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Edward Nugee Memorial Lectures

Lecture Notes June 2020

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Wilberforce Pensions

The Edward Nugee Memorial Lectures

Contents

Page

Foreword

Edward Nugee QC, who died in 2014, was the head of our chambers for over 30 years until 2006. He was a pre-eminent trusts lawyer who helped shape the modern law of pensions in seminal cases such as *Re Courage, Imperial Foods* and *Mettoy v Evans*. Under his leadership, Wilberforce Chambers became the leading set of pensions barristers with a strong tradition of expertise and specialisation in pensions law that continues and thrives today. This series of lectures is dedicated to his memory.

The Edward Nugee Memorial Lectures have now been running annually, together with the publication of an accompanying booklet of full text papers, since 2015. We are very pleased that they maintained their popularity, including this year when the lectures were in necessarily "virtual" form.

As with previous years, we have attempted to focus not only on issues arising in contentious disputes but also on issues of interest to those working on non-contentious matters. This means that, though the talks are up to date with the latest relevant developments, we seek to avoid the choice of topics being driven by issues that have arisen in recent litigation.

The first of this year's lectures was on "Requests for contribution breaks". Tom Robinson, Simon Atkinson and Francesca Mitchell looked at the issue from both the perspective of the trustees and from the perspective of the employer; from the perspective of pensions regulation, and also company and insolvency law. In view of the Covid-19 pandemic, it is obviously a hot topic and one that is likely to remain so for some time.

The second lecture, given by James McCreath and Jonathan Chew, examined a number of difficult questions in the law of rectification in the light of case law developments, including in relation to the practicalities of the subjective/objective distinction and identifying the individuals whose past intentions matter.

The third lecture, given by David Pollard and M Scott Donald of the University of New South Wales, came at investment issues from two different angles. David Pollard analysed the concept of "prudence" in the context of investment, whilst M Scott Donald provided a framework for the consideration and effective management of extreme risks in the pension scheme context.

In the fourth lecture, Michael Furness QC, Robert Ham QC and Jonathan Davey QC addressed a number of questions concerning tax – including what is a "payment" for the purposes of unauthorised payment charges, how to deal with tax in the context of previously underpaid benefits, and in specie contributions.

We hope that you find this booklet of continuing use. If you have any questions arising out of the papers, please do not hesitate to get in touch. We hope to see you in person just as soon as is possible.

Tom Robinson
James Walmsley

Speakers

Guest Speaker: M Scott Donald (University of New South Wales)
Associate Professor Scott Donald is Director of the Centre for Law, Markets and Regulation, UNSW Law, UNSW Sydney. Scott joined the Faculty in 2010 after a successful career in the funds management industry advising governments, superannuation funds, insurance companies and fund managers on investment strategy, governance and regulation. Scott teaches corporations, trusts and superannuation law at both undergraduate and post-graduate level. He regularly presents at academic, professional and industry conferences in Australia and overseas and publishes in both the academic and professional press on research related to financial services regulation, governance and superannuation policy.

Robert Ham QC
Robert was one of the first trust practitioners to specialise in occupational pension work and was invited to join the APL when it was established. He appeared in the first modern case in the Court of Appeal – *Kerr v British Leyland* – and the first modern case to go to the House of Lords – the *National Grid* case. More recently, he has been involved, both as counsel and as an expert witness, in contribution notice and FSD cases as well as the inevitable RPI/CPI cases. He is a longstanding member of the APL Pensions Litigation Committee. Chambers & Partners 2020 says that he has been "*a leading authority for years*" and The Legal 500 2020 notes he has "*a superb mind and provides wonderfully clear advice*".

Michael Furness QC
Much of Michael's work involves occupational pension schemes. He advises on all aspects of pensions law, including: scheme funding, PPF issues, investment related issues, equalisation, pension scheme taxation, S 75 debts, insurance company products, construction of scheme rules and Local Government Pension Scheme issues. His 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 frequently advises insurance companies and Sipp providers on tax and regulatory issues. The 2020 edition of The Legal 500 describes him as "*hugely experienced with an encyclopaedic knowledge of pensions law*", while Chambers & Partners notes that "*it is very reassuring to have him in your corner*". Recent cases include *Univar v Smith* (2020), *Airways Pension Scheme Trustees v Fielder* (2019) and *BT v BT Trustees* (CA) (2018).

Jonathan Davey QC
Jonathan was appointed Queen's Counsel in 2016 at just 13 years' call. Prior to taking Silk, Jonathan served on the Attorney General's A Panel of Counsel to the Crown, the most senior of the 3 Crown Panels. He has a broad commercial chancery practice with a particular focus on trusts and tax litigation. In this series of Pensions Lectures, Jonathan will be discussing the key pensions/tax Court of Appeal decision in *Gareth Clark v HM Revenue and Customs*, in which he acted for the respondents (HMRC). Chambers & Partners 2020 describes him as "*a thoroughly modern QC who gives very straightforward and to-the-point advice. He's someone who always provides answers rather than creates problems.*"

David Pollard
David is a leading and highly experienced lawyer in the pensions field and related areas. He switched to practice as a barrister at the end of 2017, after 37 years practice as a solicitor, including 25 years as a partner in law firm Freshfields Bruckhaus Deringer. His practice as a solicitor included advising employers and trustees in relation to pension law matters, including corporate transactions, scheme funding, scheme mergers, scheme changes, employer insolvency and Pensions Regulator issues. He was chair of the Association of Pension Lawyers (APL) from 2001 to 2003, and has published five books in the areas of pensions, insolvency and employment law: "Pensions, Contracts and Trusts:

Legal Issues on Decision Making"; "The Law of Pension Trusts"; "Corporate Insolvency: Pension Rights"; "Corporate Insolvency: Employment Rights" and "Employment Law and Pensions".

Tom Robinson

Tom acts across a wide range of pensions matters, on behalf of scheme trustees, scheme members, employers and bodies such as the PPF and Pensions Regulator. He has advised on matters from the operation of section 67 of the Pensions Act 1995 and section 37 of the Pension Schemes Act 1993 to trustees' duties and the PPF Levy. He has a particular interest in the interplay between pensions and insolvency law, and has written on this topic for pensions and insolvency publications. He is also instructed on rectification matters, both as sole counsel and as part of a team. According to Chambers & Partners 2020, "*he's a real team player, in command of the detail and surefooted in discussing strategic and substantive issues".*

James Walmsley

James has extensive experience in the pensions field, building on his financial and policy experience before joining the Bar. His expertise covers both the regulatory (moral hazard powers, scheme funding, trustee appointment, pension liberation fraud) and non-regulatory (formalities issues, correcting errors in administration, rectification, contractual funding arrangements, professional liability) fields. He is recommended in both Chambers & Partners and The Legal 500 for his pensions work and is described as "*fast coming up through the ranks as a go-to pensions counsel"*. He is "*acutely intelligent and very hands-on, which is a great combination*", "*has vast experience of regulatory issues*" and is "*always thinking many steps ahead"*. Recent high-profile cases in which he has been instructed include *BHS, Box Clever* and *TPR v Payae.*

James McCreath

James' practice spans Chambers' core practice areas. He was the first junior of his call to be ranked in Chambers & Partners' commercial Chancery category and was also "*highly recommended*" in Legal Week's 2016 'Stars at the Bar'. He continues to be ranked the pensions section of both Chambers & Partners and The Legal 500, with the latter stating that he is "*clearly destined for great things, a true rising star*". James 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.

Jonathan Chew

Jonathan has acted for and advised a range of institutional and pensions professional clients. He currently is involved in multiple substantial disputed rectification cases in relation to pension increases. As well as forensic trial experience, he is experienced in the procedural aspects of multi-party OPS pensions litigation, such as Beddoe applications, applications for directions under CPR 64, and representation orders. Jonathan's work spans the full range of pensions issues covering both the trusts aspects (including RPI/CPI and equalisation issues) and regulatory matters including section 75 debts and pensions liberation. He has acted for and against the Pensions Regulator and as clerk to the Pensions Regulator's Determination Panel on several occasions. Having been included in both Chambers and Partners and the Legal 500. The 2020 edition of The Legal 500 notes he is "*a tenacious advocate*" as well as "*a great team player with a considerable appetite for work and eye for detail*".

Simon Atkinson

Simon is an experienced and in-demand practitioner. He has a broad Chancery practice and believes that the giving of practical and clear advice, combined with persuasive and fearless courtroom advocacy and an eye for detail, are qualities which clients rightly demand and which he brings to the cases on which he is instructed. Simon's pensions work encompasses contentious and non-contentious instructions relating to both defined benefit and defined contribution schemes. He has advised upon and has acted in numerous pensions matters: from regulatory proceedings to ombudsman disputes, from claims for rectification of governing documentation to professional negligence actions. Simon has acted for individual and institutional trustees, companies, members and representative beneficiaries; he has also acted for and against the Pensions Regulator.

Francesca Mitchell

Francesca joined Chambers in 2019 upon successful completion of her pupillage. She is regularly instructed in her own right and as part of a team, and has gained a wide experience of Chambers' key practice areas, including pensions law. In particular she has worked on challenges to trustees' exercise of powers, equalisation of benefits, the amendment of scheme rules and associated professional negligence. In addition, Francesca recently gave an APL Seminar alongside David Pollard and Tom Robinson on the Corporate Insolvency and Governance Act 2020 and its impact on pensions.

Requests for contribution breaks

Tom Robinson, Simon Atkinson and Francesca Mitchell

Contribution breaks from the trustees' perspective

Francesca Mitchell

Introduction

1. This part of the talk outlines some of the recent guidance that has been published, particularly by the Pensions Regulator, on issues affecting pension schemes during the Covid-19 pandemic. There is a wealth of guidance, but the focus for this talk is on three aspects of the guidance for trustees which addresses:

    a. requests for easements in Defined Benefit schemes;
    b. requests for a reduction in contributions in Defined Contribution schemes; and
    c. TPR easements on reporting duties and its enforcement activities.

DB scheme funding and investment

2. The key piece of guidance on this is *"DB scheme funding and investment: COVID-19 guidance for trustees",* published on 27 March 2020.[1]

3. It makes clear that trustees should be open to requests to reduce or suspend deficit repair contributions, providing that they keep in mind a number of key principles, including:

    a. understanding the employer's cashflow and the drivers behind the request. In this regard the guidance suggests a number of questions to help trustees elicit this information from sponsoring employers who are in corporate distress;
    b. ensuring that no payments or dividends are paid to related entities or shareholders. Although extraordinary and essential intra-group payments/lending may be justifiable in exceptional circumstances;
    c. ensuring that other creditors and/or lenders are generally being supportive;
    d. any suspension should have a specified end date and should trigger to restart when trading returns to normal; and
    e. trustees should be considering only short periods of suspension. In circumstances in which sufficient information is not yet available for the trustees to make a fully informed decision, the trustees should only agree to requests for as short a period as possible, but no longer than 3 months. However, further extensions may be appropriate where other creditors have committed to support the employer for

[1] https://www.thepensionsregulator.gov.uk/en/covid-19-coronavirus-what-you-need-to-consider/db-scheme-funding-and-investment-covid-19-guidance-for-trustees

longer periods of time, and any earlier restriction by the trustees may limit that support.

4. In addition, TPR advises that it should be a condition of any agreement that full and ongoing provision of information is provided by the employer to the trustees. Further, TPR has made it clear that any release of security is unlikely to be in the members' best interests. On the other hand, if other parties or creditors are strengthening their access to the employer's assets through security, then the trustees should ensure that the scheme is given a fair share of the new security.

5. Upon a request for easements the trustees should consider the following key points:

   a. take legal and actuarial advice. Not only on whether a suspension/reduction of DRCs is appropriate, but also on the most appropriate method of doing so. For example whether that is by amending the Schedule of Contributions or simply by suspending payments without amendment in order to avoid any unintended consequences, such as triggering a winding up;
   b. contributions should be repaid within the current recovery plan timeframe and the recovery plan should not be lengthened unless there is sufficiently reliable covenant visibility, or if the existing recovery plan is short; and
   c. TPR cannot waive trustees' statutory obligations, but it will not take regulatory action in respect of late reporting or failure to make contributions during the three-month period.

   These considerations should apply to any request to suspend or reduce future service contributions, but there will be additional issues to consider (in particular, it will always be necessary to consider whether any amendment is permissible under the scheme rules).

DC scheme reducing contributions

6. TPR has recognised that some employers may be struggling to make their pension contributions. In that respect it has issued guidance specifically for employers.[2] But it has also issued guidance for trustees, it is called *"DC scheme management and investment: COVID:19 Guidance for trustees",* and published on 27 March 2020. [3]

7. If employers are paying more than the 3% auto enrolment contribution, any excess will not be funded by the Coronavirus Job Retention Scheme. In these circumstances the employer may want to reduce its contributions. Whether it can do so will depend on the employment contracts and the terms governing the pension scheme, and it may also require the approval of the employees, a trade union and/ or the trustees.

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2 https://www.thepensionsregulator.gov.uk/en/covid-19-coronavirus-what-you-need-to-consider/automatic-enrolment-and-pension-contributions-covid-19-guidance-for-employers

3 https://www.thepensionsregulator.gov.uk/en/covid-19-coronavirus-what-you-need-to-consider/dc-investment-and-transfer-values-covid-19-guidance-for-trustees

8. If this is the case and the employer wants to reduce their contribution to the statutory minimum, they can only do so if they do not breach the auto-enrolment requirements. They will also need to consider factors such as whether they will need to change the scheme rules, and whether consultation is necessary.

