by the Judge's *obiter* findings to the effect that if the majority of the directors had not pursued an improper purpose they would have taken the same decision for a proper purpose.

57. The issue can arise when considering decisions taken by a body of individual trustees, or the board of directors of a corporate trustee. In assessing such decisions, it must be borne in mind that the question as to the purpose entertained by a particular individual is, according to Lord Sumption, a subjective issue (see paragraph [15], quoted above). Consequently, whilst on the basis of the minutes of the relevant meeting all the trustees may appear, ostensibly, to be pursuing the same objects, an enquiry as to the purposes actually entertained by each trustee may reveal a divergence of view as between them, or may reveal

[6] *Cloutte v Storey* [1911] 1 Ch 18, CA

that the real purposes they had in mind do not correspond to, or are not limited to, the purposes which are set out in the minutes, or in their legal advice.

58. On this issue, Lord Sumption had this to say, in paragraph [17] (emphasis added):

> *"But what if there are multiple purposes, all influential in different degrees but some proper and others not? An analogy with public law might suggest that a decision which has been materially influenced by a legally irrelevant consideration should generally be set aside, even if legally relevant considerations were more significant … In some contexts, such as rescission for deceit or breach of the rules relating to self-dealing, equity is at least as exacting. But the proper purpose rule, at any rate as applied in company law, has developed in a different direction. Save perhaps in cases where the decision was influenced by dishonest considerations or by the personal interest of the decision-maker, the directors' decision will be set aside only if the primary or dominant purpose for which it was made was improper."*

59. Lord Sumption then addressed the question of how to identify the "*primary or dominant purpose*". Is it the purpose the directors feel most strongly about? Or is it the purpose which actually caused the decision to be made. He concluded, in paragraph [22], that the correct answer is that the exercise of the power will be invalidated if the improper purpose causes the decision to be made, in the sense that "but for" the improper purpose the decision would not have been made. On the other hand, the fact that the directors entertain an improper purpose when exercising the power will not invalidate the exercise if they also entertained a proper purpose, which would have caused them to exercise the power in the same way, even in the absence of the improper purpose.

60. It is important to note that the trial judge's findings on this point ([2013] EWHC 2631 Ch at [235] to [237]) are to the effect that the four directors who were motivated primarily by the improper purpose also had the proper purpose in mind.

61. Lord Sumption's reasoning does not deal with an alternative factual scenario in which the directors in question entertained only one purpose, which was an improper one, and did not have the proper purpose in mind at all, but the evidence shows that if they had known the purpose they were pursuing was improper they would have endorsed the proper purpose.

While that factual situation would also allow one to conclude that it was not the case that "but for" the improper purpose the decision would not have been taken, it seems that the decision would fall to be struck down, because the directors, on this hypothesis, would not have had in mind any proper purpose at all.

62. The Supreme Court gave a mixed reaction to Lord Sumption's comments on this issue. Lord Hodge agreed with Lord Sumption's judgment. Lord Clarke was "*inclined to agree*" with Lord Sumption's views on mixed purposes, but as they were not necessary in order to decide the appeal, and had not been the subject of oral argument, he preferred to defer reaching a final conclusion on those issues. Lord Mance (with whom Lord Neuberger agreed) also agreed with Lord Sumption in the result, but queried whether his views on the "but for" approach were entirely in line with the authorities, which could be said to favour a principal or primary purpose test. He too "had sympathy" for Lord Sumption's views on the subject, but was not willing to reach a concluded view.

63. The law on mixed motives is therefore unclear. Two members of the Supreme Court endorsed a clear "but for" test, but the majority preferred to keep an open mind. The judgments at first instance and in the Court of Appeal do not address the point.

The application of the purpose rule to pension schemes

64. There is no doubt that the proper purpose rule applies to pension scheme trustees, as well as to employers (as held in ***Courage***).

65. ***Courage*** is one of the classic cases in this area, in which Millett J commented that:

> "*It is trite law that a power can be exercised only for the purpose for which it is conferred, and not for any extraneous or ulterior purpose. The rule-amending power is given for the purpose of promoting the purposes of the scheme, not altering them*".

66. There is consequently a close connection between the purpose of the scheme and the purpose of the amendment power.

67. The important question left unanswered in ***Courage*** is: what are the purposes of a pension scheme which must be promoted by the exercise of the amendment power?

68. The factors that likely can be taken into account in the context of a pension scheme, as put by BA to Mr Justice Morgan at [363], are matters such as:

68.1. the terms and effect of the trust deed and rules;

68.2. the relevant historical context to those provisions;

68.3. the commercial purpose of a pension scheme; and

68.4. the statutory framework that regulates pension schemes.

69. In high-level terms, the purpose of a scheme is usually defined in an objects clause by reference to outcomes – i.e. the provision of pensions or retirement benefits – rather than by reference to whether they have been earned or the reasons of the party conferring the benefit. It is, however, always implicit that pension benefits have to be related to service with the employer - not with service with another employer. So trustees of employer A's scheme cannot grant a pension in respect of employment with unrelated employer B. This cannot be justified by a trustee on a high-level outcomes based approach that the benefit is in the form of a pension and so is consistent with the purposes of the scheme in providing pensions.

70. There has to be a connection between the benefits and the employer. The question is how close does that connection have to be?

The benevolent argument

71. The first argument run by BA was that the decision by the Trustees to give members better benefits for no reason other than to address the injustice of the change in Government policy was contrary to the express restriction contained in the objects clause of the APS trust deed against making "*benevolent or compassionate payments*".

72. That restriction was found in Clause 2 of the APS Trust Deed in the following terms:

"*THE main object of the Scheme is to provide pension benefits on retirement and a subsidiary object is to provide benefits in cases of injury or death for the staff of the Corporations in accordance with the Rules. The Scheme is not in any sense a benevolent scheme and no benevolent or compassionate payments can be made therefrom*".

73. The "benevolent payments" restriction is not wording that is familiar within the pensions industry and indeed none of those involved in the *British Airways* case had ever encountered those particular words before.

74. Whilst the arguments deployed by BA on Clause 2 are consequently unlikely to have much wider significance, it could be said that the provision of benevolent or gratuitous benefits is foreign to the purposes of all pension schemes, even in the absence of an express

prohibition. This would seem to follow from the fact that pensions are not vehicles for gifting money to people but are earned as deferred pay in the course of employment.

75. It is, therefore, instructive to look at how Mr Justice Morgan addressed the benevolent argument as part of his analysis of the wider purposes of occupational pension schemes.

76. The word "benevolent" is a difficult one to apply.

77. The House of Lords in *Chichester Diocesan Fund v Simpson*[7] held that a trust set up for "benevolent" objects did not have sufficient certainty of objects to be enforced. In *Commissioners for Special Purposes of Income Tax v Pemsel*[8] [1891] AC 531 – Lord Bramwell commented that "benevolent" meant "good was wished to others" and stated that "*certainly every benevolent purpose is not charitable. I think there is some fund for providing oysters at one of the Inns of Court for Benchers; this, however, benevolent, would hardly be called charitable*".

78. The dictionary definition of benevolent includes:

"[o]*f the general frame or habit of mind: Desirous of the good of others, of a kindly disposition, charitable, generous" or "of things: Kindly, fostering" and "well wishing, well-disposed to another*".

79. The Judge did not define "benevolent" but concluded at [477] that a payment could only be benevolent if it was responsive to individual members' personal circumstances and since the payment determined by the Trustees was not made by reference to the personal circumstances of members it was not benevolent. The Judge appeared to accept that this was not the natural meaning of the word but considered it was the meaning necessitated in the context of the APS trust deed.

80. There are, however, real difficulties with that construction which do not appear to have been confronted by Mr Justice Morgan in his analysis.

81. Two examples illustrate why the restricted construction adopted by Mr Justice Morgan is problematic:

81.1. First, it means that if the Trustees were simply to gift all members £1,000 it would not be a "benevolent" payment because it would not be responsive to the personal

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7 [1944] AC 341

8 [1891] AC 531

circumstances of members. It does not seem right that such a gratuitous payment would not be caught by the words "benevolent payment".

81.2. Secondly, it does not explain why was the fact that members had been receiving RPI increases and would now be receiving CPI increases was not a personal circumstance of those members. There can be little doubt that a change in financial circumstances is a change in personal circumstances. The fact that it is a personal circumstance of all members cannot be the answer; the issue cannot sensibly depend on the number of members affected by the change.

82. There are perhaps two ways of looking at benevolence or gratuitous benefits:

82.1. From the point of view of the recipient – has the recipient earned the benefit or is it an unearned gift?

82.2. From the point of view of the donor – what is the donor's motivation for the payment, is the donor motivated by benevolence or by something else?

83. In reaching his view on "benevolence" Mr Justice Morgan appears to have been influenced by the first approach, by considering the position from the point of view of the recipient. Mr Justice Morgan was particularly troubled by the fact that "benevolent" cannot in the context of the scheme mean simply an absence of entitlement because there were circumstances under the Scheme rules where members may receive payments to which they were not previously entitled – such as a disposal of surplus.

84. This may be right, but it does not lead to the conclusion that a benevolent payment must therefore be one that is responsive to personal circumstances, particularly if looked at from the point of view of the donor.

85. The way the argument was put by BA was that:

85.1. If the reason a payment is being made is that a member is entitled to it then clearly it cannot be benevolent to pay it – the member is entitled to it.

85.2. If that is not the reason the payment is being made, the issue then is whether the payment is being made for a benevolent reason or a non-benevolent reason.

85.3. There may be a number of non-benevolent reasons why a payment might be made to a member even though they had no pre-existing entitlement to it. An employer may, for example, decide to augment benefits for its business purposes; a business

reason is not a benevolent reason. A payment made to members in order to distribute a surplus and to ensure the proper administration of the scheme is also not a benevolent reason for making the payment.

85.4. There was no non-benevolent reason on the facts why the Trustees were paying members enhanced benefits: the reason the enhanced benefits were being paid was the simple benevolent reason of seeking to remedy the perceived injustice members had suffered from the change from RPI to CPI.

86. Whilst Mr Justice Morgan rejected this line of argument, it is instructive to ask what the approach taken by Mr Justice Morgan tells us about the wider purposes of pension schemes and the link between the benefits provided by the scheme and the employer.

87. In the event that there really is no purpose based restriction on trustees gifting members £1,000 for no reason other than to give them more money – whether arising from express language like that in Clause 2 or the general purposes of an occupational pension scheme – it is hard to discern any substantive link at all between the benefits provided and the employer. Indeed, as will be seen in the next section, when it came to Mr Justice Morgan's consideration of the general purposes of an occupational pension scheme outside of the specific wording in Clause 2, his analysis makes no accommodation for any such link.

The proper purposes of occupational pension schemes

The way the case on improper purposes was advanced by BA

88. The essence of BA's argument on the commercial purposes of a pension scheme was that:

88.1. Pensions are deferred pay.

88.2. The reason an occupational pension scheme is set up by an employer and, therefore, its commercial purpose is to deliver the deferred remuneration of the employer to its employees and former employees.

88.3. The role of the trustees is to deliver that remuneration.

88.4. Remuneration is and can only be set by an employer in line with its business objectives and strategies.

89. This assessment of the commercial purposes of a pension scheme is not dissimilar to the purpose of an occupational pension scheme identified by Mr Pollard in his book The Law of Pension Trusts at [9.40] – which he identifies as being:

"*The purpose of a defined benefit occupational pension scheme is to provide the stated and accrued relevant benefits to (and in respect of) the members at a cost acceptable to the employer*"

Mr Pollard explains that the "*cost acceptable to the employer*" "*allows room for the employer to agree an action that may incur extra cost – eg a benefit increase or a change in investments from "risky" equities to "less risk" bonds*".

90. Whether or not acceptable levels of cost is the right concept, what is apparent is that the concept of a "cost acceptable to the employer" in Mr Pollard's definition of purpose is serving a similar analytical role to the concept "remuneration" is serving in BA's argument. They both identify that the benefits set have a necessary link to the employer and the fact that it is the employer's pension scheme.

91. The necessary link on BA's argument between the benefits and the employer's remuneration does not necessarily mean that only the employer can change benefits or that it is only the employer's self-interest that counts.

92. The question in each case (following BA's argument through) is why are the benefits being changed by whomever has the requisite power to do so? Is the reason consistent with the purpose of delivering the employer's remuneration or is it inconsistent with that purpose?

93. There may well be situations in which trustees could change or refuse to change benefits against the wishes of the employer and properly maintain that their purpose in doing so is consistent with the purpose of delivering the employer's remuneration:

    93.1. First, there are situations where trustees change benefits in order to preserve the existing value of the benefits that have been promised to members. An example of this is the limited power in Rule 15 of the APS rules before it was amended, which enabled the Trustees to replace the index where it became necessary to do so to ensure pensions were increased by an appropriate national index reflecting the cost of living. If PIROs ceased to be published, it would be necessary for the Trustees to seek to replicate the previous level of benefits as best as they can by selecting another appropriate index, whether or not that results in slightly better benefits.

    93.2. Secondly, there are situations where a disposable surplus arises that has to be dealt with and the trustees might decide that some of that surplus should be used to improve members' benefits – not least because part of that surplus represents

employee contributions. The employer may not want this to happen but the trustees could quite properly say that changing benefits in this situation is not inconsistent with the purpose of delivering the employer's remuneration. The Scheme is in surplus so the additional benefits are not jeopardising the delivery of existing benefits, nor is it adding any unwanted costs on the employer. The trustees are also not changing the benefits in order to step into the shoes of the employer as paymaster of the business. The purpose is simply to deal with an administrative issue that has arisen.

93.3. Thirdly, there are situations where an employer wants to increase the benefits without being willing to ensure those additional benefits are funded and the trustees refuse to permit the employer to do so on the basis that it puts at risk the ability of the trustees to deliver the existing benefits that have been promised to members.

94. In the particular circumstances of the *British Airways* case, BA argued that the Trustees were not exercising the amendment power conferred upon them to deliver BA's remuneration of its employees and former employees. Rather by seeking to grant members better benefits the Trustees were acting to set the level of remuneration at a level that was unacceptable to the employer. They were essentially taking over as paymaster of the business because they did not like the fact that BA only paid APS members PIRO increases and they wanted to increase those benefits.

95. That was not consistent - BA argued - with the very essence of a pension being deferred pay.

96. It is also very different from the numerous situations in which trustees exercise powers in order to preserve or safeguard the value of existing benefits – such as changing commutation factors, determining transfer in values or setting inflation proofing increases – where the trustees are making decisions in order to deliver the true value of the pay set by the employer to members.

The approach taken by Mr Justice Morgan

97. Mr Justice Morgan did not accept BA's approach to the purpose of a pension scheme.

98. The Judge concluded instead at [422] – [423] that the purpose of a pension scheme was to "*deliver the benefits as they are defined from time to time*". In other words, he adopted the high-level outcomes based approach to purposes, that a pension scheme exists simply to

provide pensions, without specifying any apparent necessary connection between the pensions provided and the employer.

99. The purpose articulated by Mr Justice Morgan is, therefore, silent on whose role it is to set the benefits of members.

100. The reasoning appears to be that, provided you comply with the terms of the amendment power, whatever changes are made to the scheme become the new benefits defined "*from time to time*" that have to be delivered. The new benefits *ex hypothesi* become part of the purpose of the scheme and it is consequently those benefits that then need to be delivered. There is, accordingly no particular purpose to a pension scheme beyond providing pensions in accordance with the trust deed and rules.

101. This led Mr Justice Morgan to ask the question whether there was anything in that purpose as articulated which imposed a requirement of BA's consent into Cl.18 when it came to changing benefits.

102. He concluded that there was nothing which necessitated such a consent requirement to be imposed and he said that:

> "*it is not appropriate to use the general concept such as the purposes of a pension scheme to write in a requirement of BA's consent to the unilateral power to amend conferred by Cl.18*".

103. It is thus apparent that Mr Justice Morgan considered that linking pensions directly to the concept of pay in the way BA was arguing effectively involved implying a consent requirement into the amendment power by the backdoor.

The practical consequences of Mr Justice Morgan's approach

104. There are a number of potentially significant practical consequences to the approach taken by Mr Justice Morgan.

105. First, it means there are no effective purpose restrictions at all on what benefits trustees can grant if they have a unilateral power to change the trust deed and rules.

106. This means that provided trustees comply with the terms of the amendment power the only effective restraint on what benefits they can grant is one of rationality.

107. Yet if the purpose of the scheme is to provide whatever benefits the trustees decide to provide, how can it be irrational to provide them? Trustees with unilateral amendment powers are consequently not limited in deciding (i) to increase benefits by 100%; (ii) to change the rate of accrual or (iii) even to change the normal retirement date of members.

108. Whilst unilateral amendment powers vested in trustees are not commonplace in occupational pension schemes, they do exist beyond the specific instance of APS. It is known, for example, from the case of *PNPF Trust Co v Taylor*[9] that the Pilots' National Pension Fund also contains such a unilateral amendment power.

109. The commercial ramifications of Mr Justice Morgan's approach are consequently likely to be significant.

110. In the commercial world, pension benefits in many industries (including the airline industry) are very often influenced by complex negotiations between an employer and trade unions. The idea that trustees with unilateral amendment powers could simply override the outcome of any such negotiations if they did not like the outcome will no doubt leave a number of employers in similar positions looking rather anxiously at their pension scheme provision.