9. In relation to consultation, those employers with at least 50 employees are legally required to consult for a minimum of 60 days if they are decreasing the employer contributions. However, TPR has eased the regulatory action if the employer fails to consult for the full 60-day period, subject to certain conditions being satisfied:

    a. the main condition is that the proposed reduction in contributions is only in relation to furloughed staff.
    b. If the employer wants to reduce contributions for other members of staff who have not been furloughed through the Coronavirus Job Retention Scheme, they are still required to consult for 60-days.

10. If a change to the scheme rules is required, the power to do this could rest with the trustees, the employer, or be shared between them. It will depend upon the individual scheme rules.

11. If the power is with the trustees, they will need to make sure that any decision taken is in the best interests of the members:
    a. Although the employer is not an object of the trustees' powers, the trustees can consider the likelihood of the employer being able to continue as a going concern if it continues to pay the current rate of contributions.
    b. But the risk must be genuine, and trustees should consider whether any change should be temporary.

12. If the power rests solely with the employer, the employer should notify the trustees before making any changes.

Reporting duties and enforcement activities

13. In response to the Covid-19 pandemic, TPR has eased some of its reporting duties and enforcement activities.

14. In relation to reporting requirements, TPR said that if the breach (i) will be rectified within a short time frame (i.e. not more than three months), and (ii) does not have a negative impact on savers, then there is no need to report it to TPR. But trustees should nonetheless keep records of any decisions made and of any action they take.

15. In relation to TPR enforcement, TPR has made clear that it will make decisions on a case-by-case basis and adopt a flexible approach (i.e TPR will grant longer periods for compliance and take the impact of Covid-19 into account).

16. Finally, the Ombudsman has confirmed that it will take into account all of TPR guidance if it receives any complaint about delay, and although (at present) these easements are only in place until the end of this month, TPR has said it will review whether other flexibilities or

restrictions are required, and whether these easements should be extended beyond the 30th June. As such, we will have to wait and see what further steps TPR takes.

Requests for contribution breaks: issues for trustees to consider

Simon Atkinson

1. With guidance coming thick and fast from TPR, it is reassuring that the regulator is taking a pragmatic and a scheme-by-scheme approach given the varying needs of employers and the pressures being faced by trustees.

2. It is important to remember, however, that guidance is just that. Trustees have wider issues to consider than just regulatory ones; they have a plethora of legal and actuarial issues to consider when a request for a contribution holiday or reduction is made. Trustees also have to deal with the commercial realities of sponsoring employers facing huge economic uncertainty. Trustees face potentially conflicting demands from employers on the one hand and from members on the other. How should trustees respond to requests for contribution holidays / reductions in these circumstances?

3. Trustees will need to be alive to, *inter alia*, the following broad issues:

    a. Powers: what powers do the trustees have and how, if at all, should they be exercised?
    b. Persuasion: if contribution holidays / reductions are requested, how are trustees to communicate their decision in response to the employers / membership?
    c. Penalties: what can go wrong if trustees agree to contribution breaks / reductions?

Powers

4. The first question for trustees must always be: is it within the scope of their powers to agree to a break or reduction in contributions?

5. Trustees will need to be alive to the risk that contribution suspensions / reductions may inadvertently trigger winding up provisions, particularly if imposed unilaterally by employers. Given that risk, however, and the consequent risk of triggering a s. 75 debt, employers are unlikely to act unilaterally; they will seek to negotiate with the trustees. Nevertheless, the trustees must be sure to check that agreeing to any contribution holiday / reductions is not going to have unfortunate and unintended consequences for the scheme.

6. In practice, in the context of defined benefit schemes mutually agreed contribution suspensions / reductions in respect of deficit repair contributions are unlikely to present too much of a problem. The amounts to be paid by scheme employers fluctuate depending on the schedule of contributions agreed with the trustees. Trustees and employers are experienced in negotiating different rates as might be required from time to time.

7. Reductions in respect of future service contributions may, however, be more problematical in both DB and DC schemes. The trust deed and rules may well specify the member's entitlement. DC schemes which make provision for contribution rates higher than the 3% auto enrolment minimum are likely to specify a particular percentage payable by the

employer and, absent a scheme amendment, it may not be possible to reduce those contributions.

8. If contribution holidays / reductions are or may not be permissible under the scheme rules, one option for trustees to consider is whether any power of amendment may be exercised so as to permit contribution holidays / reductions in certain specified situations.

9. If the trustees do have a power to amend, whether jointly with the employer or solely, then they will need to consider whether it is appropriate in the circumstances to amend the scheme rules. Trustees must of course only exercise their powers for proper purposes. The case of *Re Merchant Navy Rations Pension Fund* [2015] EWHC 448 (Ch), [2015] Pens. L.R. 239 provides some helpful indications (albeit in a very different factual context) that it may be permissible and appropriate to take into consideration the interests of the employer when exercising a power provided that the primary purpose of securing the benefits due under the rules is furthered by the exercise of the power: [233]. Trustees also have to be alive to the reasons why they are being asked to exercise their powers by an employer. As was noted in *British Airways plc v Airways Pension Scheme Trustee Ltd* [2018] EWCA Civ 1533, [2018] Pens. L. R. 19, even where a power is apparently unlimited, its use to alter the constitutional balance of an entity can amount to a breach of the proper purpose principle: [103].

10. Of course, it may well be in the best interests of members as a whole for trustees to agree a break / reduction in pension contributions if that will help the employer to continue as a going concern; thus it may well also be in the best interests of members to amend the scheme to introduce a power to agree a contribution holiday / reduction. Nevertheless, this will always be a highly fact dependent question to which the trustees will need to give anxious consideration.

11. A further issue to which the trustees of DB pension schemes will need to have regard is the statutory scheme funding regime set out in Part 3 of the Pensions Act 2004. Under s. 227 the trustees can revise a schedule of contributions but the scheme actuary must certify that any revised schedule will be sufficient for the statutory funding objective to be met by the specified end date. Accordingly, if there is to be a revision to the agreed schedule of contributions then the trustees will need to seek input from the scheme's actuary as part of the discussions and agreement with the employer.

12. As for any recovery plan to which a DB scheme may be subject, TPR expects that in most cases any shortfall in contributions will be made good during the existing recovery plan period (unless the remaining period is particularly short). Accordingly, any contribution holiday / reduction should not generally result in a lengthening of any existing recovery plan.

Persuasion

13. Even if the trustees do have the power to agree a contribution holiday / reduction with the employer, they also need to consider how they are going to negotiate effectively with the employer while at the same time keeping the membership up-to-date and 'on board' so far as possible.

14. Trustees have the unenviable task of being caught between employers who are looking to preserve cash reserves at present and the membership who will be concerned about the value and security of their pension and, particularly if they are still active members, the viability of the employer.

15. How then is a trustee to deal, strategically as well as legally, with a request for a contribution holiday / reduction?

16. It is notable that TPR's guidance expressly states that it expects trustees to be *"open"* to requests from employers and to have an understanding of the employer's cashflow and needs as well as the position of the company's creditors. Accordingly, trustees should not reject out of hand an employer's approach.

17. Openness, however, goes both ways. TPR expects employers to be frank: full and ongoing information should be provided. Furthermore, openness does not mean that trustees should be a push over in any discussions nor that they should accept at face value an employer's assertions as to the reasons for seeking contribution holidays / reductions. TPR points out that contribution holidays / reductions should be as short as possible, and generally no more than 3 months, particularly where the information given by the employer is unclear or incomplete.

18. Trustees should also be alive to the risk that the cash freed up by any contribution holiday / reduction may be used either to treat other creditors preferentially or to benefit shareholders. As to the former, there is of course a tendency for struggling businesses to rob Peter to pay Paul. If other creditors are tightening the screws, then the pension fund should not be seen as a resource for bailing the employer out of a difficult spot with lenders; trustees should be asking employers what support the employer's lenders are giving in these difficult times. As for the latter, the employer should not generally be bailing out other group companies at the expense of the scheme nor should shareholders be enjoying dividends. The trustees will need to be asking the employer for information in these respects before agreeing to any contribution holiday / reduction.

19. Remember, the guiding principle is always: what is in the best interests of the objects of the scheme? In principle, a genuine request for suspensions / reductions in contributions may well be in the interests of members since it will give the employer the chance to trade out of any temporary difficulties. But in practice the trustees need to be very careful to ensure that this is in fact so.

20. As for the membership, the trustees will of course not only need to ensure that they are at times acting in their interests but also need to be aware of the risk of future criticism or complaint.

21. As trustees know all too well, complaints to the ombudsman and the court are frequent. Trustees may take decisions now in haste and be repenting of them at leisure in the future.

22. It is worth bearing in mind the following nightmare scenario. The trustees agree a contribution holiday hoping and believing that the employer will be able to ride out the storm. Contributions are paused for, say, three months. The employer then asks for another pause; that is agreed to as trading conditions haven't improved. As the government support packages wind down, however, debts and taxes fall due. The employer essentially continues in a zombie form for a short while and then enters insolvency. Contributions haven't been made for, say, six months. Members have lost jobs, the value of their pension pots have gone down and the scheme's deficit has ballooned. Members are angry and are looking to scrutinise the trustees' actions. In those circumstances, will the trustees be able to explain why they agreed the contribution holidays and the basis on which those decisions were taken? Will they be able to identify the safeguards they put in place to try to avoid the very eventuality which has arisen? Waving through a request for a contribution holiday will look extremely unflattering in the cold light of day of corporate insolvency. Members may seek to claim not just the missed contributions but also the lost investment returns on them

23. The provision of information to the membership can be of critical importance. Timing may be tight so consultation with the membership may not always be possible, though it is of course always better to err on the side of openness if possible. Members will not thank you later for what they consider to be clandestine dealings.

24. What consultation or information is required or advisable depends on what is being proposed. If the contribution reductions affect conditions of employment, the employer is going to have to contact members anyway. But where what is being proposed relates to deficit repair contributions, for example, consultation may not strictly be necessary in advance of reaching agreement with the employer. Nevertheless, it is generally good practice to keep the membership up to date as to what the trustees are doing in these difficult conditions.

Penalties

25. The third broad issue to which trustees will need to have regard are the penalties potentially applicable to them.

26. As noted above, trustees need to obtain actuarial input if revising schedules of contributions. There are penalties under PA 2004, s. 227 if trustees fail to take all reasonable steps to secure compliance with the requirements of that section.

27. It is important to note that unpaid employer contributions are <u>not</u> prohibited employer related investments, since they are expressly excluded from the scope of the Pensions Act 1995, s. 40 by the investment regulations.

28. Furthermore, as already noted above, TPR are taking a flexible and case-by-case approach to enforcement. They are sympathetic to the plight of all interested persons at this time. Provided therefore that the trustees are taking proper advice and acting responsibly and reasonably, then it is doubtful that TPR will subsequently criticise the trustees even if future events might prove that in retrospect it would have been better for the membership had no

contribution holiday / reduction been agreed. The law and TPR do not expect trustees to be soothsayers.

29. Finally, it is worth just mentioning the tax implications of contribution holidays / reductions. The Finance Act 2004, s. 179 treats unauthorised employer loans as prohibited and may trigger an unauthorised payment charge. While HMRC's guidance to pension scheme trustees has been rather less substantial than TPRs during the Covid-19 pandemic, it has indicated that arm's length commercial negotiations, including payment holidays on loans or rents, will not trigger an unauthorised payment charge. While it is difficult to describe contribution holidays as payment holidays on loans, the overall tenor of HMRC's approach seems to suggest that provided trustees and employers are approaching negotiations in a robust and commercial manner, then criticism will not be levelled.

Conclusion

30. In conclusion, therefore, there are a number of issues which trustees of pension schemes will need to grapple with if an employer makes a request for contribution suspensions / reductions. The bottom line for trustees is to take advice when faced with such a request and to do it quickly.

Issues for the employer

Tom Robinson

Introduction

1. This part of the talk looks at contribution breaks from the perspective of the employer. The classic scenario is easy to state: a company trying to preserve cash and maintain a viable business that looks to its creditors in order to agree postponements or waivers of forthcoming payments.

2. A pension scheme is an obvious creditor for the employer to look to in order to seek payment holidays. There are perhaps four main reasons for this:

   a. The first is that the scheme has a very obvious interest in seeing the employer survive. TPR's message for several years now has been that the best support for a pension scheme is a strong employer, and it is repeating that message at present.[4] Further, the trustee board is likely to include people with a history of supporting the employer or its group, and with knowledge of the employer's business and its current employees, so that in that sense too they may feel they have an interest in seeing the employer survive.

   b. The second is that the business does not need the scheme's services on a day to day basis in order to continue as a going concern. We can recognise the industrial relations issues and other communications issues that need to be managed as part of suspending contributions to a scheme, but they are of a different nature to those that arise when negotiating with key suppliers or lenders, who may be prevailed upon to introduce new money in order to fund a restructuring or simply keep the business trading during what is hoped to be a short term crisis.

   c. The third reason that employers will be tempted to look to the Scheme is because of its long-term nature. The Scheme can and must take a long-term view. Employers may consider that the Scheme can adjust its Recovery Plan and other income projections in order to cope with suspensions of contributions in the short term. For Recovery Plans, there is a well-trodden path of back end loading.

   d. A further reason for the employer to look to the scheme for relief from cashflow pressures is that it may have suffered a lesser impact than the employer over the past few months. This is of course fact specific. Some schemes will have seen substantial falls in asset values since the pandemic began, and some businesses have seen revenue vastly increase. However in a number of cases this may provide a further reason for employers to look to the Scheme.