111. Secondly, the practical concerns are not limited to unilateral powers but must also extend to bilateral powers.

112. If there is an overarching purpose to an occupational pension scheme in the terms adumbrated by Mr Justice Morgan, that purpose must inform the way bilateral powers can be exercised just as much as unilateral powers.

113. Even in the much more common cases where there are bilateral amendment powers, the consequence of the decision of Mr Justice Morgan appears to be that:

    113.1. Trustees can refuse to exercise the bilateral power of amendment even where the employer is seeking to reduce future benefits because they have become unaffordable, simply on the basis that the trustees consider that members should continue to be paid more than the employer wants to pay its employees.

[9] [2010] Pens. L.R. 261

113.2. Trustees can legitimately lobby the employer to exercise the bilateral amendment power to increase members' benefits and spend scheme resources hiring professional advisers to assist in that process.

If the purposes of an occupational pension scheme are silent on whose role it is to set the benefits, there is no purpose based restriction on the trustees taking a different view of what pay members should receive and acting accordingly.

114. Thirdly, the analysis could have practical implications for the Scheme Specific Funding regime in Part 3 of the Pensions Act 2004.

115. Whilst negotiating funding between the trustees and the employer is a difficult exercise at the best of times, it at least has the virtue that both parties are aiming for the same thing. Both the trustees and the employer want to see the benefits that have been promised to members funded and delivered. The debate is typically about the rate at which those benefits are funded and the risks that are taken in achieving a fully funded position.

116. The analysis of Mr Justice Morgan appears to mean that there is no reason why trustees cannot take a different view from the employer as to what the future level of benefits in the scheme ought to be and seek funding for that different benefit level. The negotiation then becomes not just about the rate and risks of funding but about the funding target itself.

117. This is not just theoretical. It is in fact what happened in the *British Airways* case itself where the funding negotiations became as much about what assumption to make for future benefit improvements as about funding existing benefits.

Conclusion

118. Whilst rejecting BA's arguments on the commercial purposes of an occupational pension scheme, Mr Justice Morgan also granted permission to appeal to BA on the two issues of benevolent payments and improper purpose.

119. These are due to be heard by the Court of Appeal at the beginning of May 2018.

120. There may consequently be more clarification to come on what the purposes of an occupational pension scheme~~s~~ actually are for which scheme powers, including both bilateral and unilateral powers of amendment, can be exercised. What is particularly important is that a clear analysis is provided of what the necessary connection actually is between a scheme and the employer and what the significance of the fact that the scheme

is performing an important commercial function for the employer has on the application of the proper purposes doctrine in this context.

121. In the meantime, there appears to be little (if any) prospect, applying the approach of Mr Justice Morgan in the *British Airways* case, of setting aside decisions taken by employers or trustees on the grounds of an improper purpose, provided those exercising the power comply with the actual terms of the trust deed and rules.

LECTURE 2

RPI, CPI and beyond

Michael Tennet QC, Emily McKechnie and James McCreath

Introduction

1. We are all involved in cases on either side of this debate. For that reason, we do not intend in this paper to express our views on the subject, but to set out factual material and arguments which arise from it.

2. Since the Government's decision to replace the Retail Prices Index ("RPI") with the Consumer Prices Index ("CPI") for the purposes of statutory increases to pensions in payment and revaluation of deferred pensions, and the decision of Vos J in *Danks v Qinetiq Holdings Ltd* [2012] EWHC 570 (Ch) [2012] Pens LR 131 that it is permissible to use a power to select between indices in respect of accrued benefits as well as prospective benefits, the choice of which inflation index to use in pension schemes has been catapulted to the top of many agendas.

3. It is therefore commonplace now for practitioners to find themselves advising on powers to select the basis of indexation of benefits ("powers of selection"); powers which were perhaps included originally in an attempt to allow the scheme in question to adapt to changes in revenue practice and not prejudice their tax-approved status now offer to employers the valuable opportunity to move to a significantly cheaper basis of indexation. The issue has also now entertained the Courts on a number of occasions - in *Arcadia Group Ltd v Arcadia Group Pension Trust Ltd* [2014] EWHC 2683 (Ch), twice (so far) in *Buckinghamshire v Barnardo's* [2015] EWHC 2200 (Ch) [2015] Pens LR 501, [2016] EWCA Civ 1064 [2017] Pens LR 2, and *Thales UK Ltd v Thales Pension Trustees Ltd* [2017] EWHC 666 (Ch) [2017] Pens LR 15 – as well as forming the backdrop to the BA case. There is more to come: *Barnardo's* is to become the second pensions case to go to the Supreme Court.

4. Very broadly, the issues raised in these cases can be divided into two categories, a division we intend to follow in this paper:

(1) 'Gateway' questions: schemes sometimes but not always have 'gateway' provisions which must be passed before the index can be changed, which raise questions of construction as to whether or not there is a power of selection, whether it has become exercisable, and by whom.

(2) 'Discretion' questions: there will then be a question as to how the discretion to select or change an index, usually but by no means always vested in the Trustees, should be exercised so as to choose the index to apply.

5. As with any comparable power, any discussion of what the relevant considerations are when exercising a power of selection inevitably involves asking what the purpose of that power is. Given that we are considering a particular power, it does not follow that the answer to that question will be the same as the answer to the more general question considered in the first paper, as to what the general purpose of a pension scheme and a power to amend is.

6. The answer that seems to have attracted Warren J in *Thales* is that the purpose is to protect members from the effect of price inflation; see para [20]. However, as the Judge recognised, that is a high level point, and not one which is of great assistance without more.

7. Putting the purpose in this way however does starkly raise the question as to what extent the employer's financial position, and its desire to reduce the cost of providing benefits by changing to a less costly index, can be relevant considerations in selecting an index. On one reading, Warren J in *Thales* at para [134] appears to suggest that only in exceptional circumstances could a cheaper index be selected so as to reduce costs to the employer. In that paragraph he was considering a power vested in the Trustees: if the reading suggested above is a fair one (and it is arguable that it is not), that raises the issue as to whether the employer can take account of its own interests when the power of selection is vested in it.

8. Whatever the relevance of financial considerations, however, it is apparent that the Trustees and/or the employer (as the case may be) must be able to satisfy themselves that any index they select is a suitable way of protecting pension benefits from inflation. It therefore behoves those of us advising on these issues to have some understanding of the technicalities of the indices, and the debates that are still raging amongst statisticians and behavioural economists as to the merits and demerits of CPI or RPI, or indeed the other indices that are available.

9. We stress though the 'some' in 'some understanding.' As we explain below, one of the interesting features of the *Thales* decision is that it is has to an extent clarified the scope of the understanding of the statistical debates which those exercising a power of selection can be expected to have.

10. The RPI/CPI debate is one on which a lot of money turns, and also arguably to an extent emotion; for all the flaws statisticians attribute to it, RPI retains a familiarity which along with its financial benefits ensures its continued popularity among members.

11. It is therefore one that is likely to stay. Leaving aside the possibility of some legislative override, it is not one however which is likely to remain the same. For example:

    (1) The composition of the indices continues to be updated and changed. For example, the house prices index used in the calculation of RPI in March this year was changed from the 'House Prices Index' to a superior new index, the 'UK House Prices Index', the only change in recent years which Warren J in *Thales* considered to be 'material' within the meaning of the rules of the scheme in that case.

    (2) The Digital Economy Act 2017 has granted the Office of National Statistics ("ONS") new and extensive powers to acquire information about consumer spending. While it will no doubt take time for appropriate systems to be put in place to allow data gathered with such powers to be collected and used, these powers offer the possibility that at some stage the differing statistical methods used in RPI and CPI where data is not available – which explain in part the different characteristics of the indices – will give way to actual data – reducing the difference in their behaviour.

    (3) New indices continue to be developed and introduced. Indeed, just as CPI has over the years supplanted RPI for at least some of its functions, now too it has been supplanted for at least one of its; from March this year, it was replaced as the ONS's headline rate of inflation by CPIH, an index which is identical to CPI save that it includes a way of measuring housing costs.

“Gateway” provisions

12. In this section, we set out the principles that govern the construction of these kind of provisions, and then consider three typical examples of such provisions: clauses that are triggered by RPI being “replaced”, clauses triggered by it being “changed”, and clauses triggered by it being “materially changed.”

The Principles of Construction

13. As with the construction of any provision of a pension scheme, the starting point in construing “gateway” provisions is that ordinary principles of construction apply; see for example *Barnardo’s*, para [8].

14. There are, however, certain glosses that can be put on those principles. The first three come from *Barnardo’s*, para [10], and are familiar:

“There are, however, at least three points of special relevance to the interpretation of pension schemes. First, all or almost all pension schemes are intended to be tax efficient and to comply with Inland Revenue requirements. So Inland Revenue requirements are relevant to their interpretation. Secondly, pension schemes should be interpreted to have reasonable and practical effect. Thirdly, since the rules of a pension scheme affect all those who join it (in some cases many years after its inception) other background facts have a very limited role to play.”

15. The last two we will deal with are less familiar, and emerge from the judgment in *Thales*.

16. The first of these addresses the question we have alluded to above about the scope of understanding which those exercising powers can be expected to have of statistical matters. To decide, for example, whether RPI has been “materially changed” requires a degree of statistical literacy, and there is no reason to suppose that the average trustee or employer will have that. While no doubt they will take advice, how in depth and specialist does that advice have to be?

17. Warren J answered that question in the following terms, at para [17]:

"The expert evidence has enabled me to acquire an understanding of the compilation of price indices, of their different purposes and of the merits and demerits of different indices. I must be careful, however, in the use of that understanding when approaching the issue of construction, not to impute the understanding which I have gained to the relevant users of the Rules. In this context, the relevant users are the Company and the Trustees in which are vested the discretions to adopt a different index of basis of determination of variations to pensions. They are not experts in the field. In deciding whether [the relevant gateway provisions had been passed], they will need to take expert advice; they will need to take such advice as well in order to determine the nearest alternative index or the basis for ongoing benefit improvements. I do not consider it right to expect the Company or the Trustees to take advice (or be compelled to take advice in order to carry out their duties) from persons with the level of expertise of Mr Johnson [the Company's expert, whose qualifications were set out at para [13] of the judgment] and Ms Leyland [the Trustee's expert, whose qualifications were set out at para [14]]. It cannot be right to expect them, through their advisers, to drill down into the sort of detail with which I have been provided, every time they need to consider whether [the relevant gateway provisions had been passed]. A broader-brush approach is required, an approach which allows the Scheme to be operated in an administratively sensible and commercial way."

18. Thus it will be necessary to take advice, but there is no need to get very detailed advice from the most eminent of statisticians or economists.

19. The <u>second</u> gloss ties in with what we have said already above about the purpose of these provisions. It is very tempting to approach provisions such as these secure in the knowledge that, as we all know that the purposes of indexation is to "protect members from the effect of price inflation", the provisions should be construed purposively with that in mind: in other words, they should be construed so as to maximise flexibility to allow that purpose to be fulfilled.

20. Warren J, to an extent, warns us off an approach such as this in *Thales*. Rather than assume that such is the purpose of rules and construe them on that basis, instead the proper approach is to construe the rules themselves in order to determine how *in the particular case of the*

scheme in question, the draftsman has chosen to afford members protection from price inflation. In other words, there is no set way in which it is right to provide that protection; it all turns on the construction of the particular provisions. Warren J put it as follows at para 20:

"As Mr Green submits, abstract appeals to the purpose of the provisions being to "protect members from the effect of price inflation" (as it is put in the Company's skeleton argument) are empty without an attempt to see what provision is actually made in these particular Rules as to how that should be done. Of course the purpose of the provisions is, at a high level, to protect members from the effect of price inflation. Both RPI and CPI achieve that. The question is how is that protection to be afforded; and that is a matter of construction of the relevant rules which do not spell out in unequivocal terms how it is to be done."

Replacement

21. One not uncommon category of clause talks of RPI being *"replaced"* or of switches being permitted to a *"replacement"* of RPI.

22. Barnardo's is a topical example of precisely such a clause. The relevant provision in that case provided for uprating to take place by reference to the following defined term (see paragraph 8(vi) of the first instance judgment) (our emphasis):

"Retail Prices Index means the General Index of Retail Prices published by the Department of Employment or any replacement adopted by the Trustees without prejudicing Approval."

23. A close cousin to these clauses which appears in other Schemes is 'gateway' provisions that apply when RPI ceases to be 'published.'

24. The argument that is run on these clauses relies on the contention that RPI has now been 'replaced' for many of its functions by CPI. The headline rate of inflation, inflation targeting, uprating of benefits, and statutory indexation all now occur by reference to CPI or one of its derivatives, whereas previously they were done by reference to RPI or its derivatives. Even though RPI continues to be produced and used for other purposes, it is sometimes even suggested that it has ceased to be published; an argument usually based on the fact that it is no longer the headline rate of inflation, and was in 2013 de-designated as a National Statistic.

25. There are obvious difficulties with these arguments. As to 'replacement', it is difficult to disagree with the analysis of Warren J in *Barnardo's* that allowing anything short of discontinuance to count as 'replacement' is too imprecise to be of practical use (see paragraphs [75] – [77]). As to 'published', the argument appears to be compellingly rebutted by the fact that RPI – while no longer enjoying the status it once did – is still published.

26. Indeed, there appears little prospect of that changing. RPI is used for fewer functions than it has been in the past, but it is still used for a wide variety of purposes. There are government bonds linked to RPI that go out to the 2060s. As an index, it is here to stay.

27. *Barnardo's* gave rise to a more interesting question as to who has to do the replacing. The words are capable of two interpretations:

    (1) RPI or any index that both (a) replaces the RPI and (b) is adopted by the Trustees; or

    (2) RPI or any index that is adopted by the Trustees as a replacement for the RPI.

28. Both Warren J and the Court of Appeal considered that (1) was correct. Whether or not they were right to do so is now going to be decided by the Supreme Court. To the best of the authors' knowledge, the representative beneficiary has applied for permission to cross-appeal on the question whether s.67 of the Pensions Act 1995 applies to provisions which permit a change of the index used for indexation purposes, thus preventing such a change being made in respect of benefits accrued by service prior to such a change. That of course involves challenging the correctness of *Danks v Qinetiq Holdings Ltd* [2012] EWHC 570 (Ch), [2012] Pens LR 131.

"Changed"

29. Provisions in this category permit an alternative index to be selected in the event that RPI is "changed" or "altered" in some way.

30. What is sufficient to constitute such a change or alteration?

31. What may seem like a trivial question becomes immediately complicated once the nature of an index is understood. RPI, like any well-maintained price index, goes through frequent "routine" changes to its composition. For example, every year, the basket of goods and services whose prices are monitored in the index is updated to reflect changes in consumer spending. Can "changes" such as these, which are inherent to the operation of the index, really have been intended to permit an alternative index to be chosen?

32. Those changes can be contrasted with non-routine, one-off changes to the methodology. These might involve for example new methods of data collection (going beyond simple improvements of the kind which are instigated every year), the introduction of new categories of spending (such as the introduction of council tax in the mid-1990s), or potentially even a change in mathematical approach (in 2012 ONS proposed, a proposal subsequently abandoned, to change the formula used in the construction of RPI).

33. There are two changes in particular in recent years. One is relatively historic, from 2010, and is frequently encountered in cases such as these. The second is more recent, from 2017.

34. The first was a change in the method of collecting clothing prices. Collecting clothing prices poses a challenge for those constructing an index; for prices over time to be compared, it is necessary to have a policy defining which categories of item will be treated as the same from one month to the next. For many items, this is simple: a pint of milk is a pint of milk, and a pack of apples is a pack of apples.

35. Clothing however is difficult. Styles change frequently as fashion changes, and deciding whether a new item should be treated as comparable to an item now out of fashion is not straightforward. The difficulty is compounded by the fact that there are frequent sales in clothing, causing prices to oscillate more than in other sectors.

36. Prior to 2010, the UK had generally reported lower inflation in clothing than comparable European countries, for no obviously good reason. To address this, the ONS changed its guidance on collecting prices, permitting more items of clothing to be treated as comparable to one another. This was thought of as a minor change in methodology.

37. It did not however have a minor effect: it caused the value of RPI to increase by around 0.5% every year, and widened the gap between RPI and CPI. We return to this in the next section, dealing with 'materiality.'

38. The second change was a change made in 2017 to the index of house prices used in the compilation of RPI. Previously, RPI had used the Office of National Statistics House Price Index, which had four relevant features:

(1) It was based solely on data from mortgage lenders;

(2) The set of properties was based on a reference set from 2000;

(3) Price information for Northern Ireland was included; and

(4) Whether the mortgage application recorded a purchaser's income to be in the top 4% of households by income, the index excluded those transactions (consistently with the exclusion of spending by such consumers in RPI more generally).

39. The ONS HPI was far from perfect:

(1) The data in question did not allow the prices of new properties to be included;

(2) Because it was based solely on data from mortgage lenders, it excluded properties bought for cash, which make up a substantial part of the transactions;

(3) The reference set of properties dated back to 2000.

40. In light of these deficiencies, the ONS developed a new index for housing prices, the UK House Price Index, which addresses these problems, and which has been used in the calculation of RPI since 27 March 2017. This is based primarily on data from the Land Registry.

41. While the UK HPI appears to be universally accepted as a 'better' index than its predecessor, it does involve some significant departures:

(1) Purchases by the top 4% of households by income are no longer excluded, as the data used does not allow them to be identified; and

(2) Data from Northern Ireland is not used in the compilation of the index, because of difficulties in obtaining it timeously.

42. What then can constitute a change to RPI, triggering the availability of a power to alter the index? Is it only a non-routine change? If so, do all such changes count, or only some of them? What is the dividing line – is it changes of sufficient importance or materiality to justify consideration of an alternative index?

43. This issue was raised in *Thales*. To understand how, it is necessary to explain a little bit about that case. That case concerned two quite different provisions, both of which uprated benefits by reference to RPI, but which contained different 'gateways' permitting a change away from it:

(1) There were provisions governing ongoing 'CARE' accrual – the 'CARE provisions'. The gateway provision there required the 'compilation' of RPI to be 'materially changed' before a power to change index arose. We consider this question in the next section.

(2) There were legacy provisions governing historic final salary accrual, known as the 'TOPS' provisions. The question in respect of these rules was whether RPI had been 'otherwise altered', raising squarely the question we are considering in this section.

44. The Trustee, representing the members, argued that "otherwise altered" required a change which went beyond the maintenance of or a routine change to RPI, and instead changed the essential character of RPI. Otherwise, the 'gateway' would be in reality an open door, as the circumstances permitting a change would prevail year after year after year.

45. The employer argued to the contrary that "altered" should simply be given its ordinary meaning: the Oxford English Dictionary says that something has been "altered" if it is "made

different in some respect, changed." Had the draftsman envisaged a qualification as to the significance of the changed required, he would have said so.

46. Warren J agreed with the employer. He held at paragraph [126]:

"In my judgement, the phrase "otherwise altered" is to be given the wide meaning for which Mr Ham contends. Although there is force in Mr Green's argument that an alteration does not include a routine change of the type already mentioned many times in this judgment, I do not consider that it carries the day. In effect, Mr Green asks me to construe "otherwise altered" as meaning "otherwise materially altered" in the same way as a change to the compilation of the RPI must be a material change for it to be replaced under the CARE Rules. I do not consider that it is correct to limit the meaning of the ordinary English word "altered" to arrive at that result."

47. The consequence of this holding is that Warren J considered that the concept of an "alteration" to RPI – which appears indistinguishable from that of "change" – was sufficiently wide to encompass the annual updates to the basket of goods and services, as well as more unusual or significant changes (see his definition of "routine" at paragraph [123]).

48. On the facts of *Thales*, that holding did not lead to practical difficulties. That was because there was a subsequent provision directing the Trustees to determine the basis for uprating benefits *"having regard to the alteration made."* Hence, Warren J held, while a routine change might open the gateway, it would not lead to it inevitably being walked through; such a change should not, having regard to it, lead the Trustee to depart from RPI. Only changes which make a material difference should have that effect (see paragraph 129).

49. Such a construction could be more problematic where the discretion to choose a new index is not trammelled in this way. Why should a routine change provide an opportunity for a move away to an index which is potentially less beneficial to members? Did the draftsman really intend minor events such as that to have such significant consequences? Those questions would become even more pressing if the provisions conferring a discretion to choose a new index on their proper construction excluded RPI as an object.

50. Before we leave the subject of "change", there is a further gloss on this. That results from a decision made by the ONS in 2013, commonly referred to as a decision to "freeze" RPI. A statement from the National Statistician in March 2016 referred to that decision in the following terms:

"The RPI would continue to be maintained through routine changes. This covers all changes required to continue production of a consistent, fit for purpose RPI (for example the annual update of the basket and weights, computer systems upgrades and improvements to data validation and quality assurance methods). With due consideration to the requirements of the Statistics and Registration Services Act 2007, ONS would only consider making methodological changes to the RPI if to not do so would inhibit the improvement of CPIH and the Consumer Prices Index."

51. This appears to indicate some sort of intention to change ONS's approach to making changes to the RPI, but it suffers from one small problem: absolutely no one appears to know what it means. As Warren J put it at paragraph [65] of *Thales*, by reference to the expert evidence before him:

"In my judgment, the "freeze" is so opaque and its consequences so unpredictable that it cannot sensibly be described as a change in compilation at all."

52. The line between "routine changes", changes which if not made "would inhibit the improvement of CPIH and the Consumer Prices Index", and other changes is not at present possible to distinguish. Plainly, changes can still be made to RPI: the change in the housing prices index earlier this year is an obvious example of such a change.

53. This does not mean that the "freeze" however can be ignored. In particular, it may at some stage in the future lead ONS to decide <u>not</u> to adopt a methodological change to RPI which it would otherwise have implemented. That may give rise to an interesting question as to whether or not a deliberate decision to keep RPI as it is can constitute a "change" or an "alteration."

“Material change”

54. The third and final kind of “gateway” provision we consider is that which requires some form of change, but qualifies it. *Thales* provides a good example, where in the case of the CARE provisions, the “compilation” of RPI had to be “materially changed” before the gateway opened. Thus the provision was as follows (see paragraph [8]):

"If the Government retail prices index for all items is not published or its compilation is materially changed, the Principal Employer, with the agreement of the Trustees, will determine the nearest alternative index to be applied."

55. The argument in *Thales* centred on whether ‘materiality’ was to be judged by reference to the methodological significance of the change, or by reference to its effect. The clothing change we have already described poses that dilemma acutely. Methodologically, it was a tiny change. But in effect, it was substantial: it increased the rate of inflation, and it set in train the series of events that saw RPI have its status as a national statistic withdrawn, and which led to the decision to “freeze” it.

56. Warren J went firmly for the former. He held, at paragraph [84]:

“A change is material, I suggest, if it results in the RPI functioning and operating in a way which either does not fulfil its original purpose (to provide a measure of inflation for the typical household) or does so in a way which is materially different from the way in which it did so before the change.”

57. One reason that Warren J gave for this conclusion was practical. As the evidence in front of him reflected, the effect of a change in compilation can vary over time. Thus he considered:

[48] ….If the effect of a change in compilation is to be taken into account, the Company will need to engage in a constant monitoring of the RPI. It will not be enough to look each year at the changes in compilation but it will be necessary to examine on a regular basis precisely how and why the level of the index has changed and the extent to which particular past changes (perhaps a considerable time in the past) have had an effect

on that level. The Trustees too, in deciding whether to agree to the Company's determination, will need to consider the same matters in order to satisfy themselves that there has been a material change in compilation.

[49] In contrast, if effect is not relevant, then all that needs to be done is to consider changes in compilation. Routine changes of the sort which I have already mentioned to keep the index fit for purpose can be ignored: indeed, on one view it would not be necessary even for the Company to consider these changes but only to satisfy itself that no changes other than routine changes have been made. Changes of a non-routine nature would be likely to be given some publicity and would no doubt come to the notice of the Company's and the Trustees' professional advisers and be taken account of accordingly.

58. On that basis, Warren J preferred the practical consequences of only looking at methodology.

59. But he also considered that determining "materiality' by reference to methodological significance rather than effect was the better interpretation of the rules: the question under the rules was whether the <u>compilation</u> was materially changed. There was no reference whatsoever to 'effect' (see paragraph [43]).

60. He did however in the same paragraph raise the possibility – presumably notwithstanding his practical concerns – that different words could bring about different conclusions. For example, he posited the example of words requiring a 'material change in the index', as being a situation where it was arguable that effect was determinative.

61. So for even a very slight modification in the wording used, the precise meaning of 'material' is at the very least open for argument in future cases.

62. Turning to the application of his construction, Warren J thought that the only change in recent years that passed the materiality threshold was the change in the house prices index. The key factor in his judgment was the inclusion of prices paid by the top 4% of purchasers by income. He regarded this as a significant change to the treatment of a significant component of RPI: see paragraphs [75] and [85].

The exercise of a discretion to select a new index

63. Moving on then from the gateway provision, once the power to select a new index has been triggered, a discretion will arise as to whether or not to replace RPI with CPI (while other indices do exist, they invariably do not appear to appeal to employers).

64. At this stage, there will be a number of difficult considerations which the donee of the power will have to grapple with. And that exercise is likely to take place against a backdrop of strong emotions, with the employer wanting to save a significant amount of money by switching to CPI, and the members wanting to preserve the more valuable uplift by reference to RPI. Few issues appear to raise such strong emotions than the apparently technical choice of an uprating index.

65. We cannot in this paper seek to address each and every factor that may or may not be relevant to the exercise of the discretion, but have sought to identify the factors which are likely to cause the greatest difficulty.

(1) The purpose of the power of selection

66. As with the exercise of any power, the first issue which arises is to ask what the purpose of that power is.

67. The obvious starting point is that the purpose is to protect members against the effects of inflation.

68. *Barnardo's* per Warren J at §78:

"The Rules provide for increases to pensions in payment and in deferment: the purpose of such a provision is to protect the members to some extent at least from the effects of price inflation. The definition of "Retail Prices Index" is there to provide a measure by which those increases are to be awarded. A power to switch the index, if such a power exists, ought properly to be exercised only to ensure that the index in use best reflects the policy of providing protection from inflation."

69. But that obvious starting point flatters to deceive in its apparent straightforwardness. The term "inflation" is, on analysis, a much more complicated one than one might imagine, and different groups will experience inflation differently. This raises technical statistical issues the details of which go beyond the scope of this paper, but which may need to be grappled with in the context of some schemes.

70. One point that can be made however is that the use of RPI and CPI to protect against inflation is somewhat different to protecting members against an increase in the "cost of living." While the phrases are used synonymously in layman's speech, to a statistician "cost of living" is a technical phrase denoting the cost of achieving a given level of welfare.

71. Neither RPI nor CPI seeks to be a cost of living index (although some say CPI has hallmarks of one). A true "cost of living" index would recognise that as the cost of one good increases, consumers will maintain their welfare without suffering the full effects of the price rise by substituting a cheaper good which offers the same welfare for a lesser price. RPI and CPI do not seek to measure this, instead measuring the change in prices of a typical basket of goods and services (see the discussion of this by Warren J at paragraphs [19] – [20] of his judgment in *Barnardo's*). Thus they will give a result which is higher than a true "cost of living" index.

72. That however is not to say that it follows that they are both overly generous. A "cost of living" index in this narrow sense would be not just practically unachievable, as 'welfare' cannot be measured, but would in any event not allow pensioners to benefit from increases in standards of living over time. Again, the details of the technical debates are outside the scope of this paper, but it could be said that both RPI and CPI in fact fail to allow pensioners to maintain relative living standards over time.

73. Turning from these general considerations to more particular ones, scheme documents will often state that benefits are to be uplifted by reference to RPI unless and until the power of selection is exercised. That raises an issue as to whether RPI should enjoy some special status because it is named expressly under the rules.

74. In the ordinary course, it is unlikely that the mere mention of RPI will elevate its status. Reference to RPI may be nothing more than an attempt to use plain English to describe the

basis on which benefits are uprated, against a background where RPI was the only price index in existence for many years.

75. Recognising this fact, in *Barnardo's* Warren J focussed at a higher level on the role of a price index, concentrating on its status as an officially published index of prices rather than its component parts (§60):

"…the replacement must, in my view, be one which has the same status as RPI at the time of the 1988 Rules, namely an officially published index. For this purpose, the various indices currently compiled by the ONS are officially compiled and the ONS itself is a relevant authority. Further, not only must the replacement index be of the same status, but it must also have the same purpose. By that, I mean that the index must be a measure of price inflation by reference to a basket of elements and not some different index, such as a measure of wage inflation. Its purpose, however, is to be assessed at a fairly general, and not at a detailed, level; the selection of elements to go into the basket and the statistical techniques by which an index is created are, in that sense, matters of detail which do not feature in identifying the purpose of the index at this general level."

76. This is not surprising. To define the purpose of indexation by reference to the narrow characteristics of RPI would be, effectively, to hardwire RPI into the rules irrespective of whether this is necessitated by a true construction of the rules.

77. But that point of course is subject to Warren J's observation in *Thales*, quoted above, that provisions relating to price increases must be construed on their own terms, to determine what provision *they* make as to how protection from inflation is to be afforded. The words used *may* indicate that an index, whether RPI or some other index, does indeed have an elevated status in the rules.

78. For example, suppose that the specified index is not RPI, but some specific wage-tracking increase. On the face of things, that would seem to be a pretty powerful pointer that the primary intention is to protect members not from inflation per se, but from overall erosion of their purchasing power on retirement relative to the rest of the population. That would suggest that there is not free range to choose between indices: the starting point should be an index that achieves those purposes.

79. As another example, it is not uncommon to see a gateway provision followed by some restriction on the discretion requiring the new index to be chosen 'having regard' to the way in which the gateway is passed, or something to that effect: that was the case with the provisions in *Thales*, for example. In such cases, the elevated status of the original index may be clear from the words themselves.

(2) The purpose and the relevance of affordability

80. In the real world, however, employers do not want to move away from RPI to CPI because they have a preference for the statistical properties of CPI as a better measure of inflation. Their real reason for exercising a power of selection, or requesting that trustees do so, will be because it will save them money; often an awful lot of it.

81. But that gives rise to a problem: if the purpose of a power of selection is to protect members against the effects of inflation, is it legitimate to have regard to the employer's financial position?

82. When it comes to broader powers, like powers of amendment, or powers to impose contributions, we know from cases like *BA* and *MNRPF* that it is legitimate to look at the interests of the employer or employers under the Scheme.

83. But powers to choose an index are arguably different. They are narrower powers for a clearly understood and defined purpose – to provide protection against inflation – which the interests of the employer on the face of things have nothing to do with. Given that, is the power of selection in fact more circumscribed?

84. There appear to us to be two possibilities.

85. First, it may be said that the employer's financial position is relevant, but there is no power to select an index *simply because* it will save the employer money. What considerations as to the financial position cannot do however is 'trump' the narrower purpose of a power of selection: the donee may, depending on the circumstances, legitimately say 'we think both these indices protect members against inflation appropriately, but we will go for the cheaper

one of them on the basis that it is cheaper', but they may not say 'we think this index does not adequately protect members, but as it is cheaper we will go for it anyway.'

86. Second, affordability is irrelevant. The donee of the power of selection must take a view as to which index best achieves the purpose of protecting members against price inflation, and affordability has nothing to do with that.

87. As yet, this is not an issue that has been decided in the case law. There is however a dictum in *Thales* which on an initial reading appears to support the second, more purist, of these possibilities, at paragraph [134]:

"…the determination of a basis of pension increase under Rule 4.4.4(b)(i) is for the Trustees alone. They are, as under Rule 4.4.1(b)(i), subject to fiduciary obligations when making the determination: it would require exceptional circumstances for them to adopt an alternative index, such as CPI, in order to reduce the costs to the Company if, in so doing (as in current circumstances would be the case), they would be acting to the detriment of the beneficiaries of the Scheme. I accept, of course, that a change in the RPI may result in the Trustees having to choose a new index and that their practical choice may be between one, such as CPI, which saves the Company money and makes the beneficiaries worse off, and one, such as the RPI as altered, which costs the Company money and makes the beneficiaries better off. Their choice must be one which they can properly make in accordance with their fiduciary duties and must be made "having regard to the alteration". It is difficult to see how they could properly adopt an index acting under Rule 4.4.4(b)(i) unless it would also be within their powers under Rule 4.4.1(b)(i)."

88. It is far from clear however on a closer reading that this passage is an endorsement of that 'purist' view. Arguably Warren J is only addressing the prior question of whether a change can be made *solely* for the purpose of saving the employer cost. If so, what he says cannot be regarded as controversial, and it does not address the question of whether, *once* the trustees have identified indices all of which would provide appropriate protection against inflation, they can then take account of affordability in choosing between them.

89. There is also an indication the other way in the Court of Appeal judgment in *Barnardo's*. If affordability was irrelevant, then on the face of things there should be no difficulty at all in

using powers of selection to choose a *more* financially onerous index if events are such that that better protects members against the effects of inflation. However, Lewison LJ at paragraph [35] said the following:

"Mr Rowley also said that adherence to RPI has, as things turned out, been to the members' benefit, but things could have turned out differently with the result that pensions no longer kept pace with inflation. The implications of that submission, if correct, would be that the trustees had power to impose greater financial obligations on the sponsoring employer without obtaining the employer's consent. That is, in my judgment, an unlikely conclusion."

90. If the purist approach is the right one, that has obvious implications for trustees and employers considering a switch away from RPI: the 'real' motive for the switch in almost every case will not in fact constitute a relevant consideration.

91. It also has implications for the acceptance by trustees of the 'quid pro quos' which in practice a savvy employer will often offer in return for a switch from RPI to CPI: such as some improved funding package, or allowing accrual to continue.

92. Such 'quid pro quos' will often make Trustees feel easier about accepting such a switch. But on the purist view, it is not clear that they should make a difference. If the purpose of the power of selection is to provide protection for members against inflation, why are such 'quid pro quos' relevant to its exercise? What does their existence have to do with protection against inflation? Arguably, they do not promote that purpose and accordingly should not be relevant to the exercise of such a power.

93. In any event, it is clear that the suitability of any given index is a consideration of the utmost importance. The question then becomes, can we say whether RPI or CPI is more suitable for inflation-proofing benefits under a pension scheme?

(3) <u>Is RPI or CPI more suitable?</u>

94. Having posed the question, we do not intend to answer it. As we have said, we are involved in cases on both sides of this debate. What follows is an attempt to set out the most important

arguments commonly encountered. One view, of course, is that there is no good answer to this question: both are suitable.