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4 https://www.thepensionsregulator.gov.uk/en/media-hub/press-releases/2020-press-releases/trustees-and-employers-must-work-together-to-protect-savers-tpr

3. In my view it is worth those advising the employer being clear which of those reasons, or others, mean the scheme should be asked to assist. Identifying the reasons ought to help shape the strategy for getting a contribution break agreed.

4. TPR recognised from very early in the pandemic that requests for contribution breaks by employers may be appropriate reactions to the current situation.[5] However, just as for the trustees, directors of the employer, its group, and those advising them have a number of issues to consider before putting in place such breaks.

5. Those issues can be grouped as follows:
    a. The need for compliance with insolvency and associated legislation, both as it is now but also with regard to the new Corporate Insolvency and Governance Bill 2020;
    b. The position of TPR & pensions legislation;
    c. Non-statutory considerations.

Non-statutory considerations

6. I'd like to start by identifying some non-statutory considerations that directors ought to have in mind in this scenario of contribution breaks. By this I mean equitable principles, common law rules, and guidance. There are three that I think are particularly important in the context of this talk:
    a. "equality is equity";
    b. Transparency;
    c. Prudence.

7. The first is the maxim that "equality is equity", which arguably underpins the scheme of pari passu distribution in insolvency procedures and leads to a need carefully to justify any proposal to treat creditors differently. We have seen that in the context of CVAs[6] and it will be important in the context of the new restructuring plan found in the Corporate Insolvency and Governance Bill 2020. We know that the PPF and TPR have for a long time been concerned to see that in situations of distress the scheme is treated fairly and that other creditors are not put in a better position than the scheme as a result of a restructuring. So one key consideration is how a contribution break fits with dealings with other creditors. If creditors are being treated differently, there need to be good reasons for that.

8. That is not to say there cannot be good reasons. It may be that the Scheme can be offered security or other mitigation that protects its position while the contribution break lasts, and it may be that the financial impact on the scheme can be addressed by later contributions in a way that is not possible with other creditors who need regular payments in order to stay afloat. It may also be that differential treatment can be justified for business continuity

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5 https://www.thepensionsregulator.gov.uk/en/covid-19-coronavirus-what-you-need-to-consider/db-scheme-funding-and-investment-covid-19-guidance-for-trustees/guidance-for-db-scheme-trustees-whose-sponsoring-employers-are-in-corporate-distress.

6 For example in the context of the challenge to the Debenhams CVA in September 2019: *Discovery (Northampton) Ltd v Debenhams Retail Ltd* [2020] BCC 9 at [12].

reasons, and / or by differences in perception. In a case last year challenging the Debenhams CVA[7] the High Court accepted that treating landlords differently to suppliers in the CVA proposal could be justified on the basis that there is a different perception caused by renegotiating liabilities with landlords holding long term leases above market rent, as opposed to suppliers operating on an order by order basis.

9. The second is transparency and provision of information. Obviously there are important statutory obligations that govern the provision of information from employers to trustees[8], but I have in mind here a more general principle that, to the extent possible, the employer should provide full information to the trustees as to a financial situation of distress, and its proposals for dealing with it. You can choose to see the source of this in TPR's guidance[9], you can see it is a sensible part of negotiating, or you could see it as an aspect of the fiduciary duty that directors have to act with regard to the interests of creditors when the company is in the zone of insolvency.[10]

10. The final consideration is prudence. I use this to refer to the need for the employer to be prudent in assessing its financial situation and financial needs. It's stating the obvious to say that one should avoid making one request for a contribution break only to have to make a similar request a few months later. That can easily give the impression that the contribution break is only postponing the inevitable, which is something the PPF in particular is very concerned about.[11]

11. These talks are dedicated to the memory of the late Edward Nugee QC. One of his cases when sitting as a Judge was *Re Berkeley Applegate (Investment Consultants) Ltd (No 2)*.[12] In that case he applied general equitable principles to an insolvency situation to hold that in an appropriate case the court will permit an insolvency office-holder such as a liquidator to draw upon trust property in the company's possession for his own remuneration and expenses. So it seems appropriate to start this talk by noting the importance of these non-

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7 *Discovery (Northampton) Ltd v Debenhams Retail Ltd* [2020] BCC 9 at [110].

8 Regulation 6 of the *Occupational Pension Schemes (Scheme Administration) Regulations 1996* [SI 1996/1715] imposes a duty on employers to (i) disclose on request to the trustees such information as is reasonably required for the performance of their duties or those of professional advisers, and (ii) disclose to the trustees the occurrence of any event which there is reasonable cause to believe will be of material significance in the exercise by the trustees of professional advisers of their functions.

9 For example the guidance of 27 March 2020 dealing with Covid-19 and employer requests for easements.

10 In *West Mercia Safetywear Ltd v Dodd* [1988] BCLC 250 (CA) Dillon LJ approved an approach from Australian authority that when a company was insolvent "the interests of the creditors intrude" as they become "prospectively entitled" to displace the power of the shareholders and the company's assets are "in a practical sense their assets".

11 See its Principle 6 for participating in restructurings: "*We will consider the overall viability of the employer's restructuring proposal. Rarely is the pension deficit the sole cause of the employer's distress and where this is the case we will wish to ensure the proposals have a reasonable chance of success. This is particularly important if any of the mitigation provided by the employer is reliant on the business going forward*" (https://www.ppf.co.uk/sites/default/files/2019-01/guidance_on_the_ppfs_approach_to_employer_restructuring.pdf).

12 [1988] 4 BCC 279 (Ch).

statutory considerations. We often underestimate how important non-statutory considerations can be to success in negotiating or getting TPR's or a court's approval for a particular outcome with creditors.

12. It seems to me that applies particularly to dealings with the pension scheme creditor, given the importance of equitable considerations in pensions law.

13. It perhaps also applies particularly in the current climate, when bodies such as the Cabinet Office are issuing "Guidance on responsible contractual behaviour in the performance and enforcement of contracts impacted by the Covid-19 emergency".[13] That guidance, issued on 7 May 2020, makes clear it is non-statutory guidance, but says that the Government "strongly encourages" parties to contracts to follow it. It expressly covers situations where parties cannot make payments due under an agreement. Its objectives include avoiding insolvencies and "destructive disputes". The responsible behaviour that it encourages includes:

> *"being reasonable and proportionate in responding to performance issues and enforcing contracts (including dealing with any disputes), acting in a spirit of cooperation and aiming to achieve practical, just and equitable contractual outcomes having regard to the impact on the other party (or parties), the availability of financial resources, the protection of public health and the national interest."*[14]

14. Since a recovery plan, and matters to be included in a schedule of contributions, must be agreed between trustee and employer[15] one might find room to rely on this non-statutory guidance in the context of contribution breaks. It obviously won't alter trustees' powers and duties, but may help set context in discussions with other bodies such as TPR.

Insolvency and associated legislation

15. The next group of issues arises under insolvency legislation and associated legislation. By "associated legislation" I mean the Companies Act 2006 and in particular section 172(3). This provides that the directors' general duty to promote the success of the company "for the benefit of its members as a whole" has effect "subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company".

16. That subsection gives statutory recognition to the common law principle that directors must have regard to the interests of a company's creditors when the company enters the zone of insolvency. That principle was recently discussed in detail by the Court of Appeal in *BTI 2014*

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[13] See: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/883737/_Covid-19_and_Responsible_Contractual_Behaviour__web_final___7_May_.pdf

[14] Ibid, para 14.

[15] Section 229(1) of the Pensions Act 2004.

LLC v Sequana SA,[16] which held that the duty was triggered when the directors knew or should have known that the company's insolvency was "probable".

17. That duty is the first issue I want to raise under this heading. The second is wrongful trading. The third is a change introduced by the Corporate Insolvency and Governance Act 2020, namely the introduction of a moratorium to give the company a statutory breathing space from creditors.

Duty to have regard to the interests of creditors

18. The codification of directors' duties in the Companies Act 2006, at sections 171 to 177, mainly takes the form of a prescriptive list. For example section 173 provides "a director of a company must exercise independent judgment" and s.175(1) provides "a director of a company must avoid a situation in which he has, or can have, a direct or indirect interest that conflicts, or may possibly conflict, with the interests of the company". That is deliberate. The White Paper that led to the Companies Act 2006 made clear that a statutory statement of directors' duties was desirable because it would make the law "more consistent, certain, accessible and comprehensible" which in turn would enable those duties to be more widely known and understood.[17]

19. By contrast, the duty to have regard to the interests of creditors is simply referred to in the Companies Act, with no prescription of when it arises or how the interests of creditors are to be treated.

20. Section 172 begins: "*A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole*". There is then a list of matters to which the director must have regard, for example the interests of the company's employees. Section 172(3) states "*The duty imposed by this section has effect subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company.*"

21. That leaves at least two key questions unanswered:
    a. In what circumstances will such a rule of law arise?
    b. What is the director required to do in order to comply with it? In particular, are the interests of creditors paramount or simply another matter that must be considered but not to the exclusion of matters such as the interests of employees?

22. As matters stand, with the *Sequana* case having been decided by the Court of Appeal but permission to appeal having been granted,[18] the answer to the first question is that the duty will arise when the directors knew or should have known that the company is or is likely to become insolvent. The word "likely" in this context means probable. The duty can therefore

16 [2019] EWCA Civ 112.
17 (Cm 6456), para 3.3.
18 The appeal was due to be heard on 25 March 2020, but was adjourned due to the Coronavirus pandemic.

arise before the company enters an insolvency process. That makes some sense, since it is at the time before formal insolvency that the directors retain their powers but the assets under their control are ones to which creditors, not members, are prospectively entitled.

23. However the challenge is then to describe <u>when</u> the duty arises. In Sequana the Court of Appeal noted a wide range of descriptions in the case law, including "the verge of insolvency", "nearing insolvency", "approaching" insolvency and a "real risk" of insolvency.

24. It rejected these in favour of the test identified above. It was common ground, and the court did not appear to dissent, that the content of the duty does not vary according to the degree of risk of insolvency.[19]

25. The answer to the second question is that, again as matters stand, the courts' clear preference is to treat the interests of creditors as paramount. In *Sequana* this was stated, obiter, by David Richards LJ,[20] and it has similarly been stated obiter in earlier cases.[21] That does not however mean that once the duty arises then trading should stop. The courts have recognised that even where the duty arises creditors' interests may be best served by continued trading, e.g. to allow a refinancing rather than a liquidation.[22]

26. More importantly, the test is in most cases subjective: the director must act in what he or she considers, in good faith, would be most likely to promote the success of the company having regard to the interests of creditors. That is a subjective test, and to show a breach of it requires showing that the director did not act in good faith. However the starting point must be that the directors did turn their minds to the interests of creditors. If it can be shown that the director had no regard to those interests, or even that they unreasonably overlooked the interests of one major creditor, then an objective test applies and the courts will ask what action an honest and reasonable director would have taken in the same circumstances.[23] This is likely to give a more promising route to a successful claim.

27. Coming back to the issue of contribution breaks, it would be sensible to proceed on the basis that if the company needs to ask creditors for payment holidays then the creditors' interests duty may well be engaged. It then becomes important to have regard to the interests of all creditors, and be able to show that the directors have done so, even if the result of doing so is a decision to continue trading and try to reach agreements with certain key creditors or sources of new money that will tide the company over what the directors consider (in good faith) is a short term problem.

28. Finally, a warning that when dealing with corporate groups it is easy to focus on the interests of the creditors of the group, and even on the financial circumstances of the group, rather than the specific situation of separate group entities.

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19 [2019] EWCA Civ 112 at para [119].

20 [2019] EWCA Civ 112 at para [222].

21 E.g. *Colin Gwyer & Associates Ltd v London Wharf (Limehouse) Ltd* [2003] 2 BCLC 153 at [74].

22 E.g. *Facia Footwear Ltd v Hinchcliffe* [1998] 1 BCLC 218 at 225.

23 *Re HLC Environmental Products Limited* [2014] BCC 337 at [92]

Wrongful Trading

29. It is important for the directors and their advisers to be aware of the law on wrongful trading, and it is certainly topical as the government announced early on in the pandemic that it would be suspending wrongful trading provisions for three months from 1 March 2020. The Corporate Insolvency and Governance Bill does not in fact do that, but does in large part remove the financial consequences of engaging in wrongful trading.

30. Wrongful trading is also relevant for pensions lawyers as one of the events that employers must notify to TPR under the notifiable events regime[24] is the employer receiving advice that it is trading wrongfully, or a director or former director of the company knowing there is no reasonable prospect of avoiding liquidation (which is part of the wrongful trading test). The new Pension Schemes Bill introduces financial penalties for breaches of this regime, although it looks as though its path to the statute book will be delayed.