95. The context in which the argument arises is that, although RPI and CPI are both measures of price inflation, based on a sample of representative goods and services, they have a number of crucial differences. These reflect, in part, their different backgrounds: RPI was developed in the UK as a measure of the inflation experienced by a typical household, while CPI is the UK's 'HICP' – Harmonised Index of Consumer Prices – a common measure of macroeconomic inflation introduced pursuant to the Maastricht Treaty as a precursor to European Monetary Union.

96. Three differences in particular are significant.

97. First, the two indices measure the inflation experience of quite different populations. RPI seeks to measure the inflation experience of a 'typical' household. To do so, it excludes data relating to those whose spending is not typical of the rest of the population; the top 4% of households by income, and pensioners dependent on state support for 75% or more of their income. It also excludes institutional spending (such as by care homes). It includes spending by UK tourists abroad, but excludes spending by foreign tourists in the UK.

98. CPI conversely seeks to measure inflation across the economy as a whole. Thus it does not exclude data for the categories excluded in RPI, and includes spending in the UK by foreign tourists, while excluding spending by UK tourists abroad.

99. Second, there is different coverage of goods across the two indices. Most significantly, RPI seeks to include the price of owner-occupied housing costs – such as mortgage interest payments and the costs of repairs, proxied by a measure of depreciation – whereas CPI excludes them.

100. Third, they have different statistical properties. In particular, at the 'elementary aggregation stage', when data for particular items is turned into the elementary indices which are subsequently combined to form the index itself, data is not available as to how much is spent on each kind of that item. Thus in creating the elementary index for apples' the ONS will know that different prices were paid for different apples, they do not know how many expensive

apples are bought compared to cheap ones, or how many are bought in a supermarket or a local store. Accordingly, they do not know how much weight to attach to a price rise in the expensive apples in the index for apples.

101. In the absence of such data, it is necessary to use mathematical formulae. RPI uses a formula called Carli, an arithmetical average, while CPI uses Jevons, a geometric average. It follows from the mathematical properties of these formulae that for a given set of data Carli will always provide a figure for inflation which is equal to or higher than that provided by Jevons.

102. The arguments, based on these differences, that CPI is more suitable tend to run as follows:

(1) It is appropriate to exclude owner occupied housing costs for uprating pensions, because that provides a more accurate reflection of pensioner spending. All other things being equal, a rise in interest rates will cause RPI to rise because of its effect on mortgage interest rates. Pensioners generally will not have a mortgage, and therefore do not require protecting from rising interest rates; on the contrary, they typically have large savings pots, and so will benefit from a rise in interest rates.

(2) It is sometimes argued that the population base of CPI is more likely to cover pensioners: that will depend on the makeup of the membership of a particular scheme.

(3) Proponents of CPI argue that it is a more accurate measure of inflation than RPI. Many economists argue that the use of Carli causes RPI to over-state inflation, and that has been exacerbated by the effect of the change to the collection of clothing prices in 2010 explained above. CPI thus avoids over-compensating pensioners.

(4) As a result of the use of the Carli formula, RPI has lost its national statistics status, and has prompted the ONS publicly to discourage people from adopting RPI for the future. This in turn has contributed to CPI being used to uprate public service pensions, as well as those private pensions incorporating minimum statutory revaluation and increases.

103. The proponents of RPI would accept none of the above. Instead, they would argue the following:

(1) The population coverage of RPI is *more* suitable for pensioners than that of CPI. The inclusion of the top 4% in CPI means that it is representative of the inflation experience of a household more than halfway up the income scale. How many pensioners really fall within this bracket?

(2) Owner-occupied housing costs – which are included in RPI but excluded from CPI – include not only mortgage interest costs, but also proxies for other costs, like repairs and so forth. These are costs that homeowners do in fact have to meet, and pensioners are more likely to be homeowners than the rest of the population.

(3) A proponent of RPI would not accept the criticisms of Carli above: they would say that those are the result of dry axiomatic analysis rather than real evidence. But in any event, even if RPI overestimates economy-wide inflation, they would say (i) that pensioners' generally experience inflation which is higher than average, and (ii), and in any event, CPI in certain circumstances underestimates even average inflation. The purpose of indexation is to *protect* against inflation, not provide increases that match inflation as closely as possible. You can at least argue that an index that gives a bit more than inflation does a better job of *protecting* against inflation than one that gives a bit less.

104. Behind these headline points, lies considerable technical statistical detail. Again, it is beyond the scope of this paper to explore that, but we hope the above is useful as a guide to the shape of the arguments which fall to be run under this heading.

LECTURE 3 (PART 1)

Public and European aspects of pensions law

What is the relevance of limits on the authority's powers?

Paul Newman QC

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Extrinsic contracts in public sector pension schemes: What is the relevance of limits on the authority's powers?

Paul Newman QC

Introduction

An employee of a public sector body enters into a contract with his or her employer promising enhanced benefits under a public sector pension scheme. In so promising, the authority exceeds or misuses its augmentation powers under the provisions of the pension scheme. Can the public body avoid the contractual obligation to the employee on the basis that the contract is *ultra vires* and therefore void and unenforceable?

This is not an uncommon occurrence in the field of public sector pensions. A typical example is where the employee and the authority agree terms whereby the authority agrees to exercise its discretion augment the employee's benefits under the pension scheme when he or she comes to take early retirement. When the employee takes early retirement, the authority declines to exercise the discretion to augment, claiming (for example) that it is too expensive. Accordingly, the employee cannot claim an entitlement to the enhanced benefit from the scheme administrators.

If this occurred in the private sector, where the employer was a company, the employee would have a claim in damages for breach of contract, on the basis that:

(1) where the company has a discretion to augment the pension under the scheme, but exercises that discretion not to augment in breach of contract, that will amount to a breach of the implied term in the contract that the employer will do all that is necessary to perform its obligations thereunder;[10]

(2) a contract made by a company is automatically *ultra vires* and void only where the company has no capacity to enter into it, in the sense of having no constitutional power to do so; if the company has the power to enter into the contract, but in so entering the contract it acts in excess or abuse of its powers, the contract is valid, unless the other contracting party has notice of the excess or abuse of power;[11]

(3) as the employer has the power to augment the benefit, but refuses to do so, that refusal constitutes an abuse of its powers, in that it is exercising them in breach of contract: provided (as will usually be the case) the employee is not aware of the abuse, the employer cannot avoid contractual liability on the basis that the contract is *ultra vires* and void.

The company law distinction between transactions beyond the powers of the corporate body, and those which are in excess or an abuse of existing powers, was once mirrored in the principles applicable to public bodies. Thus, a distinction was drawn between errors of law made within and outside the jurisdiction of public bodies, with only the latter errors rendering the decision in question a nullity.[12] Those distinctions were swept aside in the landmark House of Lords decision in *Anisminic Ltd v Foreign Compensation Commission* [1969] 2 AC 147, where it was held that errors made within the capacity of the public body in question also rendered that body's decision a nullity.

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[10] *Mackay v Dick* (1881) 6 App Cas 251, at 263 per Lord Blackburn.

[11] *Rolled Steel Products (Holdings) Ltd v British Steel Corpn* [1986] Ch 246 at 302-304 per Browne Wilkinson LJ.

[12] See *R v Northumberland Compensation Appeal Tribunal, ex p. Shaw* [1952] 1 KB 338 at 346 per Denning LJ.

The width of the public law grounds for avoiding transactions made in excess of existing powers of public bodies has led to numerous examples of public bodies avoiding (or evading) contractual obligations made with unsuspecting members of the public. These examples have covered pensions promises made by public bodies to their employees. However, this has caused disquiet amongst the judiciary, and has led some Judges to seek to row back from a strict application of public law principles to transactions which have a private law element. The current position has accordingly been described, in a recent unreported pensions case in which this issue was raised (but in the event did not need to be decided), as *a vexed question on which the law remains uncertain*.[13]

Application of the public law principle

Following *Anisminic*, contracts involving public bodies have been avoided on the basis of the general principles of public law governing the exercise of powers, such as: the requirement to have regard only to relevant matters;[14] the requirement not to exercise powers for an improper purpose;[15] and the requirement not to exercise powers irrationally.[16]

These principles have been applied to invalidate agreements relating to pensions and related employment terms. For example:

(1) in *Hinckley and Bosworth BC v Shaw* [2000] LGR 9, the council had agreed a redundancy package with an employee, under which the employee would receive a significantly enhanced salary for the final year of his employment. This was done in order to increase the employee's statutory redundancy benefits. It was held that this contract was entered into for an extraneous purpose, and not in order to fix the employee's rate of pay, and was *ultra vires* and void;

(2) in *Eastbourne BC v Foster* [2002] ICR 234, the council and employee agreed redundancy terms whereby the employee's employment was extended for an additional year. The purpose of this term was to extend the employee's employment beyond his 50th birthday, which would bring him within the eligibility for early retirement benefits under local government arrangements. It was agreed between the parties that the agreement was *ultra vires*. At first instance, it appeared that the Judge considered that the reasons which lay behind this were both that it provided the employee with irrationally generous payments and also that it was entered into for an improper purpose.[17]

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[13] *Police and Crime Commissioner for Greater Manchester v Butterworth* (unreported, 10 November 2016) at [25] per Jonathan Crow QC (sitting as a Deputy Judge of the High Court).

[14] An attempt by a police authority to vary the terms of an agreement so as to reduce the charges made to certain train operators was invalidated because the authority had failed to consider whether it could levy correspondingly higher charges against other operators: *London & South Eastern Railway Ltd v British Transport Police Authority* [2009] Po LR 157 at [46] per Collins J.

[15] In *Crédit Suisse v Allerdale BC* [1997] QB 306, an authority guaranteed the overdraft of a company as part of a scheme designed to evade borrowing restrictions imposed by central government; the guarantee was invalidated on the basis that it amounted to the pursuit of an improper purpose.

[16] In *Hazell v Hammersmith and Fulham LBC* [1990] 2 QB 697, an authority entered multiple complex financial transactions despite lacking officers with the training or experience to deal with such transactions, and without having taken any legal advice. It was held that the authority's actions had been irrational, and the contracts were therefore *ultra vires*.

[17] See per Rix LJ at [8]. See also the comments on the Judge's decision by Moses J in a later application in the same case: *Foster v Eastbourne BC* [2003] EWHC 948 (Admin) at [23]-[24].

Judicial disquiet

From time to time, Judges have expressed concerns about public authorities seeking to rely on these principles to avoid their contractual obligations to individuals or private bodies who were unaware of the excess or abuse of the authorities' powers.

For example, in *Stretch v West Dorset District Council (No.1)* (1999) 77 P&CR 342, Peter Gibson LJ said this (at 353):

> *It seems to me unjust that when public bodies misconstrue their own powers to enter into commercial transactions with unsuspecting members of the public, those bodies should be allowed to take advantage of their own errors to escape from the unlawful bargains which they have made. For a local authority to assert the illegality of its own action is an unattractive stance for it to adopt. It is the more striking when, as in this case, the transaction in question is as mundane as a building lease; and the local authority, by taking the point against the member of the public with whom it or its predecessor contracted, thereby robs that member of the public of part of the consideration for entering into the lease. I venture to repeat what I said in Credit Suisse v Allerdale Borough Council [1997] QB 306 at p. 344: As a matter of policy, there is much to be said for the view that a citizen who contracts in good faith with a governmental body should not have to bear the risk that the contract may be beyond the legal powers of that body.*

Judges have been similarly critical of public authorities arguing that their conduct was *ultra vires* because, for example, they had been irrationally generous. In *Newbold v Leicester CC* [1999] ICR 1182, Simon Brown LJ said this (at 1191):

> *… one may safely assume that no court is going to be astute to allow public authorities to escape too easily from their commercial commitments.*
>
> *That should particularly be the case where, as here, legitimate expectations have been aroused in the other party (who clearly entered the contract in good faith), where the relationship between the parties is essentially of a private law character, where it is the authority itself which is seeking to assert and pray in aid its own lack of vires, and where that lack of vires is suggested to result not from the true construction of its statutory powers but rather from its own Wednesbury irrationality. The burden upon the authority in such a case must be a heavy one indeed …*[18]

Thus, in *London Borough of Barking v Watts* [2003] ICR 1059, an employee received a pension for 30 years based on her automatic entitlement to a long service award. The council sought to reduce the payment on the ground that it had discovered the long service award should have been based on merit rather than provided automatically. The Ombudsman upheld the employee's complaint and Jacob J rejected the council's appeal, holding as follows (at [26]):

> *Suppose it was unlawful to give the award automatically but lawful to give it on proved merit. And suppose it was in fact given automatically but that, if it had been necessary to prove merit, Miss Watts could have done so. I cannot think it would be right to deprive her of her enhanced pension now because she was not required to prove her case for an LSA in 1969. Mr Goudie suggested otherwise - that the doctrine of ultra vires means that if an ultra vires award was made that is an end of the matter - it is just hard luck on Miss Watts that the award could have been made intra vires. I very much doubt that. Mr Goudie's reliance on cases where a Council*

[18] See also *Gibb v Maidstone & Tunbridge Wells NHS Trust* [2010] IRLR 786 at [6]–[7] per Laws LJ.

simply acted ultra vires and a third party suffered as a result (as in some of the interest-swap cases) is beside the point. The problem I have in mind is where a body acts ultra vires in favour of a party who (naturally) accepts the decision at the time but who, if he had been required or allowed to put his case, could have shown the body how to act intra-vires in his favour: the ultra vires act prevents an intra vires act.

A turning point?

The concerns identified in the above cases led the Court of Appeal in *Charles Terence Estates Ltd v Cornwall Council* [2013] 1 WLR 466 to indicate that a more flexible approach may be taken in cases where the public body has entered into a contract in excess or abuse of its powers.

In that case, the appellant company (C) had entered into arrangements with two local housing authorities (H) whereby C purchased identified properties and then leased them back for subletting to housing tenants, including vulnerable people in priority need. The respondent local authority (R) had taken over H's rights and liabilities, whereupon it reviewed the arrangements with C and stopped paying rent. C commenced proceedings against R for recovery of unpaid rents. R argued that H had breached their fiduciary duties by failing to have regard to market rents when agreeing the terms of the leases with C, and that as a result they had acted *ultra vires* such that the leases were void.

The Court of Appeal held that H was not legally required to have regard to market rents, but Maurice Kay and Etherton LJJ[19] went on to consider what the effect on C's claim for unpaid rent would have been had R established a breach of fiduciary duties by H.

(1) Maurice Kay LJ (at [17]) drew a distinction between public law proceedings at the suit of an interested party, and private law proceedings in which a public body sought to rely on its own breach of duty to escape its contractual obligations. The Judge said that, in the former type of case, a decision made in breach of fiduciary duty may be characterised as *ultra vires* and void, but the latter type of case was *"conspicuously different"*.

(2) The Judge (at [28]-[30]) accepted that *Credit Suisse v Allerdale, supra,* showed that there are circumstances in which a public authority can successfully invoke its own public law error as a defence to a private law claim, but a close analysis of that case demonstrated that the act in question was what the Judge described as "pure" *ultra vires*, giving rise to a lack of capacity: the authority did not have the power to enter into the transaction in issue.

(3) As regards the treatment of acts which were not "pure" *ultra vires*, the Judge (at [30]-[34]) identified a difference in the leading judgments of Neill and Hobhouse LJJ in the *Credit Suisse* case:

  (i) Neill LJ referred to the ending of the distinction in public law cases between decisions of public authorities which went to jurisdiction or capacity, and decisions which were vitiated by error within the jurisdiction,[20] and said that the distinction should not be introduced into the private law arena: all *ultra vires* acts were therefore void;

  (ii) Hobhouse LJ did not agree, and said as follows:[21]

  In resolving a private law issue it is always necessary to have regard to who are the actual parties to the issue. This may affect the analysis of the issue and

[19] Moore-Bick LJ (at [39]) agreed with both judgments.

[20] Citing the *Anisminic* case.

[21] [1997] QB 306, at 346-357.

> *the answer which private law gives to it. Some improper conduct of the decision-making body may be material within the broader spectrum of administrative law but it will not necessarily be material as between the parties to a private law dispute …*
>
> *… considerations of the knowledge of, or degree of notice to, a party who is asserting a private law right may be relevant to the question whether the right is enforceable against another where there has been some irregularity in the transaction which is alleged to have given rise to the right.*
>
> *Private law issues must be decided in accordance with the rules of private law. The broader and less rigorous rules of administrative law should not without adjustment be applied to the resolution of private law disputes in civil proceedings. Public law, that is to say, the law governing public law entities and their activities, is a primary source of the principles applied in administrative law proceedings. The decisions of such entities are the normal subject matter of applications for judicial review. When the activities of a public law body, or individual, are relevant to a private law dispute in civil proceedings, public law may in a similar way provide answers which are relevant to the resolution of the private law issue. But after taking into account the applicable public law, the civil law proceedings have to be decided as a matter of private law. The issue does not become an administrative law issue; administrative law remedies are irrelevant …*
>
> *[Counsel's] arguments make the error … of using administrative law language and concepts without making the necessary adjustments. It remains necessary to ask what amounts to a defence to a private law cause of action. Want of capacity is a defence to a contractual claim; breach of duty, fiduciary or otherwise, may be a defence depending on the circumstances. To say that administrative law categorises all grounds for judicial review as 'ultra vires' does not assist. In civil proceedings the question is whether, after taking into account the relevant public law, there is on the facts a private law defence. By a parity of reasoning, how a Divisional Court would have decided an application for judicial review and what remedy, if any, it would have granted in the exercise of its discretion is not material.*

(4) Maurice Kay LJ (at [37]) said that, in cases other than of "pure" *ultra vires*, Hobhouse LJ's analysis was to be preferred. There was no logical reason why the assimilation of the various types of public law error in administrative law should extend to the use of such an error as a defence to a private law claim. It would be highly undesirable if, years after time expired for the making of a prompt public law challenge by a person with a sufficient interest, a historical breach of fiduciary duty should inevitably lead to the defeat of a private law claim brought by a party which acted in good faith throughout.