31. "Wrongful trading" is the term used in the Insolvency Act 1986 to describe the situation where a director knew or ought to have concluded that there was no reasonable prospect that the company would avoid liquidation or administration, but the company carried on trading regardless. In such circumstances a liquidator or administrator can bring proceedings seeking payment from the director to the company's estate, which will usually be fixed at the amount by which the company's net liabilities increased during the period of wrongful trading, due to the director's conduct. There is a defence if, from the time he knew or ought to have concluded that there was no reasonable prospect that the company would avoid liquidation or administration, the director "took every step with a view to minimising the potential loss to the company's creditors as he ought to have done".

32. The relevant sections are 214 and 246ZB of the Insolvency Act 1986: the former applies if the company enters liquidation and the latter if it enters administration.

33. In most cases there are two key questions: should D have concluded that there was no reasonable prospect that the company would avoid liquidation, and if so, did he thereafter take all steps that he ought to have done to minimise loss to creditors?

34. These are both objective questions. Unlike the creditors' interest duty, wrongful trading does not involve subjective questions or proof of lack of good faith. That is presumably why in March 2020 the Government announced the suspension of this provision due to Covid-19. It requires an assessment of whether a company will avoid insolvency and what ought to be done to protect creditors, and both of those issues are extremely difficult at the present time.

35. The "suspension" is in fact achieved by requiring the court to assume that the director is not responsible for any worsening of the financial position of the company or its creditors between 1 March 2020 and 30 June 2020 (or one month after the new Act comes into

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[24] Pensions Regulator (Notifiable Events) Regulations 2005/900, Reg 2(2)(c).

force).[25] This can be extended using secondary legislation. That should remove the financial consequences of getting these decisions wrong. It also neatly removes the risk of disqualification as a director for wrongful trading, as that requires a court declaration that the director is liable to pay money as compensation for wrongful trading.[26]

36. In the short term therefore we have a pretty clear steer from the Government that directors should not be penalised for getting decisions wrong about continuing to trade in the current climate, unless they did not even turn their minds to the interests of creditors or act in good faith.

37. For pensions lawyers we have a complication that wrongful trading provisions are not in fact suspended, so that the notifiable event regime will still be triggered by advice that the employer is trading wrongfully.

Moratorium

38. In view of the points made above, there should be no difficulty in negotiating with the Scheme for a contribution break, even if the directors are not also at that time negotiating with other creditors, as long as there are good reasons for any difference in treatment and as long as they act in good faith and with regard to the best interests of the company's creditors as a whole.

39. However what if the trustees cannot or will not agree? The answer may be the new moratorium introduced by the Corporate Insolvency and Governance Bill. Unlike the changes to wrongful trading, this is a permanent change. It is also a change that has its genesis long before the current pandemic. It formed part of a consultation in May 2016 on improving the UK's corporate insolvency framework.

40. The intention is to provide the company with a breathing space from creditors. Assuming there is no outstanding winding up petition against the company, and the company is "eligible" (i.e. not a bank, insurance company, or another company subject to a specialist insolvency regime) the directors can file papers at court and commence a moratorium on legal action by creditors for 20 business days. This is capable of extension for another 20 business days by the directors and up to a year, with creditor or court consent. The papers include declarations by the directors that the company is or is likely to become unable to pay its debts as they fall due, but also a statement from an insolvency practitioner who is to "monitor" the moratorium, that the moratorium is reasonably likely to achieve the rescue of the company as a going concern. So unlike administration, the purpose <u>must</u> be survival of the company.

41. Also unlike administration, the moratorium is not (at present) an insolvency event under s.121 of PA 04. So it does not trigger a s.75 debt or a PPF assessment period, and the trustees will retain voting rights in respect of any debts due from the employer (s.137 PA 04).

[25] Clause 10 of the Corporate Insolvency and Governance Bill 2020.

[26] CDDA 1986, s.10.

42. The moratorium restricts the enforcement or payment of a category of debts described as "pre moratorium debts for which the company has a payment holiday during a moratorium". There are also "moratorium debts", which are debts that arise during the moratorium, save those that arise then due to obligations incurred beforehand. For example where the company enters a new contract during the moratorium. There are also "pre-moratorium debts" for which the company does not have a payment holiday, including rent for periods during the moratorium and "wages or salary arising under a contract of employment".

43. Where do contributions to a pension scheme fit? Unpaid contributions to a DB pension scheme under a schedule of contributions will in my view be pre-moratorium debts, and the company will have a payment holiday in respect of them. There is sometimes argument that the phrase "wages or salary" includes pension contributions because pensions are so often referred to as deferred pay. And in the Bill the phrase "wages or salary" is defined as including "a contribution to an occupational pension scheme". However it seems to me that is not a reference to contributions due from the employer to the scheme under the schedule of contributions, but rather to amounts the employer deducts from wages in order to pay to the scheme as employee contributions. There are perhaps three reasons for this:
    a. the reference to "a contribution to an occupational pension scheme" in the list of what may comprise "wages and salary" in this part of the Corporate Insolvency and Governance Bill has been taken from paragraphs 99(5) & (6) of Schedule B1 to the Insolvency Act 1986. In the context of para 99 it will almost always only refer to amounts deducted from wages and salary rather than deficit repair contributions because that paragraph only applies in administration, which will have commenced PPF assessment (save in cases of a last man standing scheme) and stopped payments of deficit repair contributions;
    b. the full description of the exclusion to pre-moratorium debts for which there is a payment holiday in the Bill is "amounts payable in respect of wages or salary arising under a contract of employment", with "wages or salary" in turn being described as including "a contribution to an [OPS]". It is not easy to see deficit repair contributions as "arising under a contract of employment";
    c. as a matter of policy, because the moratorium is intended to give a breathing space in order to allow survival, and to give protection from all but essential debts required for ongoing trading or a restructure. Deficit repair contributions feel far from the other defined moratorium debts and on the contrary feel like precisely the debts that the moratorium should give a breathing space from.

44. The moratorium prevents steps to place a company into an insolvency process, prevents legal process against the company, and prevents enforcement action by creditors such as the trustees in the form of enforcing any security. It is potentially a very useful tool to explore options for rescue, including refinance. In the original consultation in 2016 it was proposed to last 3 months, but even a 20 business day period that the directors can double gives a useful further option. And the possibility or implied threat of going down this route might help negotiations with trustees and other creditors.

Pensions Legislation

45. I have mentioned the notifiable event concerning wrongful trading. However employers in this scenario of contribution breaks also need to consider whether any other notifiable event has arisen. In particular is a decision to request such a break a decision to take action which will result in a debt which is or may become due to the scheme not being paid in full? I suspect not, unless what is sought is writing off current unpaid contributions and restructuring the Recovery Plan.

46. Separately, advisers should note the Pension Schemes Bill currently passing through the House of Lords. This is not the place to discuss it, including its new criminal offences, and in any event it may well be changed in light of the Corporate Insolvency and Governance Bill.

TPR guidance

47. On 20 March 2020 TPR issued guidance for DB scheme trustees whose sponsoring employers are in corporate distress. From the perspective of the employer, that guidance was useful. It expressly said that requests for contribution breaks may be appropriate in the current circumstances, and was realistic about the fact that engagement with trustees was likely to be complicated by many new demands on an employer's time.

48. On 27 March 2020 TPR issued guidance for employers on DB scheme funding in the context of Covid-19. It began: "We recognise that this is an extremely difficult time for many businesses, with significant uncertainty around trading continuity, staffing, and the longer-term implications for a number of sectors".

49. TPR then emphasised the importance of providing information to trustees: regular updates on the employer's outlook and contingency planning.

50. It said that it would be "pragmatic in scenarios where trustees are being asked to agree to a previously unforeseen arrangement (such as DRC reductions or suspensions, or additional debt being secured over employer assets) provided four criteria are met:
    a. The need for this can be justified.
    b. A plan is made for deferred scheme payments to be caught up (e.g. beyond the shorter term).
    c. A plan is agreed for mitigating any detriment caused to the scheme "(we recognise this may not always be possible and any decision to proceed without mitigation should be made in accordance with trustees' fiduciary duties)".
    d. "The scheme is being treated fairly compared with other stakeholders. In particular, we would first expect payments to shareholders (as well as other forms of value leaving the employer) to have ceased."

51. The guidance concludes with a reassurance to employers "that we will take a reasonable, pragmatic and proportionate approach to our regulation of scheme funding". The guidance is clear that contribution breaks may well be appropriate, and that short ones (under 3 months) can be appropriate even while fuller information is being obtained. The regulatory

easements in that guidance, including on late payments of contributions, were said to last till 30 June 2020.

52. I think it is worth highlighting the references to providing information, and to fair treatment of the scheme. What does fair treatment mean? It does not preclude differential treatment. Indeed the courts have recognised, again in the context of CVAs, that differential treatment of creditors may be <u>necessary</u> in order to achieve fairness.[27] To take an example, barring all creditors from suing a company may be unfair on those who only want to sue so that they can claim on an insurance policy. Separately, paying certain creditors in full may be necessary to ensure the business continues. Those would include service providers and essential suppliers. The court has accepted that is not the sign of unfair prejudice to other creditors who are not so favourably paid.[28] As noted above, perception plays a part here too.

53. Where should the pension scheme creditor sit vis a vis a category of essential suppliers? Treating it less favourably than other creditors in terms of payment holidays may be justified, for example by the mitigation it can be offered. If that is proposed, the important points in my mind are that the employer is transparent with information, prudent, and able to justify any departure from the principle that equality is equity.

[27] *Prudential Assurance Co Ltd v PRG Powerhouse Ltd* [2007] BCC 500 at [83-91].

[28] Ibid. See also *Mourant & Co Trustees Ltd v P Hollis & Ors* [2010] EWHC 1890 (Ch) at [67(d)].

Does Four Seasons really treat the recification of pension schemes differently?

James McCreath and Jonathan Chew

1. In 2012, no less an authority than Christopher Nugee QC, as he then was, remarked in an article that he *"used to think I understood rectification reasonably well."*[29]

2. Ours is a legal system which prides itself on the certainty of the principles it applies in a commercial context. It is a bit surprising therefore that some of the most basic principles of contract have been so controversial in the last decade or so: questions of construction, of implication (if it is any different), and of rectification.

3. The fate of the principles governing rectification is perhaps the most extraordinary. Whereas the revolutions which Lord Hoffmann sought to inspire in construction and implication were undone at the highest level, by the Supreme Court, in rectification the Court of Appeal has stepped in. So how have we got here?

4. The story begins with the factual findings of Mr Justice Briggs in *Chartbrook v Persimmon* [2007] EWHC 409 (Ch) [2007] 1 All E.R. (Comm) 1083. As is well known, that case concerned the formula for the calculation of the purchase price of development land. There was an exchange of correspondence prior to the contract which indicated that the landowner accepted that the formula would work in the way the developer subsequently argued. Notwithstanding that, Mr Justice Briggs accepted the evidence of the landowner's directors that they subjectively thought the formula worked in the way they contended, and for that reason refused rectification.

5. When the case reached the House of Lords ([2009] UKHL 38 [2009] 1 AC 1101), the developer's contention was accepted as the proper construction of the contract. But the House of Lords went on to consider, obiter, what the requirements for rectification were, and introduced a revolutionary change. Rather than seek out the parties' subjective intentions, at least in the case of commercial contracts, the hunt was for a 'prior consensus', the content of which was to be objectively construed.

6. That of course was in the contractual context, as was the subsequent Court of Appeal applying it, *Daventry DC v Daventry and District Housing Ltd* [2011] EWCA Civ 1153 [2012] 1 WLR 1333. So too was the Four Seasons case, *FSHC Group Holdings Ltd v GLAS Trust Corp Ltd* [2019] EWCA Civ 1361 [2020] Ch 365. That arose out of security documentation over a shareholders' loan in 2016. The documentation did more than just put in place security – it ended up imposing a primary obligation on the claimant to pay certain indebtedness. The Judge at first instance held that objectively and subjectively, this was not intended, and granted rectification.

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[29] *Rectification after Chartbrook v Persimmon: where are we now*, Tru L.I. 2012 26(2), 76

7. The appeal to the Court of Appeal did not seek to challenge the decision about subjective intentions, but did say the Judge had misconstrued the objective intentions of the parties. The Court of Appeal, at the end of their long judgment, held that he had not. That would have been sufficient to dispose of the appeal. But the Court grasped the nettle and asked whether the objective test was the correct one. Their answer was that it was not. What matters is the subjective intention of the parties.

8. That conclusion is the result of an exhaustive analysis of the authorities and consideration of the competing precedence of contradictory decisions. To even try to summarise that would take much longer than there is space for in this paper.

9. Instead, we want to draw out three features of the case because of the impact they will have in the pensions sphere.

10. First, the Court of Appeal held, at [176], that in the case of a written contract, whether the parties had a common intention in respect of a particular matter is to be judged as a subjective matter. That is as a matter of psychological fact (see [6]).

11. Second, the Court of Appeal held, at [176], that there had to be an *"outward expression of accord"* such that the parties understood each other to share that intention. That was a significant finding, as there was Court of Appeal authority to the effect that whether or not there was an outward expression of accord was merely an evidential factor, and that is also the basis on which the pensions cases have proceeded.

12. Third, the Court of Appeal, at [78] – [79], expressly referred to those cases, with apparent endorsement, holding that while contractual cases require an outward expression of accord, it is sufficient in cases where "consent" is necessary that the intentions of the trustee and employer coincide, even if they never actually discuss that.

<u>II. Pensions Cases and the "Outward Expression of Accord"</u>

A. *FSHC*: Outward Accord a Substantive Requirement…

13. In his summary of the requirements of rectification at [176], Leggatt LJ held that, where the basis for rectification of a "written contract" is a pre-existing common intention mistakenly not recorded by "the document":

> "*it is necessary to show an "outward expression of accord" meaning that, as a result of communication between them, the parties understood each other to share that intention.*"

14. In doing so, Leggatt LJ rejected the proposition that this requirement was of solely evidential value in proving the parties intentions (at [76]). This was contrary to widespread understanding prior to *FSHC*, both in respect of the rectification of contracts and more

widely. Chitty, for instance, treated it as an evidential requirement, by reference to *Munt v Beasley* [2006] EWCA Civ 370, a landlord and tenant case, and Hodge on Rectification charted the cases to conclude that it may not be required (see 9-59).

15. *Munt v Beasley* was disapproved of in *FSHC* on the grounds that the authorities relied on for it, apart from *Gallaher v Gallaher* [2005] Pens LR 103 at [117] were not, in fact, authority for the proposition. We might remark that the relatively casual disregard of a Court of Appeal authority on the point given by a judge of the authority of Mummery LJ should be surprising, but given the wider attacks on statements of the law from Lord Hoffmann, is not in fact unexpected. The other cases were justified on the grounds that tacit agreement may be sufficient for an outward expression of accord: see [80]-[87]. *Gallaher* was said to be different as a pensions case.

16. Having prayed in aid *Joscelyne v Nissen* [1970] 2 QB 86 as authority, Leggatt LJ gave 3 reasons why it was sound in principle at [77]:

Reason (1): The power to rectify is to correct mistakes in recording what has been actually agreed, not to make an agreement for the parties.

Reason (2): Rectification does not just prevent enforcement of the written terms of the contract, it rewrites it. This can only be justified on mutual agreement, and contractual agreement is based on objective intentions.

Reason (3): It would be capricious for a document to be rectified to make it comply with A's private intention just because, unknown to A, B shared that private intention. If the intention was not disclosed, there is no injustice or unconscionability in holding them to its terms.

17. There may be an unspoken reason for the elevation of outward expression of accord to a requirement of principle: to mitigate against the risk of rectification based purely on subjective intention upsetting valid bargains (or inducing unscrupulous and fact-heavy disputes over such bargains and abusing the legal process to extract settlement thereby). Centuries of suspicion of the interference of "equity" as "a roguish thing" no doubt leaves its mark[30].

B. …But Pensions Cases are Different, Apparently

18. Leggatt LJ was driven to accept *Gallaher* as authority for the proposition that the requirement was purely evidential because the point had been specifically disputed in that case: see [110]-[117]. Etherton J (as he then was) held that the requirement was purely evidential following *AMP v Barker* [2001] Pens LR. *Gallaher* and *AMP* will be well known to this audience, as will *Re IMB Pension Plan* [2012] Pens LR 469 at first instance which Leggatt LJ also considered.

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30 See: *Table Talk of John Selden* (ed Pollock 1927) p43*,* from the first half of the 1600s, in the passage more famous for equity varying according to the Chancellor's foot. Later Lords Chancellor felt this jibe keenly, see e.g. Lord Eldon LC in *Gee v Pritchard* (1818) 2 Swans 402, 414.

19. The reasoning for pensions cases as being different, at [78]-[79] of *FSHC* was as follows:

Reason (4): These cases are ones where the power of the amendment is subject to obtaining the consent of the employer. So, "*in this situation no agreement between the trustees and the employer is needed in order to effect a change in the rules: it is sufficient that the employer gives its consent to the proposed change.*" It follows that rectification can be justified if the independent intention is the same, because then the employer will approve what the Trustee has done (*FSHC* at [78] by reference to *AMP v Barker*).

Reason (5) The consensus where an amendment power requires consent "*is a different animal from the agreement or consensus which is relevant in a contractual case*" (*IMB* at [19] approved at [79] of *FSHC*).

C. Is this Different Treatment Justifiable?

20. Daunting though it may be to challenge a near-universally-acclaimed judgment from a new Supreme Court judge, the authors' view is that it is not beyond doubt that the reasons given for treating pensions cases differently apply with the breadth that Leggatt LJ suggests. Specifically:

a. The three "positive" reasons for requiring an outward expression of accord in contract cases are not contract-specific and do not of themselves exclude their applications to pension trusts; and

b. The two "negative" reasons for distinguishing pensions cases from "other" rectification claims, at least arguably, result from an over-generalisation of the proposition.

21. As to reason (1), rectification not making agreements but correcting errors in recording them, this is a universal principle of rectification. This is undisputable, and undisputed: rectification of pensions deeds are not different in any material way. Seen clearly, this is less a stand-alone reason than a logical precursor to reason two.

22. Reason (2) is that contractual obligations and right are based on objective intention and mutual assent:

a. This is, it is suggested, not just a contractual truth, but a broader truth about how one approaches both intention and assent.

b. As to intention, as a result of the number of cases at the highest level on *how* documents are to be interpreted in recent years, the Supreme Court has clearly shown that *all* private law documents creating legal rights and obligations are to be interpreted and approached by reference to the same objective principles of intention, albeit with appropriate weight placed on their specific legal and factual context as part of that objective interpretative exercise. One need only list out the Supreme Court recent cases (so leaving *Chartbrook* to one side in the circumstances) to make the point: *Rainy Sky* [2011] 1 WLR 2900 (shipbuilding contract); *Marley v Rawlings* [2015] AC 129 (a wills case, expressly at [20]); *Arnold v Britton* [2015] AC

1619 (residential long lease); *M&S v BNP* [2016] AC 742 (commercial lease); *Wood v Capita* [2017] AC 1173 (share SPA); and of course *Barnado's v Buckinghamshire* [2019] Pens LR 4, for pension schemes themselves.

c. In short, if unilateral documents such as wills and trust documents like pension schemes are to be interpreted using the same objective principles as a contract, one would expect any application of an objective test elsewhere in the law similarly to apply to pension schemes.

d. The notion of mutual assent could be said to be similarly universal:

(i) The "mutuality" requirement depends on the document being bilateral – but it need not be contractual. Take accession to a pension scheme by deed, whether a member or a new participating employer. The existing employer or trustee would need to make the requisite invitation and a relevant deed or other document be executed to record membership. There is mutuality there, but not contractually so.

(ii) The need for assent is even more universal; it is founded in personal autonomy and individual liberty. As a matter of private law, A cannot require B to take something B does not want. This is manifested in the notion of freedom of contract,[31] but also the rights of beneficiaries under a trust or a will to disclaim a benefit otherwise conferred by another's unilateral act.[32]

e. If that is right, then *all* private law rights are based on an objective assessment and assent. So reason (2) is not a reason to treat pension schemes differently

23. Reason (3), caprice to allow rectification where the difference is not known to both parties, can in principle apply as much to a pension trust as to a contract. Pension schemes are multi-party instruments in respect of funds to which both members and employers have commercially contributed: why should those parties not be held to the terms as presented.

24. Negative reasons (4) and (5) are based on the need for "consent" rather than "agreement". To split out two potential arguments, we take reason (4) as being the narrow ground that the scheme document required only "consent" rather than agreement, and reason (5) as a wider ground that trustee/company agreement in a pension scheme context is somehow qualitatively different to contractual consent.

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31 For freedom of contract in the modern law, see Chitty 1-032. While disputed, one of the more convincing philosophical justifications for a narrow restitutionary claim such as mistaken payment (and the change of position defence) is the balancing of the personal autonomies of both actors. See the work of E. Weinrib, e.g. "The Normative Structure of Unjust Enrichment" in C. Rickett and R. Grantham (eds.), Structure and Justification in Private Law (Oxford 2008), 21. There is at least some analogy between recovery of a mistaken payment and rectification of a mistakenly-executed document.

32 A beneficiary may disclaim an interest such that a resulting trust arises: *Re Guinness' Settlement* [1966] 1 WLR 1355, even where the benefit is conferred by statutory intestacy rules, a beneficiary may disclaim: *Re Scott* [1975] 1 WLR 1260.

25. So, as to reason (4) and the pension cases being based on consent:

a. This is, as far as it goes, a legitimate reason for the distinction in that different words are used. But it may nevertheless be questioned: (i) how much difference really is there between the concepts of "consent" of two parties and "agreement", (ii) how much was intended, and (iii) if reason (3) is right in that it would be capricious to rectify to reflect an entirely unspoken intention, why does that reasoning not apply with equal force to a "consent" requirement?

b. It is true that the reported cases on amendment powers tend to use the word "consent" rather than "agreement", although Lord Briggs in the Court of Appeal in *Safeway v Newton* [2018] Pens LR 2 summarised that requirement as requiring "*the agreement of the Scheme trustee*", suggesting at least another member of the Supreme Court may not agree with the distinction. However, the PLC standard draft refers to "agreement" (at clause 6.1).[33] Similarly, elsewhere in the cases are other powers requiring "agreement": see the power to replace the principal employer in *Shannan v Viavi* [2018] Pens LR 11 at [10] or the requirement for the agreement of the principal employer to a different pension increase in *Ove Arup v Arup UK Pension Scheme* [2020] EWHC 1064 (Ch) at [6] or *Thales* [2017] Pens LR 15.

c. However, while it may be legitimate to treat "consent" as different to "agreement" it opens up the real prospect of the substantive test for rectification being different for different pension schemes depending on their wording.

d. It would be far from satisfactory that the requirement to rectify a purported exercise of a power turns on whether "consent" or "agreement" is required. The substantive pension schemes are not materially different, yet the legal test would be. The problems around validity of amendments depending on different formality requirements are well known from the cases from *Bestrustees v Stuart* [2001] Pens LR 283 to *Gleeds* [2015] Ch 212, but even pensions litigators would not want this history to be repeated a second time as farce.[34]

26. What then of the substantive argument, reason (5), that an "agreement" or "consent" in a pensions context is different in nature by "agreement" or "consent" in a contractual case:

a. First, as a matter of principle, why should these words be treated differently. Literally, they mean the same thing. Substantively, they are intended to convey the same principle: that of consensus with another party.

b. Secondly, if the analysis above that the principles of (i) objective interpretation and (ii) the need for assent are universal in private law, or at least apply to pension schemes, why should they be different. A trustee needs to know what an employer is proposing in the same way as any other contractual counterparty.

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33 https://uk.practicallaw.thomsonreuters.com/1-501-5637?view=hidealldraftingnotes&documentSection=co_anchor_a945415

34 See Marx, The Eighteenth Brumaire of Louis Napoleon.

c. Thirdly, authorities that discuss how the operation of pensions trusts differ from contracts do not do so on the basis of the nature of "agreement". For instance, in *IMG* [2010] Pens LR 23 at [153]ff, Arnold J considered member/trustee interaction and whether an extrinsic contract was formed. He held it was not. In so doing, he decided there was no intention to create contractual legal relations, which was required (at [163]), in part because (i) as what was presented was a *fait accompli* there was no suggestion the agreement of the members was required (at [166]), and (ii) since the plan rules were to prevail, the parties intended to operate within the confines of the plan and not an extrinsic contract (at [168]). Of course, since this was a decision on extrinsic contract, it does not directly address the question of what consent/agreement means in the context of a pension scheme itself.

d. Nevertheless, the core point, that there was no suggestion of any different approach to intention when considering intention in relation to pension schemes, stands. More broadly, the classic authorities on the interpretation of pension schemes do not suggest that a different test applies (see e.g. *Stevens v Bell* [2002] Pens LR 247 and *Barnardo's* above).

e. The reasoning in *IMG* may point to the difference between scheme "consent" and contractual "agreement": it goes to the legal mechanism by which rights are altered in that consent is given within a pre-existing scheme rather than the entry into a new legal contract. But, for all the reasons given, it does not follow from using a different legal tool that a different test for rectification should apply. If the purpose behind rectification is the same across all documents, which it ought to be, it does not follow a scheme should be different.

f. Prior to *FSHC* it had been suggested that "an outward expression of intention is unnecessary in cases of voluntary dispositions" (per Lewison LJ in *Day v Day* [2014] Ch 114 at [46]-[50] – a settlement case), and as such where the relevant power was unilateral an outward expression of accord was not looked for in *MNOPF v Watkins* [2013] EWHC 4741 (Ch). But a "consent" requirement is on any view a sort of bilateral requirement, and this cannot therefore be an excuse.

g. Again before the decision, an academic suggestion from Australia (DM McClean SC in "*Recent Developments in the Law of Rectification*" (2006) 80 ALJ 427 at 431) is that "outward expression of accord" was not required where there is "*an absence of an actual negotiation or bargain*". It is suggested that elevating this distinction to a test would be unjustified in principle and unhelpful in practice. In principle, the legal act of amending with consent is the same whether or not there was a "negotiation or bargain" over the terms of the new amendment, and looking into the quasi-commercial aspects of the proposed amendment to determine the applicable legal test is difficult to justify. In practice, determining whether or not the threshold of negotiation has been met may be difficult: what of, for instance, an amendment agreed in principle whose wording passed between lawyers on both sides with amendments being made until it was agreed. That could fall on either side of the line.