(5) Etherton LJ substantively agreed with the distinction made by Maurice Kay LJ between different *ultra vires* acts of a statutory body: the Judge said (at [45]-[47]) that, if a transaction with a third party was beyond the capacity of a statutory body, it was void; if it was within that body's capacity, the transaction was not void even if it was a breach of duty.

(6) The Judge referred to the *"classic exposition"* of the corporate position by Browne-Wilkinson LJ in *Rolled Steel Products (Holdings) Ltd v British Steel Corpn, supra* who identified the *"critical distinction"* between acts done in excess of the capacity of the company on the one hand and acts done in excess or abuse of the powers of the company on the other, and who held that the latter acts would be valid provided that the other party did not have notice of the excess or abuse of powers.

(7) The Judge said (at [49]) that he saw no sound reason why the position should be any different where the issue is the validity of a commercial private law transaction between a corporation which is a public body and a third party. The Judge (at [51]) also favoured the analysis of Hobhouse LJ over that of Neill LJ in the *Credit Suisse* case.

Should *Charles Terence Estates* be followed?

Whilst the Court of Appeal's comments in *Charles Terence Estates* were *obiter*,[22] there are sound reasons for following and applying its analysis.

(1) To allow any act which would be *ultra vires* in the public law sense to be a defence to a contractual claim would cause considerable uncertainty as to the validity of commercial transactions between public bodies and otherwise-unsuspecting third parties.[23]

(2) There is no principled connection between the application of the *ultra vires* doctrine in the Administrative Court, and its application in private law cases. In public law cases, it is not enough just to ask whether the relevant act was *ultra vires*: the claimant must show that he has standing to bring the claim; he must bring the claim promptly; and the remedy he seeks may be refused in any event as a matter of the Administrative Court's discretion. Yet none of those matters are relevant to a private law defence of want of capacity. Thus:

    (i) whereas public law cases must be commenced promptly and within three months,[24] transposing the public law concept of *ultra vires* into the private law on void contracts would result in contracts being declared void many years after they were concluded;

    (ii) the absence of discretion in private law remedies would mean that, by applying the public law doctrine of *ultra vires* to law on void contracts, Courts would be compelled to declare contracts void, even where they considered this to be unjust or contrary to the public interest or to the need for commercial certainty in contractual relations;

    (iii) the public law discretion can be exercised so as partially to uphold and partially to quash the relevant administrative act,[25] whereas there is no such concept of partial *ultra vires* incapacity in private law.[26]

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[22] Although Etherton LJ's approach has been adopted by HHJ Waksman QC (sitting as a Deputy Judge of the High Court) in *Pro-Vision Systems (UK) Ltd v United Lincolnshire Hospital NHS Trust* (unreported, 21 February 2014) at [176].

[23] This is illustrated by the principle that the law will strive to protect innocent third parties who have relied upon the apparent validity of an *ultra vires* act: *White v South Derbyshire District Council* [2013] PTSR 536 at [37] per Singh J.

[24] CPR r.54.5(1).

[25] See, for example, *Agricultural, Horticultural and Forestry Training Board v Aylesbury Mushrooms Ltd* [1972] 1 WLR 190.

[26] *Haugesund Kommune v Depfa ACS Bank* [2012] QB 549 at [135] per Etherton LJ.

(3) There are more general policy reasons - such as the promotion of a consistent application of legal principles - for assimilating the private law rules on capacity and void contracts for private companies and public bodies.

However, there remain difficulties with a straightforward application of the Court of Appeal's analysis.

(1) The Court was not referred to leading authorities, such as *Hinckley and Bosworth BC v Shaw*, *supra* and *London & South Eastern Railway Ltd v British Transport Police Authority*, *supra*, where the issue was directly in point.

(2) Etherton LJ's assertion that he could see no sound reason why the position should be any different for public authorities as compared with the position for companies, requires closer analysis:

   (i) For example, it might be thought more important to protect public funds from misuse than corporate funds;

   (ii) in any case, the position of public authorities is materially different as a matter of law, as private parties contracting with public authorities can in many cases protect themselves against a defence of *ultra vires* by using the certification process under s.1 of the Local Government (Contracts) Act 1997, which will protect the contracting party from any *ultra vires* defence;[27]

   (iii) moreover, the *ultra vires* principle applicable to companies has been abrogated by a series of provisions under the Companies Act 2006, in order to ensure the security of transactions between companies and those with whom they deal.[28] Thus, if the validity of contracts entered by public authorities were in future to be governed by the common law principle set out in *Rolled Steel Products (Holdings) Ltd v British Steel Corp*, that would not create consistency between public and corporate contracts.

Other cases

The case law around the time of, and subsequent to, *Charles Terence Estates* has, if anything, rendered the law on this issue even more uncertain. Two cases in particular require consideration.

The first is the decision of the Supreme Court in *Lumba v Secretary of State for the Home Department* [2012] 1 AC 245, which was decided the year before *Charles Terence Estates*, but was not cited in that case.

Although the facts of *Lumba* were very different, the Supreme Court reasserted the *Anisminic* approach to treating a flawed decision within the capacity of the public body as a nullity, and did so in the context of a private law claim. This is contrary to the approach of Hobhouse LJ in *Credit Suisse*, as adopted by the Court of Appeal in *Charles Terence Estates*.

In *Lumba*, a foreign national prisoner continued to be detained at the expiry of his sentence, purportedly under statutory powers to detain pending deportation. He sought judicial review of his continuing detention, a mandatory order for his release, and damages for false imprisonment. The majority of the Supreme Court held that his detention was unlawful because the Home Office had

[27] Although this process is only available for particular types of contracts, and does not cover typical employment contracts.

[28] For example, s.31(1) of the Companies Act 2006 Act provides that a company's objects are unrestricted, unless its articles of association specifically restrict those objects.

taken account of an irrelevant consideration in deciding to detain the prisoner, in the shape of an unlawful policy. This was not a case of lack of capacity, as it was expressly held[29] that the prisoner would inevitably have been detained had the lawful, published policy been applied in his case. Nonetheless, his detention was held to be unlawful, because there was no lawful decision to detain him.

The argument for the Secretary of State, which was rejected by the majority of the Supreme Court, was that only legal errors which were in fact causative should be treated as invalidating the detention, so that a detention which could have lawfully occurred had the existing policy been adopted should be held to be valid. The majority held that this argument was contrary to principle, both as a matter of tort law and as a matter of administrative law. On the latter point, the majority considered that, so long as the public law error was material, all such errors had the effect of rendering the executive act in question *ultra vires*, unlawful and a nullity.[30]

Whilst reaffirming the *Anisminic* principle, *Lumba* was a case about the tort of false imprisonment, not a contract case. The Secretary of State's argument effectively sought to introduce a new public law principle of causation into the private law test for false imprisonment, so as to avoid tortious liability. This is not dissimilar to a public body seeking to avoid a contractual obligation by invoking a public law defence. A Court may therefore seek to distinguish *Lumba* so as to prevent in a contract case the very outcome which the Supreme Court was striving to avoid in the tort case.

One point of distinction is that the tort of false imprisonment has as one of its elements the requirement that there is no lawful justification for the imprisonment. Given that requirement, it is not surprising that a decision to imprison which breaches public law is not "lawful" for this purpose, even if there is a statutory power to imprison. This can be contrasted with contract cases, which concern the contract law doctrine of lack of capacity, and which should be decided on private law rules rather than purely public law principles.

The law is not made any clearer as a matter of principle by the latest case on the subject, *Central Tenders Board v White* [2015] BLR 727, a decision of the Privy Council. In that case, the authority had accepted a tender for a building project despite the tenderer failing to comply with the authority's instructions that all tenderers must state, on their form of tender, what the duration of the works would be.

The authority was found not to have departed from its own procedures, as its procedures permitted non-conforming tenders to be considered. However, Lord Toulson went on to consider the position had there been a procedural irregularity on the facts, stating as follows:[31]

(1) there is a difference between a case of procedural irregularity in the formation of a contract of a kind which a public body has power to enter, and a case of a public body purporting to conclude a contract of a kind which it has no power to make;

(2) any attempt to nullify a contract entered into following a procedural irregularity would have to be assessed in the light of the seriousness of the breach and the degree of any injustice and public inconvenience which may be caused by invalidating the act, as well as any alternative remedies available to a person legitimately aggrieved by the conduct of the public body;

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[29] At [59]-[60] per Lord Dyson.

[30] See, in particular, per Lord Dyson at [66] and [87] and Lord Kerr at [247]. In the course of his judgment, Lord Dyson (at [70]) specifically rejected one of the main points relied upon by the Court of Appeal in *Charles Terence Estates*, namely that the tighter time limits and discretionary remedies available in judicial review sit uneasily with the application of public law principles in a private law context.

[31] at [19]-[26].

(3) it would be a serious denial of a party's rights to invalidate a contract because of a procedural defect in the contractual process, and would offend against orthodox principles of private law (contractual rights) and public law (the right not to be deprived of property without compensation);

(4) it would be wrong for a court to quash an administrative decision in such a way as to nullify a contract made between a public body pursuant to a legal power and a person acting in good faith, except possibly on terms which adequately protected that person's interest.

Lord Toulson concluded that a failure by the authority to follow its own procedures for entering a contract would not render the agreement *ultra vires* and void.

Lord Toulson's comments were obiter, and made without the benefit of detailed argument.[32] Yet they serve to reinforce the view adopted in *Charles Terence Estates* that public law errors, short of a lack of capacity, should not be used in the private law field to invalidate contractual obligations.

Conclusion

The assimilation of all public law errors as events which render a public authority's decision a nullity may well make sense in public law, particularly given that judicial review remains a discretionary remedy even if the grounds for review have been made out. It makes less sense where the result is the avoidance by the authority of its obligations to unsuspecting contracting parties, particularly where it is the authority which seeks to avoid its own obligations.

Despite *Anisminic* and *Lumba*, there remains real scope for the application of the analysis in *Charles Terence Estates* to apply private law principles when determining the validity of a contract made between a public authority and a third party. There will always be situations where an authority's lack of capacity will render the contract void come what may, even in situations (such as in pensions cases) where those contracts cannot be protected by the certification process in the Local Government (Contracts) Act 1997. But short of those situations, an argument that a pension agreement made between a public body and a blameless employee should be honoured irrespective of any public law error involved in the formation or terms of the contract is likely to receive a sympathetic hearing from the Courts.

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[32] *Ibid,* at [20].

LECTURE 3 (Part 2)

Hampshire v Pensions Protection Fund

Thomas Seymour

1. The question is this:

Individual Approach [Hogan/Hampshire]

Does Article 8 of the Insolvency Directive (as interpreted by ECJ caselaw) confer a universal minimum entitlement of 50% of pension benefits accrued at onset of employer insolvency?

OR

System-Based Approach

Is Article 8 satisfied by a system under which the generality of members receive 50% of accrued pension benefits, subject to a margin of discretion, having regard to IORP's socio-economic objective?

2. The System-Based Approach had been thought to be the correct approach. The ECJ's decision in *Robins v Secretary of State for Work and Pensions* (2007) had been understood in this way. The PPF had been designed on this assumption – with its compensation cap exclusion of indexation for benefits earned from pre-1997 service.

3. In *Hogan v Government of Ireland* (2013) - however - the ECJ appears to have interpreted *Robins* as requiring the Individual Approach; and the Court of Appeal in *Hampshire v PPF* (2017) has now provisionally reached the same conclusion by majority, whilst referring the issue to the ECJ for a preliminary ruling. This obviously has potentially far-reaching implications.

4. I will look first at the Insolvency Directive and the types of claim which arise, and then the caselaw on Article 8.

The Insolvency Directive

5. Recital 3 to the Insolvency Directive recites the intention as follows:

Article 1

"it is necessary to provide for the protection of employees in the event of the insolvency of their employer

"and to ensure a minimum degree of protection, in particular in order to guarantee payment of their outstanding claims"

The whole recital is qualified by what I shall term the Socio-Economic Objective

"while taking account of the need for balanced economic and social development in the Community"

6. *Pay Claims.* Articles 3-5 did impose minimum protections – guaranteeing pay claims covering the remuneration during a specified minimum period of the employment relationship, with powers to cap payments but not below a level socially compatible with the social objective of the Directive.

7. Article 8 - by contrast - is set at a very high level of generality:

(1) It does not specify the content of any necessary measures.
(2) It does not direct payment in full – and in *Robins* the ECJ confirmed that although, unlike Article 4, there is no specific power to cap, there is no obligation on member states to ensure payment in full
(3) It does not specify any minimum level of protection

8. *Abuses*. Note, however, that Article 12(a) states that the Directive does not affect member states' option to take measures necessary to avoid abuses.

Types of Claim: direct/Frankovic damages

9. Pension scheme members can have recourse to two types of claim

A Direct Enforcement in member state. Where the Article concerned is both (a) sufficiently precise and (b) unconditional"[33]

Clearly Article 8 as worded is not sufficiently precise to permit a direct claim for 50% protection under the Individual Approach

B Frankovic: damages claims v member state

Absent direct enforcement, the individual's claim is a *Frankovic* damages claim for breach by the member state in not giving effect to Article 8 by appropriate legislation in the member state. But this must satisfy three requirements:

(1) The Directive must be intended to confer individual rights: so if the System Approach is correct, a *Frankovic* claim under A.8 is not going to be sustainable
(2) The breach must be sufficiently serious: there must be a *"manifest and grave disregard"* on the part of the member state.
(3) There must be a direct causal link between the breach in not transposing the Directive and the individual loss sustained.

The Case law

[33] In *Francovic*, a direct claim failed: because the guarantor of pay provisions could not be identified with sufficient precision.

10. At the outset, it is worth noting the following:

(1) The ECJ cases - *Robins* and *Hogan* – were both *Frankovic* damages claims – not claims based on the direct effect of Article 8.

(2) The national systems concerned – the UK (before the PPF) and Ireland - did not come close to providing 50% for the generality of members and so were plainly non-compliant even on the System Approach.

…………………………………..

Robins v Secretary of State for Work and Pensions

11. The claimants were numerous employees of ASW, an insolvent company, sued the UK Govt. Their primary argument - that A.8 required funding in full – was rejected. The ECJ noted that *"some latitude"* was left to member states as to means of securing protection; it also noted the socio-economic objective in the recital.

12. The second issue was whether the national system was incompatible with Article 8. The issue was not framed in terms of 50% or any specific minimum at all. The ECJ decided that **"a system such as that in issue was incompatible with A.8": "it does not ensure the protection provided for by the Directive"** [59-62]

13. The mere infringement by not implementing Article 8 was not a **sufficiently serious** breach for damages: the State must have manifestly and gravely disregarded the limits of its discretion.

14. The ECJ emphasised that member state had *"considerable discretion for purposes of determining the level of protection"* [74].

15. The Pensions Law Report headnote commented: *"Whilst the ECJ criticised a scheme which covered less than 50% of expected benefits, it did not set a particular bar to the level"*. Certainly the UK Government and pension lawyers generally did not interpret Robins at the time as conferring a universal 50% entitlement: and I doubt if other member states did so.

The True Ratio of Robins – individual or system approach?

16. The ECJ had stated in a key passage:

> "provisions of domestic law that may, in certain cases, lead to a guarantee of benefits limited to 20% or 49% of the benefits to which an employee was entitled, **that is to say of less than half of that entitlement,** cannot be considered to fall within the definition of the word "protect" … **[Robins 57]**

That sentence, *if taken on its own*, points towards a universal 50% entitlement.

But the very next paragraph [58] appears to connote a system-based approach: for it criticises UK arrangements because 35,000 out of 65,000 of members who suffered the loss of 20+% lost 50% or

more of their benefits. This was an unnecessary observation if there was a universal individual entitlement to 50% protection.

As noted, the issue and the decision was formulated in terms of System not Individual Entitlement, and it is therefore hardly surprising that that is how the case was understood in the UK.

17. In *Independent Trustee Services Limited v Hope***,** commenting on *Robins* in 2009, Henderson J clearly did not consider there was a universal entitlement. He said that there was no indication that the ECJ had the position of higher earners in mind. It was:

> **"all but inconceivable …. that the ECJ would hold the existence of a cap on PPF compensation to be incompatible with Article 8 …**
>
> **the real dispute would be about the level at which the cap may legitimately be set having regard to the social and economic factors referred to in the Directive and the degree of latitude afforded … by relative imprecision of wording"**

Hogan v Ireland

18. The members of the Waterford scheme faced losing well over half their benefits on insolvency. *Frankovic* claims were brought and initial issues referred to the ECJ as to whether legislative measures in Ireland complied with Article 8. The Irish Government argued that it had taken steps to comply, though there was in truth, no extensive system in place.