27. These suggestions notwithstanding, it is settled, at Court of Appeal level and in respect of deeds requiring "consent" at least, that no outward expression of accord is necessary as part of the test for rectification. Certainly, in two pensions rectification cases before the Masters applying *FSHC* the requirement was treated as not applicable: see *Blatchford* [2020] Pens LR 5 at [23] and *Colart* [2020] Pens LR 3 at [7].

28. The requirement of an outward expression of accord, whether evidential or substantial, is a significant limitation of the importance of subjective intention in rectification. While Leggatt LJ's reversion to a subjective test could be viewed as a widening of the field of rectification, the "expression of accord" requirement goes the other way. If anything, outside the pensions context, *FSHC* has turned the test of rectification from a single one, of whether there was an objective outward expression of mistaken accord, to a double one, of (a) whether there were subjective mutual mistakes and (b) whether they were communicated to the other side.

29. In the remainder of this talk, we address the evidential consequences of this new subjective *FSHC* test and its impact on pension scheme rectification claims.

III. Evidence

30. We now turn to consider two evidential points. The first is what is meant by 'cogent' evidence in the context of pensions rectification. The second, given what we are told about subjective intention in *FSHC*, is the extent to which it is really useful to have every single participant trot along to give evidence about what they thought. We will then deal with the linked question of whose intention matters in the case of corporate decision-makers.

A. 'Cogent' evidence

31. It is often said that rectification requires *"cogent"* evidence. In Four Seasons itself, the Court of Appeal referred with endorsement to a passage in *IBM* in which Warren J, among other things, referred to this requirement. Our thesis is going to be that this requirement is overstated.

32. The requirement is an evidential one, it should be said, rather than a strictly legal one. The standard of proof in a rectification claim is the same as in any civil claim – it is the balance of probabilities (see e.g. *AMP v Barker*, para [59]). The point underlying the requirement is that the written instrument is likely to be the best guide to what the parties *intended.* As Brightman LJ put it in *Thomas Bates and Son Ltd v Wyndham's Ltd* [1981] 1 WLR 505:

> *It is not, I think, the standard of proof which is high, so differing from the normal civil standard, but the evidential requirement needed to counteract the inherent probability that the written instrument truly represents the parties' intention because it is a document signed by the parties.*

33. In the case of a simple, one-off, contract, the logic of this is clear. The parties in general terms can be expected to know what it is they're signing, or at least their lawyers can, and it is a fair inference that they would not sign anything if they were not happy with it. In

commercial dealings, there is also an obvious attraction in warding off speculative claims seeking to escape from clear contractual obligations (cf *The Olympic Pride* [1980] 2 Lloyd's Rep 67).

34. There may be analogous situations with some pension deeds. Suppose a simple and discrete amendment was made by a deed: reducing future accrual rates from 1/60th to 1/80th for example, and absolutely nothing else. That deed would be clear and easy to understand, and anyone coming along later and saying the real intention was to reduce accrual to 1/90ths would face plain difficulties.

35. But the vast majority of pension claims are in a wholly different world. The error typically involves some unintended benefit change, resulting from some accident of drafting, in an isolated clause of a lengthy and highly detailed document. To expect any of the Trustees or decision makers to pick up a point of such detail is fanciful. It will often have gone many years without being picked up by specialist pensions lawyers as they review the deed over time. When the mistake is an unintended benefit change, the decision makers can hardly be expected to carry around the detail of the previous rules themselves, or undertake a tortuous comparison between the previous rules and the new ones.

36. The notion therefore that one can take some comfort from the fact that the parties have signed the deed that it truly represents their subjective intentions seems peculiarly inapt in the case of pension schemes. If anything, the complex formal deed is the *worst* evidence of their intentions. The better evidence is surely the documents which the witnesses can be expected to have read, digested, and understood - documents such as board papers or notes of advice from lawyers, - and minutes of contemporaneous meetings, which on the face of things minutes of meetings can be expected to accurately record what was said.

37. What then of arguments from certainty? Here too, the pensions context is quite different from the commercial contractual context. In the commercial context, it is desirable that parties know where they stand, and the benefits of that can justify otherwise harsh results. It is better that a few people should be held to bargains they did not mean to make than that people's contractual obligations should be too readily challengeable.

38. Compare that to pension schemes. Ordinarily when this kind of mistake is discovered, the scheme will have been administered for years as if the mistake had not occurred – people will have been paid benefits on the basis of the rules as they were believed to be, not as they were. Indeed, the fact that that is so is often evidence which supports the claim that there was a mistake. Granting rectification in those circumstances actually promotes certainty – rather than have to unpick and recalculate benefits, you can carry on as you were.

39. It is difficult therefore to see any principled or policy justification for the *"cogent"* evidence requirement in most pensions rectification cases. Whether it has been decisive in a case since *Lansing Linde Ltd v Albe* [2000] Pens LR 15 is another matter, but it would in any event be better for it to be consigned to the jurisprudential dustbin. What matters is if you can prove a mistake, and the evidence necessary to do that will differ according to the facts, and in particular the nature of the document you are seeking to rectify and the error it contains.

B. Who should give evidence?

40. That moves us on to the next question. One quite often sees in rectification claims statements from large numbers of the individuals involved in the document in question. There is a logic to that. As we are dealing with subjective intention, there are few sources of direct evidence of what an individual subjectively intended other than their own evidence. It is possible that some individuals may have said something in a meeting which was recorded in the minutes, but the chances of that capturing any expression of intention by many, let alone all, decision makers is in practice small. Other documents – briefing papers, advice etc – are not direct evidence of subjective intention, but evidence from which inferences can be made.

41. But that logic we would suggest is ultimately not very convincing. In most cases, the documents are going to be the key – and perhaps the only useful – witness. There are three reasons for that.

42. First, there is the well-known point that Courts are becoming increasingly sceptical of the value of witness testimony given the fallibilities of human memory, and our tendency to reconstruct past events, and to do so in our own favour. As it happens, it was Leggatt J, as he then was, who put this issue into the spotlight in his decision in the *Gestmin v Credit Suisse* case ([2013] EWHC 3560 (Comm)).

43. These issues are surely particularly stark in pension rectification cases. Often the deeds will be relatively historic. But even when they are not, the process of drawing up a new deed will have been highly technical, and trustees and company decision makers will have had only intermittent involvement in it. They will very properly have left the detail to their advisers. In those circumstances, to expect individuals to have meaningful recollections which go beyond the story told by the documents is likely to be optimistic at best.

44. Second, and relatedly, it will be a rare case in which the Court's assessment of what objectively the parties were thinking differs from its conclusions as to what subjectively they were thinking. A Court finding the facts is likely to be pre-disposed to a finding that people believed what the objective observer would conclude they believed. Where there were a large number of undocumented discussions which witnesses are able to recall, witness evidence may inform the Court's conclusion as to what the parties were objectively intending as well as what they were subjectively intending. But in general terms one would not expect that to occur regularly in pensions cases: key discussions would ordinarily be recorded in a document or a minute of some meeting.

45. In fact, there is an irony underlying the subjective/objective debate. A great deal of ink and sweat has been spent on the debate. Some of the finest legal minds in the country have devoted time to earnest thought on it. In *FSHC* the Court at [130] said that the number of judges or retired judges commenting on the issue was unprecedented. But in *FSHC* itself, no one was able to cite a case after *Chartbrook* in which the Judge made different findings as to the subjective on the one hand and objective on the other hand intentions of the parties (see [128]). *Chartbrook* in that respect is a true outlier.

46. Third, there is a particular point about pensions cases that the key issue is very often not what people *intended* so much as it is what they *did not intend*. That is because most

rectification cases are about unintended benefit changes which have by mistake slipped into deeds intended to do something quite different. What really matters in those cases is not what the witnesses were thinking, but the very fact that no one mentioned the change later mistakenly made. If you have a proper documentary trail showing what the individuals were told the deed *was* intended to do, and it makes no mention of this other change, what better evidence could you get?

47. None of this is to suggest that witness evidence is not necessary in some respects. Sometimes the documents will give rise to questions which a witness can shut down. A statement from the draftsperson of the instrument in question explaining how the error came about can be extremely valuable. Similarly, evidence from witnesses of working practices or habits (whether of the individuals or the wider business/trustee) at the relevant time may be useful, see *Gestmin* at [22]. But we are doubtful that the exercise of collating evidence from as many of those involved as possible is really fruitful. We can well see why people err on the side of caution in many cases, to avoid the risk of the Court disagreeing, but we think the Court would ultimately be wrong if it did require exhaustive witness evidence.

C. Whose Evidence: Corporate Decision-Makers

48. The final area we consider is how to apply this subjective test to obtain the right evidence where the parties involved are corporate bodies or other groups. While this will often be the case with any rectification case (even *Rose v Pym* were corporations), it will inevitably be so with pension schemes. This raises two questions: (i) whose intention is relevant; and (ii) is it their subjective intention outwardly expressed that counts.

49. As such, granting rectification requires an identification of the relevant individuals whose intention, for the purpose of the execution of the deed alleged to be subject to a rectification claim, should be *attributed* to the corporate body which executed the deed. Going back to first principles:

a. At the risk of relying on Lord Hoffmann in a rectification talk, he set out three types of rules of attribution of knowledge or intention to corporate bodies in *Meridian Global* [1995] 2 AC 500. These rules are a necessary part of corporate personality (see 506).

b. There are (i) primary rules of attribution stated in the corporate documentation (e.g. *attributing* the board's intentions on management decisions to the company); (ii) primary rules as a matter of company law (e.g. unanimous shareholder decision); and (iii) general rules of attribution that apply to all persons whether legal or natural, such as the law of agency. A properly-appointed agent will bind the company as a matter of agency law, not any special corporate rule.

c. Lord Hoffmann then went on to say that there were some exceptional cases where the Court would have to fashion a special rule of attribution for the company where the primary and general rules did not cover the situation. Unsurprisingly for him, this was for Lord Hoffmann "*always a matter of interpretation: given [the substantive rule] was intended to apply to a company, how was it intended to apply? Whose act (or knowledge, or state of mind) was* for this purpose *intended to count as the act* *etc. of the company?*". Similarly, unsurprisingly, his view was the answer lied in the usual canons of interpretation. (See *Meridian* at 507.)

d. It is worth pausing here to note that *Meridian Global* is often cited as the end of the exercise for the rules of attribution: "X should be attributed to the company: see *Meridian Global*". But that is not what it says: it is a *super*structural decision that lists out general rules of law (the general and primary rules of attribution) and recognises that special rules may be invented or divined by the interpretative exercise (depending on one's view) to deal with difficult circumstances.

50. So, how does this work with rectification of pension schemes:

a. In *IMB Pension Plan* [2012] Pens LR 469, Warren J used the term "decision makers" to describe the relevant person (at [22]). In *IBM* on the company side that was the management committee as the delegates of the board, and the board of the trust company (at [310]).

b. In *IBM*, this conclusion was reached in circumstances where there was no documentary evidence recording the conferring of authority on the management committee (at [94(vii)]) although nor was there any suggestion that there was any lack of awareness or concern on the part of the boards. Instead, Warren J relied on the wide scope of the delegated authority possessed by the management committee: see [102] and [107]. It is not easy to determine from the report of the case what the precise scope of that delegated authority was.

c. Determining who is the decision maker is a question of fact to be decided on the evidence. It will be necessary to test the limits of any delegated authority: if A delegates to B the authority to negotiate while retaining the authority to decide, B will not be the relevant decision maker. A's intention may though to be to agree to that which B has negotiated. If A holds B out as having authority even if he does not, then the general rule of apparent authority will constitute an agency for the purposes of decision making. See *Hawksford Trustees v Stella Global* [2012] at [35]-[42].

d. Putting that into the *Meridian Global* taxonomy, it appears Warren J used "primary" rules of attribution: the notion of corporate "delegated powers" as a matter of company law (whether general or specific to the articles). Were the articles etc. silent, or apparent authority relied on, it may be that the delegation occurred or appeared to occur under a "general" rule of attribution under the law of agency.

51. On either analysis, assuming the approach in *IBM* is a proper application of the *Meridian Global* principles, the task for the pensions lawyer is to identify who made the decisions, what that decision was, and under what authority. Evidence on how decisions were made in the *Gestmin* sense may be helpful in proving this. It appears that these ordinary company and agency law rules suffice and that no special rule of attribution is necessary. The warning is that the question is not only the identification of the mistaken intention, but also the linking back of that to the corporate entity: decision making has both a factual and a legal element.

52. This then raises the second question: assuming, as is usual, the relevant decision maker is a board or other committee, what does their "subjective" intention mean:

a. Can a board have a "subjective" intention at all? In principle, that could either be (1) the views of the board members shared and discussed internally, provably so, but not revealed to the outside world; or possibly (2) the coincident but unexpressed private views of the individual members.

b. While (1) could be characterised as "subjective", for evidential purposes it is highly unlikely to be different to what one would think of as the "objective" intention of the board: it will be derived from meeting minutes, discussion papers etc. in the usual way. This becomes a distinction about a difference.

c. Option (2) is much more questionable: (a) how is that the intention of the "board" rather than the individuals on it; (b) how is it to be proven? Nevertheless, in the pensions context of what was *not* intended or decided, inferred from the documents, it could be said that the Court is enquiring into the individual unexpressed intentions of the members. If it was unexpressed because it went without saying, there should be no rectification; if unexpressed because it was not intended, there should be rectification. The evidential materials from the board on that basis would be the same: it would not be discussed.