19. The Irish Government relied on the Socio-Economic Objective in the Directive, and boldly maintained that the economic situation justified a lower level of protection. The ECJ gave this short shrift. It cited the *Robins* passage at [57] ("less than half") and held that the Socio-Economic Objective was already taken account of in the "less than half" benchmark stated in *Robins*: so the economic situation afforded no defence.

20. It was not the **specific nature** of the measures that determines whether that Member State has correctly fulfilled Article 8, but rather the **outcome** of those measures [45]. The Irish Government's measures did not seem to be capable of guaranteeing "the minimum level of protection" required by *Robins*.

21. Though not entirely clear, this decision does seem to be saying that *Robins* is to be interpreted as requiring 50% minimum protection across the board [46]

22. On the issue of *Frankovic* damages the ECJ went on to hold:

(1) That Article 8 did confer rights on individuals

(2) That as from 25 January 2007 the *Robins* judgment had informed member states that correct transposition *"requires an employee to receive … at least half of the old-age benefits … for which he has paid contributions…"* [51]

In other words Robins, as interpreted in Hogan, had required member states to ensure measures were in place to provide a universal entitlement of at least 50% of accrued benefits in the event of employer insolvency.

(3) That the Government of Ireland was in sufficiently serious breach for the purposes of a claim for damages

23. Whilst the Government of Ireland's breach was particularly egregious, the *Hogan* decision by indicating that all member states were put clearly on notice on 25 January 2007 of the need to put measures in place to provide 50% universal entitlement, raises the possibility that every member state which failed to address the issue may have been in sufficiently serious breach to be exposed to liability for *Frankovic* damages. Since it is not apparent that any member state was aware that *Robins* was to be so interpreted or took any such steps, this appears to be an interesting example of the ECJ operating on a different plane of understanding from the governments of member or pensions practitioners at large.

Hampshire v PPF and DWP (2016)

24. Mr Hampshire was a member of the Turner & Newell ("T&N") Scheme which went into PPF assessment in 2006 following an insolvency event (CVA proposal). He had an early retirement pension commencing on his redundancy in 1998, then c. £49,000 with 3% annual increases. In 2006 he was 62, under scheme normal pension age. So his pension was cut drastically by the impact of the compensation cap by about 2/3rds, together with the loss of most of his rights to increases.

25. The T&N Scheme remained outside the PPF because the statutory valuation of "protected liabilities" did not exceed the assets. Mr Hampshire challenged the valuation on grounds that "liabilities" should have taken account of the 50% minimum recognised in *Hogan*. He lost before the PPF Ombudsman and in High Ct, where HHJ David Cooke interpreted *Robins* and *Hogan* as requiring a system-based approach. On Mr Hampshire's appeal, the Court of Appeal decided to refer the issue to the ECJ.

The 50% Entitlement Issue.

26. *The Issue Reference*. The Court of Appeal did not accept Mr Hampshire's contention that *Hogan* rendered the issue **"acte claire"**: hence the need for a reference: but the **provisional** view of the majority was that *Robins*, as interpreted in Hogan, conferred a universal right to at least 50% of benefits; the minority view agreed with HHJ David Cooke that the System Approach was correct.

27. The Judgement acknowledged that Article 8 *"was not on its face a promising basis for the claim advanced"* but the majority felt that the ECJ in Hogan had unequivocally decided that [57] of Robins established a minimum level of protection of universal application.

28. The issue referred to the ECJ is inextricably linked to the operation of the PPF under current legislation. Does Article 8 as interpreted in *Robins* and *Hogan* require compensation amounting to 50% of accrued benefits for every employee except for cases of abuse; or is a system of protection compliant where members usually receive more than 50% but some less by virtue of (a) a financial cap particularly on employees under scheme normal pension age at date of insolvency; and/or (b) rules limiting annual increases in compensation or annual revaluation.

29. The Court of Appeal decided – surely correctly – that, if Article 8 does confers 50% entitlement, the Pensions Act 2004 cannot be interpreted consistently with Article 8 on *Marleasing* principles,. It

would require disapplication of cap which would involve removing a fundamental feature of the legislation.

30. Mr Hampshire also boldly contends that Article 8, as interpreted in *Robins* and *Hogan*, is sufficiently precise and unconditional to be given *direct effect* as an individual right to 50% enforceable within the member state. If so, there would be no need for a *Frankovic* damages claim. The Court of Appeal also referred that issue to the ECJ but expressed no conclusion on it.

Matter for the ECJ to consider

31. The ECJ will now have to decide once and for all as between the Individual and the System Approach. Let us consider the DWP's likely arguments.

Carefully considered statutory Scheme. The fact that there is a carefully thought out statutory scheme, and much more extensive protection than in *Robins* and *Hogan*, is of course a factual distinction and makes the UK Govts position much more attractive than that of the government in *Robins* or *Hogan*; but it simply begs the question: whether the approach is individual or system-based.

Socio-economic objective: can the UK baldly say that it had regard to the socio-economic objective in developing the PPF and that it is therefore compliant. Seemingly not. The Irish Government ran this argument in *Hogan* and failed.

Cost considerations. The DWP is seeking to justify the cap on grounds of limiting the costs to the PPF, in a system in which increased costs fall on eligible pension schemes. Of itself it does not seem to answer the ECJ comment in *Hogan* that you look not at the specific measures but the outcome – and protection of less than half the benefits falls outside the meaning of protection.

Moral hazard. A rationale for the cap when introduced was avoidance of manipulation by senior management taking decisions about solvency. This is abuse. Article 12(a) says that the Directive does not prevent states from formulating measures aimed at abuse. Mr Hampshire accepted that abuse was an exception to universal entitlement. This could play a significant part in the Government's argument on the appeal. But it is questionable whether that it will suffice as an answer for the following reasons:

(1) It only relates to the compensation cap, not the limits on indexation and increases: so if the Individual Approach is correct, the PPF Scheme would still not guarantee the 50% entitlement (unless you can say indexation/increases are within a margin of discretion);

(2) The Government accepts that the cap was primarily intended at highly remunerated executives joining in years leading up to the insolvency event, but it also impacts on long-serving executives such as Mr Hampshire. The Pensions Act 2014 increased the cap for employees with over 20 year's pensionable service, though not back-dated. This was precisely because of the cap's disproportionate effect on those whose large benefits was *more a reflection of long service than very high remuneration.*

(3) Take a member whose benefits reflect high remuneration over a period of service which is not that long but where there are no circumstances suggestive of abuse or manipulation. It might constitute

his only financial asset. Why should such a member not enjoy the same 50% protection as members whose benefits are unaffected by the cap?

Further Implications

32. There will almost certainly need to be primary legislation if Mr Hampshire prevails on the primary issue. Further, direct enforcement claims under Article 8 could be made if Mr Hampshire were also to succeed on that issue.

33. This is no doubt subject to Brexit, but it is premature to conclude that this makes the subject redundant and given that the Great Repeal Bill, if and when enacted, might well preserve the status quo down to the date of enactment, subject to the possibility of subsequent repeal.

34. Potential *Frankovic* damages claims could lie against the UK Government for failing to transpose the 50% entitlement into law: certainly from 2013 (*Hogan*): but, on the reasoning in *Hogan*, possibly even from 25 January 2007 (*Robins*) if the UK's failure was "sufficiently serious" as was that of the Irish Government. It would not in my view be surprising if the ECJ rowed back from that particular conclusion, entailing as it does the possibility that all member states are exposed to claims for damages for not having taken steps to ensure the 50% entitlement following the decision in *Robins*. The limitation period for *Frankovic* claims is considered likely to be 6 years running from the date of the onset of employer insolvency.

Lecture 3 (Part 3)

Public Aspects of Pensions Law

Jamie Holmes

Judicial Review of the Regulator's use of its moral hazard powers

1. Overview

This section of the paper will explore three keys points concerning the judicial review of an exercise by the Pension Regulator ("**tPR**") of its moral hazard powers.

This section of the paper is likely to be of greatest interest to anyone against whom tPR has issued, or intimated that it might issue, a warning notice ("**WN**") concerning any of tPR's moral hazard powers (a "**Target**"). It will also be of interest to anyone who has been named as a Directly Affected Party in such a WN, such as the Trustees of the pension scheme or schemes in question, the (former) scheme employer or employers, or any liquidator of the latter.

First, I explain why it will not generally be possible to judicially review an exercise by tPR of these powers, but that such arguments could instead be made to tPR's Determinations Panel ("**the DP**").

Second, I set out my thoughts on when it might still be possible to bring a judicial review of tPR in the High Court in relation to an exercise of these powers.

Finally, I set out my thoughts as to how the DP might approach a hearing in which such arguments were put to it.

Before turning to these points, I have set out some background context to judicial review claims, and tPR's moral hazard powers, for those that are new to either topic.

2. Background Context

A. Judicial Review Claims

A judicial review challenge can be brought against any entity (although it will usually be a public body) in relation to its exercise of what a court has determined to be a public function. The challenge can concern any combination of a decision, an act, or a failure to act on the part of the entity in question, in relation to that public function.

There are broadly three grounds on which such a challenge can be brought:

> The first is that the entity has acted **illegally**: it had no power to do what it has purported to do.
>
> The second is that the act, omission, or decision was **irrational**: it was 'so unreasonable that no reasonable (equivalent) public body would have done the same' see e.g. ***Associated Provincial Picture Houses Ltd v Wednesbury Corp*** [1947] 2 All E.R. 680, [1948] 1 K.B. 223.
>
> The third is that there has been some significant **procedural unfairness** in what the entity has done and/or a failure to fulfil a legitimate expectation held by the claimant.

Judicial review claims are brought in the High Court, and a potential Claimant must first obtain permission to bring such a claim. This is generally determined by the court as a distinct first stage of the proceedings, and usually on the papers alone. The question of permission can also be addressed at the hearing of the judicial claim itself, as part of a 'rolled up' hearing.

If the challenge is successful, the judicial review court has the power to award a broad range of remedies, including a quashing order, or requiring the entity in question to think again.

B. <u>tPR's Moral Hazard Powers</u>

It is assumed that the reader is likely to be familiar with tPR's moral hazard powers, and the relevant provisions of the Pensions Act 2004. For the avoidance of doubt, by reference to these powers I mean tPR's power to issue a contribution notice ("**CN**") or a financial support direction ("**FSD**").

tPR exercises these powers by:

> Its case team first issuing a WN to the Target or Targets of the CN and/or FSD
>
> the DP, an internal but separate determination body, determining that the case in the WN is made out in accordance with the tests in the Act.

Both of these stages have been treated by the courts as the 'exercise of a public function' (as to which see below) and so could in theory be subject of a judicial review challenge.

3. First Key Point: Such Challenges Must Generally Be Made To The DP Itself

<u>Summary</u>: The starting point is that it will not generally be possible to bring a judicial review in the High Court of the Regulator's exercise of its moral hazard powers. Rather, such arguments must be raised before the DP itself. This is the *ratio* of ***Silentnight***, reported as *Grace Bay II Holdings Sarl v The Pensions Regulator* [2017] EWHC 7 (Admin); [2017] Pens L.R. 7.

In ***Silentnight***, the Targets brought a judicial review challenge on the grounds that tPR had acted both illegally and unfairly in issuing a second WN against them. Whipple J, at a 'rolled up' hearing, refused permission in relation to both grounds on the basis that the Targets had an 'alternative remedy' to judicial review in the form of the DP and its procedure, and then if necessary the Upper Tribunal.

Whipple J followed a line of case law on WN's issued by the (then) FSA pursuant to its powers under *The Financial Services and Markets Act 2000*, which are similarly determined by an internal 'Regulatory Decisions Committee' ("**RDC**"). These decisions held that, absent "*exceptional circumstances*", such a challenge could and should be made to the RDC, and so by analogy to the DP.

This existing body of case law held that this was so even where the judicial review challenge was brought on grounds of:

> illegality (alleging that the FSA had no such power at all), per ***R. (on the application of Davies) v FSA*** [2003] EWCA Civ 1128; [2004] WLR 185;
>
> irrationality (alleging that no reasonable regulator would have done the same), per ***R v Birmingham City Council, ex parte Ferrero Limited*** [1993] 1 All ER 530 (CA); and/or
>
> a failure to give adequate or proper reasons, per ***R. (on the application of Willford) v FSA*** [2013] EWCA Civ 677; (Unreported: 13 June 2013).

In light of these decisions and others, Whipple J held that there was "*nothing exceptional about [the] challenge which warrants judicial review*": see the judgment at [79].

Silentnight concerned a WN issued by the Regulator's case team, rather than a decision of the DP itself to issue a CN and/or FSD. Nonetheless, the same logic applies to such a latter decision of the DP itself: as the judicial review claimant would have an 'alternative remedy' in form of a reference to Upper Tribunal, then if necessary the Court of Appeal etc: see ***Willford v FSA*** (cited above), at paragraphs 9, 11, and 38, per Moore-Bick LJ, with whom Black LJ agreed at paragraph 53.

4. Second Key Point: The Threshold To Bring A Challenge In Court Is A High One

Summary: ***Silentnight***, and the case law on which Whipple J relied, only went as far as to hold that it would require "*exceptional circumstances*" for it to be appropriate for a potential claimant to be granted permission to bring a judicial review challenge in the High Court. However, the decision suggests that this is a very high threshold, as can be seen from the following.

The most obvious potential line of argument for a claimant seeking to establish that permission should be granted in their case is that the circumstances of their case are truly exceptional. This however falls to be assessed in light of the principles as summarised by Whipple J at paragraph 59 of her judgment. These include:

> The court taking account of whether granting permission in the case before it would lead to such judicial review challenges becoming routine.

That the court should not grant permission in the case before it merely because judicial review in the High Court would be a more effective or a more convenient procedure.

The need for the court to determine whether Parliament intended the statutory DP procedure to apply in any event.

In ***Silentnight*** the Targets submitted that their case was truly exceptional in light of the (high) cost of responding to the case in the second WN. Having considered the principles set out above, this was rejected by Whipple J: see the judgment at paragraph 78.

A second potential line of argument for such a claimant would be to submit that the alternative remedy is itself unsatisfactory in the circumstances. At paragraph 59 of her judgment, Whipple J refers to this type of submission as the usual way to establish "*exceptional circumstances*". However, in the same paragraph, she goes on to hold both that:

The mere fact that the DP does not have the power to grant the same broad range of remedies as the judicial review court, including in particular that it does not have the power to quash or remit decisions, does not mean that the DP procedure is inappropriate; and

That the existence of the right of appeal by way of rehearing to the Upper Tribunal, is capable of remedying even any serious defects in the DP's procedure.

This suggests that "*exceptional circumstances*" is a very high threshold.

Outside of the above-mentioned moral hazard powers, another important area is the issuing of s.72 notices by tPR, which have the capacity to be costly to comply with, so the lawfulness of such a notice is often an important issue for clients. The focus in such a case should be on whether (a) the notice is sufficiently clear to allow the addressee to know what falls within and outside it, which is important given the consequences of not complying with it, and (b) whether the decision to issue the notice was a proper one given its contents. [34]

5. Third Key Point: It Is Not Yet Clear How The DP Itself Might Approach Such A Challenge

Summary: the starting point is that such a challenge must generally be made before the DP itself. It is at present unclear how the DP will approach such arguments if and when they are made to it. This area will be one to watch.

The DP has not to date had to consider how it would approach such arguments. To date, it has generally held short hearings in relation to WN's concerning CN and/or FSD's and has only allowed even cross-examination at one such hearing, that for ***Sea Containers*** [2007] 40 PBLR in 2007; a procedure which it has notably not since repeated.

[34] Outside the tPR context, there is also the possibility in theory of judicially reviewing the PPF in respect of the promulgation of their levy determinations.

There is no reference in the DP's published Standard Procedure to such issues being addressed before the DP, and so it contains no special provisions in relation to them. There is also notably no reference in the Standard Procedure to the DP, for example, convening a separate hearing on a preliminary issue.

In light of the above, it remains to be seen how the DP might address such arguments, and this will be something to watch in the future.

LECTURE 4

Pensions flexibility – conflicting policies

Emily Campbell and Michael Ashdown

Introduction

In this lecture, we want to consider the coherence of the current legislative restrictions on the use by members of pension scheme assets. I am going to be talking about attacks by third parties on the tax wrapper. Michael will be talking about the role of the restrictions in sections 67, 91 and 92 of the Pensions Act 1995.

We consider that it is timely to raise the question of how legislation, introduced piecemeal over a period exceeding a quarter of a century by successive governments of different political persuasions, hangs together and whether it is any more fit for purpose. The Taxation of Pensions Act 2014 has allowed very wide access by the over 55's to their pension assets, although admittedly not in many cases without the imposition of significant tax charges. Whilst these new flexibilities are usually enjoyed within the environment of personal pension schemes, it is of course possible for members to transport their pensions from occupational pension schemes into such schemes.

Extrapolating the logic of this:-

(1) It might be thought that what members are able to do through the route of inter-scheme transfer, they might be permitted to do through a more direct route, such as assignment or surrender. As Michael will show, this is not the case; and

(2) It might also be thought that with the advantage of pensions flexibility would come the corresponding disadvantages to the member over the age of 55 of having control over pension assets. I will show that this is not the case either.