53. Particularly if a pension scheme "consent" test does not require an outward expression of accord crossing the line, it may be that when you are dealing with boards (or other decision-making groups), *FSHC* makes no difference. You still look at what was said and described at the board meeting, and interpret that to decide what they "meant". The subjective/objective distinction collapses away as a matter of evidence. The recent decision in *Univar* at [2020] EWHC 1596 (Ch) at [212] touches on this issue, and tends towards meaning (1).

54. More broadly, it may be this evidential answer is the reason why *FSHC*, whilst doctrinally interesting, has not created great waves (yet) in its application. If you need to look at intentions of groups, the tests are in substance the same.

55. Given that, despite our suggestions above, it may be thought unlikely that this will lead to any great changes in practically how pensions litigation is run. The involved disclosure exercise and searching for witnesses who can explain how the board worked and what it was thinking will remain the same, not necessarily to prove Leggatt LJ's subjective intention, but to prove the appropriate attribution rule and the substantive decision of the relevant decision maker.

Prudence in investment – impact of Covid-19 turmoil breaks

M Scott Donald (University of New South Wales) and David Pollard

The use of the "prudence" test in pension scheme investment

David Pollard

Titian - Allegory of Time Governed by Prudence[35]

> "Investment powers are an example of equitable principles being supplemented by high-level statutory statements of principle which make the law, if anything, more flexible than it was before. I do not think that we need fear such reformulations. After all most of the general statements of equitable principles which we use today are simply a way of putting the matter which occurred to some Victorian judge in the course of an ex tempore judgment which his successors sought sufficiently felicitous to be worth repeating. There is nothing sacred about such formulations and I do not see why Victorian judges should be regarded as having had some special insight into the mot juste which the Australian Parliament or Professor Goode's committee or even modern judges lack. What matters is not the source of the principle but whether the judges are willing to regard it as a principle rather than try to interpret it as a black–letter rule."
>
> Lord Hoffmann (then Hoffmann LJ) in his 1994 paper "*Equity and its role for superannuation pension schemes in the 1990s*"[36]

35 Circa 1565. The name is suggested by the barely visible inscription above the portraits: EX PRÆTE/RITO // PRÆSENS PRVDEN/TER AGIT // NI FVTVRA / ACTIONĒ DE/TVRPET ("from the experience of the past, the present acts prudently, lest it spoil future actions".)

36 *Equity and its role for superannuation pension schemes in the 1990s*, ch 5 in the book '*The Evolving role of Trust in Superannuation*' (M Scott Donald and Lisa Butler Beatty eds, 2017, Federation Press, Sydney) at p79.

The use of the "prudence" test in pension scheme investment

This paper looks at the duty of care for trustees of an occupational pension scheme in relation to in investment. It is common to refer to a duty of "prudence" or to be "prudent" or to be a "prudent person".

This paper looks at the meaning of prudence in this context and whether it helps in defining the trustee's duty of care in relation to investments. Broadly, this paper looks at:

- What does prudence mean?
- What does the investment duty of care require?
- Is it the right test for pension schemes and commercial trusts?

Trustee Investment duty

This paper primarily looks at the role and duties of the trustee[37] of an occupational pension scheme. This paper looks at the duty of care applying to the trustee in relation to investment matters. As such it does not deal with the trustee duties in other areas, for example in relation to funding or exercise of discretions in relation to benefits or in relation to funding – for example the statutory reference to funding on a prudent basis in the scheme specific funding provisions under Part 3 of the Pensions Act 2004 ("PA 2004")[38].

The discussion in this paper applies to investment by the trustees of other trusts as well, for example unit trusts and family wealth trusts. However, as discussed below, one of the important factors (contexts) in relation to the scope and ambit of the duty of care is the nature and purpose of the trust. A family wealth trust, for example, has a materially different purpose to a pension scheme.

Other duties in relation to investment

It is clear that a duty of care – or skill and care – applies to the trustee in relation to its investment powers. This is in addition to and should be considered as separate from the other duties and limits on the investment power. The duty of care and skill is separate from those other duties, although the ambit of those other duties will inform the scope and extent of the duty of care and skill.

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37 The trustee of an occupational pension scheme is now usually a separate trustee company (rather than individual trustees). The directors of the trustee company are often called "trustees" but strictly as a legal matter they are not.

38 See for example the Occupational Pension Schemes (Scheme Funding) Regulations 2005 (SI 2005/3377) in relation to the methods and assumptions determined by the trustees (usually in agreement with the employer – see PA 2004, s229) to be used in the calculation of technical provisions
- at reg 5(4)(a): "economic and actuarial assumptions must be chosen <u>prudently</u>, taking account, if applicable, of an appropriate margin for adverse deviation";
reg 5(4)(b): "rates of interest used to discount future payments of benefits must be chosen <u>prudently</u> …"; and
reg 5(4)(c): "the mortality tables used and the demographic assumptions made must be based on <u>prudent</u> principles …".
This aspect of prudence in relation to funding was discussed by Jonathan Hilliard QC and Leonard Bowman in their talk '*The virtue of prudence and other funding puzzles*' given at the APL conference in November 2019.

Those other duties and constraints are not considered in detail in this paper, although they form the context in which the courts will consider the ambit of a duty of care (or prudence). Broadly those other duties and limits are:

(a) **Within powers:** Staying within terms of the trust instrument. The trustee should only invest (or hold investments) which are authorised investments, that is within the terms of the investment power for the pension scheme. In practice it is common for pension scheme trust instruments to include a wide express investment power[39]. Such a power is also now implied under section 34 of the Pensions Act 1995 ("PA 1995"). But this is subject to any limitation in the trust instrument[40].

Any other requirements in the trust instrument also need to be complied with (for example if a third party consent is needed, other than that of an employer[41]).

It is clear that a duty of care remains on trustees, even where there is a wide investment power[42].

(b) **Act for a proper purpose:** Trustees must exercise the investment power consistent with the purposes of the scheme and the purposes of the power[43]. This can give rise to issues in some cases where trustees may be seen to have mixed motives, for example investing based on political or moral considerations, rather than investment purposes based on financial factors[44].

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39 There can still be issues on the meaning of "investment" as used in the statutory provision or in the trust instrument. Not all assets or contracts may be investments for this purpose. See eg the discussion of simple loans in *Re Wragg* [1919] 2 Ch 58; *Khoo Tek Keong v Ch'ng Joo Tuan Neoh* [1934] AC 529, PC; *Dominica Social Security Board v Nature Island Investment Co* [2008] UKPC 19 at [21] and *Dalriada Trustees Ltd v Faulds* [2011] EWHC 3391 (Ch), [2012] 2 All ER 734 (Bean J) at [58] to [64].

40 PA 1995, s34(1): "subject to … any restriction imposed by the scheme".

41 PA 1995, s35(5).

42 Eg *Nestle v National Westminster Bank Plc* [1993] 1 WLR 1260, [1994] 1 All ER 118 CA per Dillon LJ at 126c. Discussed further below.

43 For a comparatively recent example of a pension trustee decision (not on investment) being set aside for not having a proper purpose, see *British Airways Plc v Airways Pension Scheme Trustee Ltd* [2018] EWCA Civ 1533, [2018] Pens LR 19. See generally on proper purposes, Pollard '*Pensions, Contracts and Trusts: Legal Issues on Decision Making*' (2020, Bloomsbury Professional), in particular ch 30 on investment.

44 For an example of political issues, see *Martin v City of Edinburgh* 1988 SLT 329, [1989] Pens LR 9 and *R (Palestine Solidarity Campaign Ltd) v Secretary of State for Housing, Communities and Local Government* [2020] UKSC 16, [2020] 1 WLR 1774.

On economic social or governance (ESG) issues, the Law Commission reached the view that pension trustees can take into account non-financial factors if "they have good reason to think that scheme members share the concern and there is no risk of significant financial detriment to the fund": Law Commission of England and Wales Report '*The Fiduciary Duties of Investment Intermediaries*' (2014, Law Com No 350) at 6.57 and 6.101, drawing on *Harries v Church Commissioners* [1992] 1 WLR 1241 at 1247 (Sir Donald Nicholls V-C). This issue is discussed in Philip Bennett '*Must an occupational pension scheme take into account ESG factors, even if there is a risk of financial detriment to the pension fund?*" (2019) 32 TLI 239. It (or a variant taken from the statutory guidance under consideration) was also mentioned (seemingly without criticism) by the Supreme Court in *R (Palestine Solidarity Campaign Ltd) v Secretary of State for Housing, Communities and Local Government* [2020] UKSC 16, [2020] 1 WLR 1774.

For a US perspective, see Max Matthew Schanzenbach and Robert H Sitkoff, '*Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee*' (2020) 72 Stanford Law Review 381.

(c) **Fiduciary duties** – the trustees should not have an unauthorised conflict of interest or duty[45].

(d) **Statutory duties and constraints**: including the requirements (mainly under the Pensions Act 1995) for:

   a. specific requirements under the 2005 Investment Regulations[46] on the exercise of powers of investment including diversification, investment on regulated markets, restrictions on borrowing etc;
   b. trustees to produce and review a statement of investment principles (SIP)[47],
   c. trustees to taking advice[48],
   d. to consult with the employer[49],
   e. restrictions or prohibitions on employer-related investment[50],
   f. the need to appoint a fund manager (and other advisers)[51],
   g. a requirement under the Financial Services and Markets Act 2000 ("FSMA"), for trustees to be authorised under that Act if they make "day to day" investment decisions (subject to some exceptions)[52]. Most pension trustees are not FSMA authorised and so in practice delegate day to day decisions to an authorised fund manager.

This list is likely to be joined by obligations in regulations aiming to secure "effective governance" in relation to the effects of climate change[53].

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45 For example for pension trustees, see *Manning v Drexel Burnham Lambert* [1995] 1 WLR 32 (Lindsay J). See further Pollard '*The Law of Pension Trusts*' (2013, OUP) at ch 6.

46 The Occupational Pension Schemes (Investment) Regulations 2005 (SI 2005/3378) ("Investment Regs 2005"), reg 4.

47 PA 1995, s35(11). Supplemented by Investment Regs 2005, reg 2(3).

48 Advice on a SIP: in writing and from a person believed to be qualified and to have appropriate knowledge and experience - Investment Regs 2005, reg 2(2)(a). Advice on whether investments are suitable – PA 1995, ss36(3) and (4). The advice usually needs to be from an FSMA authorised adviser and needs to be given or confirmed in writing – PA 1995, ss36(6) and (7).

49 Investment Regs 2005, reg 2(2)(b). For a case on SIP consultation, see *Pitmans Trustees v The Telecommunications Group* [2004] EWHC 181 (Ch), [2005] OPLR 1.

50 PA 1995, s40 and Investment Regs 2005, regs10 to 16. Discussed in Pollard '*The Law of Pension Trusts*' (2013, OUP) at ch 19.

51 PA 1995, s47. Mode and terms of appointment are dealt with in the Occupational Pension Schemes (Scheme Administration) Regulations 1996 (SI 1996/1715, as amended).

52 Financial Services and Markets Act 2000 (Carrying on Regulated Activities by Way of Business) Order 2001 (SI 2001/1177, as amended), art 4. The exemptions include the buying or selling of units or rights in certain pooled funds (eg units in collective investment schemes or shares in investment trusts or rights under an insurance policy), provided advice has been received and considered from a relevant adviser (usually FSMA authorised) – art 4(6) and (7).

53 The Pension Schemes Bill 2020, currently before Parliament, will, if enacted, give power to the Secretary of State to make regulations requiring trustees of occupational pension schemes to consider climate change – see new s41A proposed to be added into PA 1995:
"Regulations may impose requirements on the trustees or managers of an occupational pension scheme of a prescribed description with a view to securing that there is effective governance of the scheme with respect to the effects of climate change."

Investment duty of care not a fiduciary duty

Any trustee duty of care in relation to an investment function is not in itself a "peculiarly" fiduciary duty[54] in the strict and limited categorisation of Millett LJ in *Mothew*[55]. Despite this, where exercised by a fiduciary (eg a trustee) the duty of care is still sometimes called a fiduciary duty[56] and even as a non-fiduciary duty its exercise will be subject to the "peculiarly" fiduciary duties (eg no conflicts etc)[57].

Why is the investment duty of care so important?

In current times there is much economic (and physical) turmoil. This may well place strains on an occupational pension scheme, for example a strain on the strength and ability of the employer to support the scheme – called the employer covenant – and also on the level and performance of the scheme's investments.

For occupational pension schemes the trustee has a duty of care – it needs to manage and monitor the investments and (mainly for defined benefit schemes) employer covenant. Clearly there is an increased risk that interested parties - members (and employers and the PPF[58]) - will review pension fund asset performance in retrospect and consider whether the trustee board should have done better. The current turmoil may result in more legal claims against trustees in relation to the investment performance.