Attacking the tax wrapper

Since at least the enactment of the Welfare Reform and Pensions Act 1999 ("WRPA"), pensions have been moderately effective as asset protection vehicles for members, and this lecture is concerned with the asset protection aspects of pensions. In this regard, I am really looking at the obverse scenario of the more frequently discussed topic of pensions liberation. Pensions liberators are those who wish – legitimately or (often) illegitimately – to withdraw pension assets from the legislative constraints of the wrapper in which they are held. There is, however, a group of persons who wish to lock assets in that wrapper to protect them against third parties. It is with this latter group that I am concerned.

It is relevant in this regard to consider separately the position of divorce, bankruptcy and death.

Divorce

The weakest area of protection is to be found in the context of divorce. With the introduction of pension sharing orders by section 19 of WRPA, the Family Court now has wide power to access pensions assets for the purpose of ancillary relief proceedings. Furthermore, a Judge in the Family Division will have little hesitation before regarding a spouse's pension fund as a resource. For this reason, I focus on the case of bankruptcy and death.

Bankruptcy

The example of bankruptcy was considered by the Court of Appeal in the recent case of *Horton v Henry* [2016] EWCA Civ 989. In that case, the trustee in bankruptcy of one Mr Henry applied - the day before the discharge and when Mr Henry was already 59 - for an income payments order pursuant to section 310 of the Insolvency Act 1986 ("the 1986 Act") in respect of income which might become payable to Mr Henry from his personal pension policies, were he to exercise his contractual rights under those policies to draw down a lump sum or other payments. Mr Henry's pension policies included a SIPP worth around £850k.

The question formulated by the Court of Appeal was: Does a pension entitlement in respect of which a bankrupt has a present right to elect to draw down payment (but which he has not yet exercised) fall to be included in the assessment of his income "to which he from time to time becomes entitled" within the meaning of section 310(7) of the 1986 Act when the court is considering whether and, if so, on what terms, to make an IPO under section 310?

The first instance Judge had departed from the earlier case of *Raithatha v Williamson* [2012] EWHC 909 (Ch) and dismissed the trustee in bankruptcy's application. The trustee in bankruptcy appealed, but the Court of Appeal dismissed the appeal.

Gloster LJ, delivering the judgment of the Court, considered (amongst other provisions of the 1986 Act) the terms of section 310 in conjunction with the definition of the "bankrupt's estate" in section 283. She considered the bankrupt's duty to cooperate with the trustee under section 333(1). She also considered section 11 of WRPA, which had extended the exclusion of rights under approved/registered pension schemes from the bankrupt's estate to personal pensions.

She held (at [42]) that, as a matter of construction of section 310, there was no basis for concluding that a bankrupt's contractual rights to draw down or "crystallise" his pension come within the definition of "income of the bankrupt" within section 310(7) ("*For the purposes of this section the income of the bankrupt comprises* ***every payment in the nature of income which is from time to time***

made to him or to which he from time to time becomes entitled…"). The language of section 310 was addressed to capturing income and there was no suggestion in the language that it was conferring a power on the court to require the bankrupt to exercise a power – in relation to property expressly excluded from the bankrupt's estate – to generate income. The contrary conclusion would drive a coach and horses through the protection afforded to private pensions and rights thereunder by virtue of section 11 of WRPA.

This decision puts a bankruptcy creditor in a markedly weaker position than a judgment creditor. In the case of *Blight v Brewster* [2012] 1 WLR 2841, a Mr Blight, a judgment creditor, successfully applied for an injunction pursuant to section 37(1) of the Senior Courts Act 1981 requiring Mr Brewster, his judgment debtor, to elect to draw down a lump sum from his pension in order to enable the judgment creditor to obtain a third party debt order against the pension trustees. Mr Gabriel Moss QC, sitting as a deputy judge of the Chancery Division, held, at [70]:-

> "*There appears to me to be a strong principle and policy of justice to the effect that non-bankrupt debtors should not be allowed to hide their assets in pension funds when they had a right to withdraw moneys needed to pay their creditors*".

The jurisdiction under consideration in *Blight v Brewster* has overtones of developments elsewhere in trust law. Some of you may recall the case of *Tasarruf Mevduati Sigorta Fonu v Merrill Lynch Bank & Trust Co* [2011] UKPC 17, in which the Privy Council (Cayman) held that it was appropriate – under the equivalent of section 37(1) of the Senior Courts Act 1981 - for the court to appoint receivers by way of equitable execution over the power of a judgment debtor to revoke two Cayman settlements of which he was settlor.

It might be said, therefore, that the approach in *Horton v Henry* creates an illogical distinction between the cases of bankruptcy creditors on the one hand and judgment creditors on the other. Indeed, this argument was put by Counsel for the trustee in bankruptcy in *Horton v Henry*. It was postulated by Counsel that the debtor, Mr Brewster, would have been better off presenting his own petition prior to the hearing. Gloster LJ rejected Counsel's submission. She then considered that there was a meaningful distinction between the position prior to and after bankruptcy – prior to bankruptcy pensions are not protected, after bankruptcy they are. As Mr Moss QC had explained:-

> "*Filing for bankruptcy is a relief from the ability of creditors individually to execute upon the debtor's assets, in favour of collective execution. But this relief comes at a significant price. Bankruptcy carries very important disadvantages in terms of obtaining credit and acting as a director of a limited liability company, such restrictions being designed to protect the public. A judgment debtor in my view cannot have the benefits of bankruptcy without its burdens*".

So this is where the law has got to in the case of bankruptcy. How the unpaid creditors of a discharged bankrupt of pension age will feel watching him drive past in a new Lamborghini is a matter for speculation.

Death

Historically, pension schemes have provided significant protection from inheritance tax. The Inheritance Tax Act 1984 ("the 1984 Act") acknowledges a broad exemption from tax on registered pension schemes: see sections 58(1) (d); 151. Further, by concession, a two-year tax-free period has been permitted before discretionary death benefits are distributed (IHTM17083) and the reservation of benefit rules do not apply (SP10/86). Lump sum death benefits could effectively be paid free of inheritance tax.

The downside in the past for those wishing to use pension funds as the source of dynastic wealth has been two-fold:-

1. **The requirement to purchase an annuity by the age of 75, an age survived by most pensioners; and**
2. **The special lump sum death benefits charge in section 206 of the Finance Act 2004. This charge effectively arises where a lump sum death benefit is paid in circumstances where the member has drawn some benefit from the fund or has reached the age of 75.**

Both of these downsides have, however, been substantially watered down in recent years. The requirement to purchase an annuity by the age of 75 has, following the enactment of the Finance Act 2011 and the Taxation of Pensions Act 2014, been abolished altogether. Further, whilst the special lump sum death benefits charge will in any event be levied on lump sums paid from the age of 75 at the latest, from 6 April 2016, in some circumstances the amount of the charge may be nil or at least charged at a rate lower than the rate of inheritance tax because tax will be charged at the recipient's marginal rate of income tax (see the Finance Act 2004, section 206 and the Finance (No 2) Act 2015, section 22). If a member dies at a ripe old age and the fund is split between several young adult grandchildren, it may well be that no tax is due at all.

So, is there any evidence that ever increasing pensions flexibilities have called into question the inheritance tax-free status of pension funds? This brings me on to the recent Upper Tribunal decision in *Revenue & Customs Commissioner v Parry (as personal representatives of Staveley, deceased) and others* [2017] UKUT 4 (TCC).

The case arose out of notices of determination to inheritance tax made by HMRC in respect of two alleged lifetime transfers of value by the late Mrs Staveley, who died on 18 December 2006. The

alleged chargeable transfers of value arose out of the transfer, in November 2006 and shortly after Mrs Staveley had been advised that she had terminal cancer, of her funds out of one registered pension scheme (which I will refer to as “the section 32 policy”) into another (which I will refer to as “the AXA PPP”), and the omission of Mrs Staveley during her lifetime to take any lifetime benefits from the AXA PPP.

The determinations were made on Mrs Staveley’s personal representatives, and on her two sons in their capacity as beneficiaries of the death benefit paid out of the AXA PPP after her death (the sons were also two of the three personal representatives). The determinations were appealed to the FTT, which allowed the appeals in respect of the transfer of funds to the AXA PPP, but dismissed the appeals so far as they concerned the omission by Mrs Staveley to take lifetime benefits.

The issues were hence as follows. The first issue was: was the transfer from the section 32 policy to the AXA PPP a transfer of value? The second issue was: was the omission to exercise the right to take lifetime pension benefits properly treated as a transfer of value? HMRC appealed in respect of the first issue and the personal representatives/sons appealed in respect of the second issue.

The first issue

It was common ground that the transfer of the fund from the section 32 policy to the AXA PPP was a disposition for the purposes of section 2 of the 1984 Act. This was because the section 32 policy was property, not being settled property, over which Mrs Staveley had a general power of disposition (section 5(2) of the 1984 Act) and it conferred a right on her to dispose of the death benefit under that contract, which right would form part of her estate on her death. Following the transfer to the AXA PPP, and the completion by Mrs Staveley of an expression of wish form, she no longer had that right; instead the matter was one of discretion for the scheme administrator.

A disposition which reduces the value of a person’s estate is a transfer of value, subject to section 10 of the 1984 Act (which exempts dispositions not intended to confer gratuitous benefit). That section does not, however, apply where the disposition is part of a transaction intended to confer any gratuitous benefit on any person. Accordingly, the key question was whether the disposition was part of a transaction intended to confer any gratuitous benefit on any person.

The UT held that the FTT was entitled on the evidence to find that the disposition from the section 32 policy to the AXA PPP was <u>not</u> intended to confer a gratuitous benefit on any person and that Mrs Staveley’s sole motive was to prevent surplus pension funds reverting for the benefit of her ex-husband. The UT also held that the statutory reference to “transaction” could not be construed so as to include Mrs Staveley’s omission to draw a pension, even if one took into account the “associated operations” anti-avoidance provisions. The UT also held that the transaction was not between

connected persons. Accordingly, section 10 applied and the transfer was therefore not a transfer of value for the purpose of section 3 and HMRC's appeal on this issue was dismissed.

The second issue

Section 3(3) of the 1984 Act provides that, in certain circumstances, an omission by a person to exercise a right which diminishes the value of his estate is to be treated as a disposition by him. This applies in particular where the effect of the omission is to increase the value of another person's estate. HMRC sought to evoke this provision and pointed to the naming of Mrs Staveley's sons in the expression of wish form and subsequent exercise of discretion in their favour, notwithstanding that the distribution of death benefits under the AXA PPP was at the discretion of the scheme administrator. The UT disagreed with the FTT and held that the discretion of the scheme administrator broke the chain of causation between the omission by Mrs Staveley to exercise her right to take lifetime pension and the benefits to the sons. The UT held that the proximate cause of the increase in the estates of the sons was the discretion of the scheme administrator. It followed that the conditions of section 3(3) were not satisfied so that Mrs Staveley's omission could not be treated as a disposition or therefore as a transfer of value. The appeal by the personal representatives/sons on this issue was therefore allowed.

Current position

It is understood that the case is now under appeal to the Court of Appeal and the outcome of the appeal will be very interesting to see. It will also be interesting to see whether HMRC make any further attacks on the assets of registered pension schemes using inheritance tax legislation.

<u>Conclusion</u>

The normal minimum pension age is now 55. We have got to the point where persons over that age are given unrestricted access to all of their pension fund assets – subject only to paying the appropriate income tax charges. The benefit of this new access has, however, been delivered to this group of persons by the Government without the corresponding burdens usually associated with assets over which a person has absolute control. The WRPA protections in the case of bankruptcy ought, it is suggested, to be reconsidered. Further, it is doubtful that any widespread practice of using pension funds as tax-efficient dynastic trusts will survive many Chancellors' budgets.

Statistical information published by HMRC shows that in the two years following Pension Freedom Day (6 April 2015), flexible payments from pensions were in the region of £10.8bn. It is also worthy to note that the cost to the taxpayer of pension credit (the means-tested benefit for poorer pensioners) in, for

example, 2015-16 was around £6bn[35] and must surely rise if pension assets are imprudently withdrawn.

I would argue that the use of the pensions tax wrapper as a shield against legitimate third party interests is hard to justify in the absence of the traditional corresponding public benefit, that being the provision of an income to members of pensions schemes throughout the whole of their retirement and until death.

[35] Source: Office for Budget Responsibility.

Restrictions on member autonomy: sections 67, 91 and 92 of the Pensions Act 1995

Emily has spoken about the flexibility introduced by the Taxation of Pensions Act 2014 in the context of individuals seeking to use the pension structure to shield their assets. I would like now to turn to the position of members of occupational schemes who want to make use of their pension other than by simply retiring and receiving a scheme pension and, typically also a pension commencement lump sum. This might entail the member charging or assigning her present or future pension rights as part of an arrangement with a third party, agreeing to the amendment of scheme rules to re-structure the benefits available to her, or simply commuting a larger part of her pension entitlement to cash.

The position in a personal pension is now very flexible indeed. Having reached the age of 55, a member has much more choice over drawdown or the purchase of an annuity, and can even take an "*uncrystallised funds pension lump sum*" (UFPLS), as long as she is willing to pay tax at her marginal income tax rate on 75% of the funds released. Under the overriding power conferred by the Act, such payments can be made out of a personal pension even where there would otherwise be no power to make them.[36]

Although this flexibility does not generally extend to occupational defined benefit schemes, it is usually straightforward enough to transfer from one to the other. There is now published guidance from The Pensions Regulator (TPR) regarding trustees' duties when receiving transfer requests from members who want to take advantage of the new flexibilities.[37] But the key prerequisite for such a transfer is satisfying the advice requirement in sections 48-54 of the Pension Schemes Act 2015. Except where the benefits to be transferred have a cash equivalent value of less than £30,000, the trustees of the transferring scheme are required to check that an individual who applies to transfer out with a view to acquiring flexible benefits has taken appropriate advice from a professional financial adviser who is both independent of the scheme and authorised by the FCA. If the member has received the advice, and the adviser certifies that it has been given, then it is for the member – and not the trustees or the adviser – to decide where her own interests lie, and whether to follow or ignore any recommendation her adviser had made. She may proceed with the transfer even if it is clearly not financially sensible to do so.

The law effectively now recognises that she may have her own reasons for the transfer which do not correspond to a simple financial calculation. Most obviously, she may have pressing needs which mean that she prioritises having ready access to her pension savings now over getting the best value from them in the longer term. The law treats her as an autonomous adult who, whilst requiring proper

[36] Finance Act 2004 s273B, inserted by Taxation of Pensions Act 2014 sch 1, para 79.
[37] The Pensions Regulator, "Regulatory Guidance: DB to DC transfers and conversions" (April 2015).

advice in order to be fully informed, is entitled ultimately to make her own decision. It reflects an extension of the same legal policy that has always allowed adults to make unwise but nonetheless valid decisions in relation to contracts, gifts and wills.

Statutory restrictions

However, this approach to members' ability to make decisions, even unwise ones, about their own pension rights, cuts across the existing statutory scheme for the protection of such rights. Emily has already discussed the difficulties which arise in squaring the new flexible regime with the protections afforded to scheme members' entitlements on death or bankruptcy. The logical counterparts to those protections are the restrictions placed by statute on the ability of members to deal with their pension rights as they wish. I am not concerned here to address the situation where a scheme's sponsoring employer seeks to impose changes on a member, such as a modification of accrued pension rights, a bulk transfer, or even the forfeiture of a member's entitlement. Rather, I am interested in how the law continues to deal with a member who positively *wants* to make a change.

The relevant provisions are section 91 of the Pensions Act 1995, which limits a member's ability to alienate her pension rights, section 92 which in most cases precludes the forfeiture of pension rights, and section 67 which restricts the ways in which a scheme may be amended.

Alienation

Turning first to section 91 of the Pensions Act 1995, a member of an occupational pension scheme's entitlement to a pension or right to a future pension, "*cannot be assigned, commuted or surrendered … cannot be charged or a lien exercised in respect of it, and no set-off can be exercised in respect of it* ". This has been interpreted widely. For example, Rose J held in *The Pensions Regulator v A Admin Ltd* that it even extends to the case where (very unusually) the trustees have a discretion as to the amount of pension a member will receive.[38] Section 91 does provide for very limited exceptions where (i) a member assigns her rights to a surviving spouse or dependant, or surrenders her rights in return for the provision of benefits to such a person, or (ii) the trustees seek to enforce a charge, lien or set-off, in respect either of overpayments made to the member in error, or in respect of monetary obligations due from the member to the scheme or the employer and arising from the crime, fraud or negligence of the member, or (iii) the member wishes to commute all or part of her entitlement on retirement or because of serious ill health.

Judicial treatment of section 91 has not been entirely rigid. For example, in *International Management Group (UK) Ltd v German*[39] the Court of Appeal held that section 91 did not invalidate a *bona fide*

[38] *The Pensions Regulator v A Admin Ltd* [2014] Pens. L.R. 319 at [26]-[36].
[39] *International Management Group (UK) Ltd v German* [2010] EWCA Civ 1349.

compromise of disputed or doubtful entitlements. In *Bradbury v BBC*[40] Warren J was clear that an agreement to limit future pensionable salary increases did not fall foul of the prohibition, the member having no present entitlement to such future increases.

But it is clear that in general section 91 rigorously pursues what Mummery LJ has called *"the statutory objective that a pension entitlement or right, which enjoys favourable tax treatment, cannot be used as an assignable asset"*.[41] The effect is that the autonomous adult member cannot charge or assign her pension rights. There is no theoretical objection to alienation: an interest under a private trust can certainly be assigned or otherwise disposed of by the beneficiary entitled to it, and far from imposing any restrictions on alienation, the policy of the law of trusts is to treat any express restriction on alienation as void.[42] The difference is, as Mummery LJ makes plain, in the tax advantages conferred by pension schemes, and the very limited purposes for which Parliament seemingly intended those advantages to operate.

The rigour of the provision is most clearly demonstrated by the fact that even a simple commutation of a member's entitlement is prohibited unless it is "*on or after retirement or in exceptional circumstances of serious ill health*".[43] In an occupational scheme, even a pension commencement lump sum is limited, normally to one quarter of the value of the benefits crystallised for lifetime allowance purposes, and any excess paid over this amount is likely to be an unauthorised member payment, and subject to punitive tax treatment. A lump sum payment made otherwise than on retirement is also likely to be an unauthorised member payment, and taxed as such. A commutation of benefit to pay such a lump sum would be invalid under section 91. In contrast, in a personal pension, as I mentioned before, uncrystallised funds pension lump sums may now be paid to a member who has reached 55, typically with no punitive tax treatment. Following the Taxation of Pension Schemes Act 2015, this type of payment was added to the "*prescribed circumstances*" in which a commutation is permitted for the purposes of section 91.[44]

The difference in treatment between the two types of pension could not be starker. A member who wants to take more of her pension as cash is effectively forced to transfer to a personal pension first, but then has essentially unfettered access. A member who wants to put her pension to some other

[40] *Bradbury v BBC* [2012] Pens. L.R. 283.
[41] *International Management Group (UK) Ltd v German* [2010] EWCA Civ 1349 at [28].
[42] See *Lewin on Trusts* (19th edn) at 5-179.
[43] Pensions Act 1995, s91(5)(c)(i).
[44] Pensions Act 1995, s91(5)(c)(iii) permits a commutation "*in other prescribed circumstances*". Regulation 2(1B) (b) of the Occupational Pension Schemes (Assignment, Forfeiture, Bankruptcy etc.) Regulations 1997/785 (as amended by the Occupational Pension Schemes (Consequential and Miscellaneous Amendments) Regulations 2015/493) prescribes the payment of a lump sum to a person who has reached normal minimum pension age but has not retired.

use is not prevented from doing so, but will probably have to go through the same process to access the cash, after which she can use it as wisely or unwisely as she pleases.

The effect of the section 91 prohibition therefore turns out now only to be a restriction on dealing with pension rights *in specie*, and not on dealing with the value they represent. The absolutist approach it adopts to prohibiting almost all the ways in which a member might seek to extract economic value from her pension rights sits very uncomfortably alongside the new flexibility for personal pensions.

<u>Forfeiture</u>

The second relevant provision is section 92 of the Pensions Act 1995. I will touch on this only very briefly, because it is not primarily concerned with the situation of a member wanting to make use of her pension rights. Rather, it acts as a safeguard against something being done *to* a member, namely the forfeiture of part or all of her entitlement.

The general rule is that "*an entitlement to a pension under an occupational pension scheme or a right to a future pension under such a scheme cannot be forfeited*".[45] This is subject to very narrow exceptions, such as (i) the member being convicted of treason or offences under the Official Secrets Act (ii) the member failing to claim her pension for 6 years, or (iii) the member having criminally, fraudulently or negligently caused loss to the scheme, with forfeiture permissible only to the extent of the loss.

Relevant for present purposes, though, is that forfeiture is also permitted where there has been an attempt at alienation which under section 91 is of no effect.[46] In this way, section 92 operates to bolster the section 91 prohibition: not only is an attempted alienation invalid, but if the trust deed provides that any such attempt will forfeit the member's entitlement, that forfeiture is valid. In that situation the statute provides that the trustees may decide to pay the pension to the member, her spouse or dependant, or to any person to whom the pension could have been paid under the scheme rules.[47] But this does not appear to override any provision in the trust deed prohibiting payment to the member. Section 92 therefore does nothing to temper the harshness of the punitive approach to a member seeking to make such use of her pension rights, but rather seems explicitly to endorse it.

Of course where the member's entitlement is in a personal pension, or has been transferred to a personal pension, she can now extract her money and deal with it without any fear of such punitive treatment. Save that she will have an income tax bill to pay, the money is hers to dispose of.

[45] Pensions Act 1995, s92(1).
[46] Pensions Act 1995, s92(2).
[47] Pensions Act 1995, s92(3).

Modification

The third provision I want to consider is section 67 of the Pensions Act 1995, which restricts the manner in which an occupational pension scheme can be modified. As before, I am not concerned with matters such as bulk transfers where something is being done *to* the member, but rather with modifications which the member actively wishes to agree to.

Under section 67, a "*regulated modification*" which does not comply with the strict statutory criteria is voidable, and so liable to be set aside. This encompasses all amendments to a scheme which would, or even might, adversely affect any member's subsisting rights. As I am positing a modification the member wishes to agree to, I will leave to one side the possibility of making a regulated modification without member consent, on the basis of actuarial equivalence.[48] In cases where member consent is the route adopted, the requirements are threefold: (i) member consent;[49] (ii) trustee approval;[50] (iii) reporting requirements.[51] The latter two are essentially straightforward: the trustees must determine to exercise their power to make a regulated modification, or must consent to its exercise by another (such as the employer, if it has a power of amendment), and they must notify all members to whom the consent requirement applies that they have decided to exercise the power, or to consent to its exercise. The consent requirement is more involved, as it requires that the trustees first provide information in writing about the proposed modification and its impact, give the member the opportunity to make representations in relation to it, and inform the member that the consent requirement applies, before then obtaining the member's consent, given in writing. There is also an associated timing requirement, that the modification must take effect within a "*reasonable period*" after the member gives her consent.

One situation in which all parties may now wish to make a consensual amendment is in the context of an incentive exercise such as a pension increase exchange. Many of you will have been involved in these arrangements, the basic structure of which is that the member agrees to an immediate increase to her pension, in return for giving up her right to future pension increases in excess of statutory minimums. They are normally offered because the sponsoring employer believes that it can help with de-risking and reducing its future liabilities. Plainly there is a very substantial risk to members, as a good deal for the employer is unlikely to be in their individual interests.

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[48] Pursuant to Pensions Act 1995, ss67(2)(a)(ii) and 67C.
[49] Pensions Act 1995, ss67B.
[50] Pensions Act 1995, ss67E.
[51] Pensions Act 1995, ss67F.

This is certainly the view TPR has taken. Its published statement on incentive exercises points out that "*where a member accepts an IE offer, an employer's pension liability or risk is likely to be reduced. Conversely, for members the risk that they will suffer a loss in the long run will usually increase if they accept an offer.*" Indeed, TPR's position is that only "*[a] minority (and, very possibly, a small minority) of members may have personal circumstances which result in them being in a better position through accepting an IE offer*".[52] Most relevantly for present purposes, TPR's particular concern about such exercises is that they may result in the coercion of members, or at least the exertion of undue pressure by the employer to agree to take part in such an arrangement.[53] As far as the role of trustees is concerned, TPR advises them to be particularly cautious, and to "*start from the presumption that IEs are not in most members' interests.*"[54] The concerns expressed about this sort of arrangement have also led to the adoption of an industry-wide code of good practice.[55] Although not legally binding, TPR has made clear that it should be followed,[56] and that it will "*have regard to the Industry code, wherever relevant, in the conduct of any regulatory proceedings relating to IEs.*"[57] The object of the code is to ensure fairness and transparency, with members making decisions based on appropriate advice. This is to be ensured by the code's prohibition on cash incentives and its requirement that (in most cases) the member concerned should receive appropriate advice, paid for by the employer.

The end result is that even where member, employer and trustees are in agreement about the member's entry into a pension increase exchange or other incentive exercise, the hoops to be jumped through are numerous. In particular, the trustees (and employer) should be alert to ensure full compliance with (i) the industry code's very detailed requirements; (ii) TPR's concerns about the duties of trustees, particularly in relation to managing conflicts; and (iii) the numerous requirements of section 67 itself in relation to whatever amendment to the deed and rules is required to give effect to the arrangement.

Set against the flexible regime for personal pensions, this looks at first blush like an abundance of red tape, with statutory, regulatory and good practice requirements piled one on top of another. It might be thought peculiar to be quite so demanding in relation to an exercise in varying pension benefits with the member's full agreement, while making it very straightforward for the same member to turn her pension into cash, putting it beyond the reach of pensions regulation.

[52] The Pensions Regulator, "Statement from The Pensions Regulator: Incentive exercises" (July 2012) at p2.
[53] ibid p4.
[54] ibid p3.
[55] "Incentive Exercises for Pensions: A Code of Good Practice" (Version 2, January 2016) http://www.incentiveexercises.org.uk
[56] ibid p5.
[57] ibid p2.

But in my view it would be a mistake to characterise the section 67 requirements, and the special rules around incentive exercises, in that way. They are actually quite unlike the prohibitions in sections 91 and 92, which effectively say that certain things may be done, and certain things may not be done, and that is an end of it. Those restrictions are relatively straightforward, but also absolutist in their approach. They do not give much weight to the autonomy of the individual member and her wishes, but pursue other objectives, which I will come to in a moment. Whereas the result of jumping through all the hoops I have described to make an amendment to the deed and rules, whether in the context of a pension increase exchange, or for some other reason entirely, is that the modification is ultimately permitted.

The concern reflected in the requirements of section 67 is that if the member's consent is to be relied upon to make an amendment which would not otherwise be allowed, that consent should be fully informed and freely given. It should not be the result of the member receiving partial information, being ignorant of the true impact of the change, and being put under pressure to agree to it. The same concerns are reflected throughout TPR's guidance, and the industry code on incentive exercises. This is not, therefore, regulation which is designed to stymie the autonomy of the member, but rather is designed to value and uphold it, and to ensure that the outcome is a true reflection of a genuinely autonomous decision.

It is certainly true that the requirements here are more onerous than the advice requirement for a transfer of benefits from an occupational scheme to a personal pension, which I mentioned at the start. They serve the same end, of ensuring that whatever decision the member makes is fully informed, even if ultimately unwise. But the more demanding requirements, for incentive exercises especially, also reflect a sensitivity to the reasons why an unwise decision may be made. A decision to transfer benefits to a personal pension in order to take advantage of the new flexibility is likely to be member led. If it is a bad decision, and the member persists in it despite being advised against it, then she has made her own bed and must lie in it. There has been no unfairness, no injustice done to her. Whereas an incentive exercise is almost invariably employer led. However fair the employer seeks to be (or is required to be) to the member, the employer pursues the arrangement in its own interests, not the member's. The risk of the member making a bad decision because of outside factors is much higher. Such a decision may be a reflection not of her own wishes, but of the quality of the information she receives, and the way in which it is presented, and the pressure she may feel, perhaps very subtly exerted. The more demanding requirements that apply in such a case are fully justified as attempting to insulate the member's decision-making from such matters which might *unfairly* lead her to an unwise decision.

A paradigm shift?

Having looked at the operation of sections 91, 92 and 67, it is clear that they cannot be analysed together when considering their place in a modern pensions world beset by the tension between by flexible access to personal pensions, and rigorous statutory regulation. As I have sought to explain, it seems to me that both section 67 and the guidance and regulation associated with it largely pursue the same objectives as the rules on transferring benefits from an occupational scheme to a personal pension as a prerequisite to access to the new flexibility. Section 92 on forfeiture is mostly concerned not with limiting what a member may do voluntarily, but with something that is done to her, save to the extent that it reinforces the section 92 prohibition on alienation. It is that provision which stands most obviously in opposition to the new approach, mandating a very narrow and inflexible approach to making use of pension savings, in sharp contrast to the flexibility now available in person pensions.

Why should that be the case? Below the surface, what appears to be going on is that pensions law and regulation has sought to further a number of objectives, many of them cutting across each other. It will suffice now to consider just a few which arise in relation to the provisions I have discussed.

First, there is a strong paternalistic element, of protecting members from themselves. If a member were allowed freely to alienate her pension entitlement, she might find herself much worse provided for in her retirement than she had planned or expected. If she could commute more of her occupational pension, or could do so before actually retiring, she might be tempted (as Emily suggested) to buy a Lamborghini and drive off into the sunset.

Second, there is a related concern to protect members from others – perhaps especially employers – who might seek to take advantage of them. Sections 91 and 67 pursue this goal in different ways. Section 67 tries to ensure that members take autonomous decisions on the basis of accurate information. Section 91 operates simply to prohibit many ways in which a member might be exploited, and to restrict others to limited circumstances. For example, although it is permitted to set off overpayments made to the member, or in certain cases other amounts due to the scheme or the employer, if the member challenges the amount she is said to owe, the set-off cannot be exercised until the amount has been determined by the Court (or an arbitral award).

Third, there is also a strong element of protecting the public purse. This is seen in three distinct strands. The first is that if a member did lose her pension entitlement by alienation, or spent it all on a Lamborghini, then the cost of her falling on hard times in her old age would not only be a burden to her and perhaps to her friends and relations. She would also be more likely to burden the state, through the benefits system. The second sense in which the public purse is protected relates to tax

relief. This was Mummery LJ's point about section 91 in the *IMG* case.[58] The implication is that Parliament has conferred certain tax advantages in relation to pensions saving in order to pursue a policy of ensuring that individuals are adequately provided for in retirement, motivated presumably by both of the concerns I have already mentioned: the welfare of individual pensioners, and the cost to the public purse if they fail to provide for themselves. Parliament has not conferred those tax advantages with a view to creating a privileged class of assets which can then be used in the economy in varied ways which have nothing to do with retirement saving. In this context, it is important to remember, as I mentioned earlier, that 75% of the cash taken out of a personal pension under the new regime will be taxed at the member's marginal income tax rate. Concerns about the misuse of tax relief are consequently reduced to that extent. The third protection for the public purse is against costs directly incurred. It is because of this concern that transfers from unfunded public sector schemes into personal pensions are not permitted: members of such unfunded schemes are denied access to the new flexibilities entirely, for fear that permitting such transfers would "*expose the Exchequer to significantly higher costs on a current year basis*", perhaps as much as £200 million per annum.[59]

Fourth, there is an underlying concern for the wider economy. The reason why the new flexibility for personal pensions has not been extended to occupational schemes is not because their members would not benefit from having direct access, without the need for a transfer first. It is simply a question of economics. In the Government's consultation on introducing the new flexibility, it explained that *"[i]n principle, the government would like to find a way*" to extend flexibility to members of occupational schemes. But it was concerned that "*large scale transfer (or anticipated transfer) of members of private sector defined benefit schemes to defined contribution schemes could have a detrimental impact on the wider economy*" and that it would undermine the role of occupational pension schemes as "*major investors in longer term UK assets*". Whilst the Government would in principle wish to extend flexibility and choice to members of occupational schemes, "*it will not do so at the expense of significant damage to the wider economy*".[60]

Fifth is the concern for the autonomy of members, who should in principle be entitled to make their own decisions, even unwise ones, and to exploit their pension savings as they see fit. This is powerfully expressed in the new flexibility for personal pensions, and in the section 67 member consent requirements. But it is flatly inconsistent with the approach taken by section 91 and, to a lesser extent, section 92.

[58] *International Management Group (UK) Ltd v German* [2010] EWCA Civ 1349 at [28].
[59] HM Treasury, "Freedom and choice in pensions" (Cm 8835, March 2014) at paras 5.5-5.7.
[60] ibid at paras 5.11-5.14.

These considerations cannot easily be weighed against each other, and there is no evidence of any systematic attempt to do so. Rather, different elements of the statutory regime reflect each to varying degrees, the balance seemingly depending on whatever is in vogue. The Pensions Act 1995 was in part a response to the Maxwell scandal, and seen in that context the overriding prohibitions in sections 91 and 92 are unsurprising. The objectives behind the introduction of the new flexibility regime are not wholly clear, but seem to include stimulating the pensions marketplace,[61] as well as an ideological commitment to individual choice.[62]

Individual autonomy seems to be the policy of the present moment. The statutory scheme for flexible access to personal pensions uses the tax system to encourage responsible behaviour: a higher rate of cash withdrawal will generally result in more income tax to be paid. What it does not do is impose strict limits, or rules which assume the member cannot be trusted to make her own decisions – and to live with the consequences of them. Whether this approach represents a new normal remains to be seen, and if it does, whether the older, stricter, more paternalistic approach seen in sections 91 and 92 will eventually be replaced by something more in tune with modern thinking.

[61] ibid at para 2.26.

[62] ibid at page 3.

Contact Details

Wilberforce Chambers
8 New Square, Lincoln's Inn
London WC2A 3QP
wilberforce.co.uk

Wilberforce Chambers **@WilberforceCh**

For more information about any articles written in this book or for additional copies please email wilberforce@wilberforce.co.uk

Michael Furness QC	mfurness@wilberforce.co.uk
Sebastian Allen	sallen@wilberforce.co.uk
Michael Tennet QC	mtennet@wilberforce.co.uk
Emily McKechnie	emcKechnie@wilberforce.co.uk
James McCreath	jmccreath@wilberforce.co.uk
Paul Newman QC	pnewman@wilberforce.co.uk
Jonathan Hilliard QC	jhilliard@wilberforce.co.uk
Thomas Seymour	tseymour@wilberforce.co.uk
Jamie Holmes	jholmes@wilberforce.co.uk
Emily Campbell	ecampbell@wilberforce.co.uk
Michael Ashdown	mashdown@wilberforce.co.uk