There is also the potential for criminal sanctions or civil penalties against trustees in some circumstances. The Pension Schemes Bill 2020, currently before Parliament, will, if enacted, create new criminal offences (and increased penalties), including ones that could fairly easily extend to investment decisions – for example as "conduct that detrimentally affects in a material way the likelihood of scheme benefits being received"[59] – were investments over risky and so did this result in risking the likelihood of benefits being received in full? This is discussed further below.

The pension trustee's duty of care in relation to investment is important because:

- the assets of pension schemes can be large – so any claim based on underperformance could involve very large sums; and

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54 *Snell's Equity* at 10-042, Law Commission report '*Fiduciary Duties of Investment Intermediaries*' (2014, Law Com no 350) at 3.13, citing *Hilton v Barker Booth & Eastwood* [2005] UKHL 8, [2005] 1 WLR 567 at [29].

55 *Bristol and West Building Society v Mothew* [1998] Ch 1, CA per Millett LJ at 17.

56 Eg *Pitt v Holt* [2013] UKSC 26, [2013] 2 AC 108 per Lord Walker at [73] and *Palestine Solidarity Campaign* [2020] UKSC 16 per Lord Carnwath at [44] agreeing with a submission from counsel.

57 The confusion in terminology is discussed in the Law Commission report '*Fiduciary Duties of Investment Intermediaries*' (2014, Law Com no 350) at 3.11 to 3.13 and 3.64 (fn127) and Pollard '*Pensions, Trusts and Contracts: Legal Issues on Decision Making*' (2020, Bloomsbury Professional) at ch 62.

58 The board of the Pension Protection Fund, established under the Pensions Act 2004 ("PA 2004").

59 Proposed new PA 2004, s58B. The 2020 Bill envisages further requirements for an act to be a crime, including (a) that the person knew (or ought to have known) that the relevant act would have that effect and (b) that the person has no "reasonable excuse".

- the common exonerations in pension scheme trust instruments (eg that trustees are only liable for a breach of duty if they act fraudulently or knowingly wrongly[60]) are excluded by PA 1995 from applying in relation to investment functions[61].

What is the investment duty of care for a pension trustee board?

When looking at the legal duty of care and skill on trustees (including pension trustees), commentators (and case law) generally refer to a "prudent person of business" test, citing two decisions from the 1880s. The first is the 1883 decision in *Speight v Gaunt*[62]:

> "As a general rule a trustee sufficiently discharges his duty if he takes in managing trust affairs all those precautions which an ordinary prudent man of business would take in managing similar affairs of his own."

The second is the 1886 decision in *Re Whiteley*[63], in particular the holding by Lindley LJ:

> "the duty of a trustee is not to take such care only as a prudent man would take if he had only himself to consider; the duty rather is to take such care as an ordinary prudent man would take if he were minded to make an investment for the benefit of other people for whom he felt morally bound to provide."

Implied prudence duty?

These cases are cited by most commentators in relation to trustee investment duties for trusts generally[64] and in the smaller number of commentaries on pension trusts[65]. Prudence is mentioned in the guidance on investment[66] issued by the Pensions Regulator ("TPR") and in its Funding Code of Practice[67].

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60 For examples in public documents see Pollard '*The Law of Pension Trusts*' (2013, OUP) at 14.11.

61 PA 1995, s33. Discussed further below.

62 *In re Speight* (1883) 22 ChD 727, CA (Jessel MR, Lindley and Bowen LJJ). Upheld by the House of Lords on appeal: *Speight v Gaunt* (1883) 9 App Cas 1, HL.

63 *In re Whiteley* (1886) 33 ChD 347, CA per Lindley LJ at 355. Upheld by the House of Lords on appeal: *Learoyd v Whiteley* (1887) LR 12 App Cas 727, HL.

64 Eg *Lewin on Trusts* (20th ed, 2020, Sweet & Maxwell) at 35-066; *Underhill & Hayton: Law of Trusts and Trustees* (19th ed, 2017, LexisNexis) at [49.57], citing *Cowan v Scargill* [1985] Ch 270 at 289 at 289, which itself cited *In re Whiteley*; Jonathan Hilliard and Emily McKechnie "Practice Note on Duty of Care for Pension Trustees" (Practical Law); *Jacob's Law of Trusts in Australia* (8th ed, 2016, LexisNexis Butterworths) at [17-18]; and Guy Newey 'Constraints on the exercise of trustees' powers' at p49 in ch 2 in PG Turner (ed) *Equity and Administration* (2016, CUP). *Snell's Equity* (34th ed, 2020, Sweet & Maxwell) mentions the term "prudence" (eg at [29-003] and [29-007], although in the latter case morphing into "commercial prudence"), but generally focuses on the reasonableness duty under the Trustee Act 2000.

65 *Freshfields on Corporate Pensions Law 2015* (Bloomsbury Professional) at ch 17; *Pensions Law Handbook* (14th ed, 2019, Bloomsbury Professional) at 10.22; *Tolleys Pensions Law* (loose-leaf, 2018) at chapter G1 (Clifford Sims); John Quarrell '*The law relating to investments*' (1994) APL conference; Law Commission report '*Fiduciary Duties of Investment Intermediaries*' (2014, Law Com no 350) at 3.13; Stuart O'Brien '*Trustees Fiduciary duties of investment*' (APL Conference, Nov 2018).

66 TPR's recent publication (17 March 2020) '*DB scheme funding and investment: COVID-19 guidance for trustees*' does not mention prudence. See https://www.thepensionsregulator.gov.uk/en/covid-19-coronavirus-what-you-need-to-consider/db-scheme-funding-and-investment-covid-19-guidance-for-trustees

67 TPR CoP 3 'Funding Defined Benefits' (July 2014) at [94]:

Where does a duty of "prudence" come from?

For a review of the history of investment duties, see Chantal Stebbings '*The Private Trustee in Victorian England*'[68].

As mentioned above, the 1883 decision in *Speight v Gaunt*[69] and the 1886 decision in *Re Whiteley* are usually taken as the current foundation[70] of any prudence duty for trustees in relation to investment matters[71].

Speight v Gaunt

In 1883 in *Speight v Gaunt* it was held that it was the duty of a trustee to conduct the business of the trust with the same care as an ordinary prudent person[72] of business would extend towards his or her own affairs: *In re Speight*[73]. Sir George Jessel MR held at p739:

> "It seems to me that on general principles a trustee ought to conduct the business of the trust in the same manner that an ordinary prudent man of business would conduct his own, and that beyond that there is no liability or obligation on the trustee. In other words, a trustee is not bound because he is a trustee to conduct business in other than the ordinary and usual way in which similar business is conducted by mankind in transactions of their own. It never could be reasonable to make a trustee adopt further and better precautions than an ordinary prudent man of business would adopt, or to conduct the business in any other way."

"94. As fiduciary stewards of scheme assets, trustees have a duty to invest them prudently in accordance with the scheme's provisions and the legislative framework."
Citing "section 36 of the Pensions Act 1995 and regulation 4 of the Occupational Pension Schemes (Investment) Regulations 2005 (SI 2005/3378)".

68 '*The Private Trustee in Victorian England*' (2002, CUP) at chapter 5.
On the history of the duty of care, see also M Scott Donald '*Prudence under pressure*' (2010) 4 J Eq 44 at 46 to 48; Joshua Getzler '*Duty of Care*', ch 2 in '*Breach of Trust*' (Peter Birks and Arianna Pretto eds, 2002, Hart Publishing) and Joshua Getzler '*Fiduciary investment in the shadow of a financial crisis: was Lord Eldon right?*' (2009) 3 J Eq 219.
On the impact of inflation in the Victorian age, see WA Lee '*Modern Portfolio theory and the Investment of Pension Funds*', ch 10 in '*Equity and Commercial Relationships*' (P D Finn ed, 1987, Law Book Co).

69 (1883) 9 App Cas 1, HL (Earl of Selborne LC, Lord Blackburn, Lord Watson and Lord Fitzgerald) per Lord Blackburn at 19.

70 Prudence or being prudent had clearly been applied in earlier cases, see eg *Blue v Marshall* (1735) 24 ER 1110, (1735) 3 P Wms 381 (Lord Talbot LC) at 383 "The defendant seems to have done nothing but what was prudent"; *Harden v Parsons* [1758] 1 Eden 145, (1758) 28 ER 639.
In *ASIC v Drake (No 2)* [2016] FCA 1552, Edelman J refers at [264] to "numerous earlier applications" of a prudent person test before *Speight*, including in *Oriental Commercial Bank v Savin* (1873) LR 16 Eq 203 at 206 and in the US in *Harvard College v Amory* (1830) 26 Mass 446.

71 See eg *Bartlett v Barclays Bank Trust Co Ltd* [1980] Ch 515 per Brightman J at 531B.

72 The judgments in this era, and for an appreciable time after, tend to refer to a "reasonable man" or a "prudent man" etc, but there is, of course, no reason to limit the principle to men.
Robert Megarry commented in '*Miscellany at Law*' (1955, Stevens) that it is appropriate "to attribute to insufficiently skilled advocacy the finding of the Court of Appeal that [the reasonable man] has no feminine counterpart at all", citing (the fictitious) *Fardel v Potts* (1935) Herbert's Uncommon Law 1 at 6 "at Common Law a reasonable woman does not exist".

73 *In re Speight* (1883) 22 ChD 727, CA (Jessel MR, Lindley and Bowen LJJ).

Similarly Bowen LJ at p762:

> "….it is clear that a trustee is only bound to conduct the business of the trust in such a way as an ordinary prudent man of business would conduct his own."

This was affirmed on appeal in *Speight v Gaunt*[74]. Lord Blackburn held at p19:

> "…. as a general rule a trustee sufficiently discharges his duty if he takes in managing trust affairs all those precautions which an ordinary prudent man of business would take in managing similar affairs of his own. There is one exception to this: a trustee must not choose investments other than those which the terms of his trust permit, though they may be such as an ordinary prudent man of business would select for his own money…"

Re Whiteley

However in investment matters, in applying this principle, three years later in 1886 Lindley LJ[75] in *In re Whiteley*[76] added a gloss that the duty is to take such care as an ordinary prudent person would take if he or she were minded to make an investment <u>for the benefit of other people for whom he or she felt morally bound to provide.</u>

Thus Lindley LJ at p355:

> "... care must be taken not to lose sight of the fact that the business of the trustee, and the business which the ordinary prudent man is supposed to be conducting for himself, is the business of investing money for the benefit of persons who are to enjoy it at some future time, and not for the sole benefit of the person entitled to the present income. The duty of a trustee is not to take such care only as a prudent man would take if he had only himself to consider; <u>the duty rather is to take such care as an ordinary prudent man</u>[77] <u>would take if he were minded to make an investment for the benefit of other people for whom he felt morally bound to provide</u>. That is the kind of business the ordinary prudent man is supposed to be engaged in; and unless this is borne in mind the standard of a trustee's duty will be fixed too low; lower than it has ever yet been fixed, and lower certainly than the House of Lords or this Court endeavoured to fix it in *Speight v. Gaunt*."

This is a clear (and early) recognition that the purpose of the trust (and the investment power) is a factor in moulding the nature of the relevant duty of care.

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74 (1883) 9 App Cas 1, HL (Earl of Selborne LC, Lord Blackburn, Lord Watson and Lord Fitzgerald) per Lord Blackburn at 19.

75 Lindley LJ had been the third member of the Court of Appeal in *Speight*.

76 (1886) 33 ChD 347, CA per Lindley LJ at 355.

77 Note that the reference here is to the ordinary prudent man – not to the trustee being prudent (see Ruth Goldman '*The Development of the 'prudent man' concept in relation to pension schemes*' (2000) 5 Jnl of Pens Management 219 and M Scott Donald '*Prudence under pressure*' (2010) 4 J Eq 44 at 46). Presumably the onus is on the person who is the trustee – see eg *Bartlett* on a professional trustee. So in a pension trust, it may be relevant that trustee body is part employer nominated and part member.

This was upheld on appeal in *Learoyd v Whiteley*[78], Lord Watson added, at p733:

> "Business men of ordinary prudence may, and frequently do, select investments which are more or less of a speculative character; but it is the duty of a trustee to confine himself to the class of investments which are permitted by the trust, and likewise to avoid all investments of that class which are attended with hazard."

But in considering the application of these cases, it is important to keep in mind that:

(a) Judgments are not statutes and should not be construed or followed as if they were[79].
(b) The context of the decisions needs to be considered[80], in particular that:
    i. The trusts involved were private wealth trusts, with limited implied authorised investments, and a purpose of protecting capital or balancing life tenants and those entitled in remainder;
    ii. *Speight v Gaunt* and *Re Whiteley* are decisions now over 130 years old. The cases were in the Victorian era, a time of limited inflation and less developed financial markets.

Speight and *Whiteley* can both be seen as part of a move at that time to a greater level of duty of care for trustees than previously[81]. Earlier cases on trustee's duties had indicated that legal review was not possible if trustees acted in "good faith"[82]. This reference to good faith has continued in some later cases[83], but it may be possible to construe these as using the term "good faith" in this context as going beyond subjective honesty to include proper purposes and due consideration[84].

Hoffmann LJ (as he then was) made a telling point on this in his 1994 paper[85]:

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78 (1887) 12 App Cas 727, HL.

79 See eg *Royal Brunei Airlines Sdn Bhd v Tan* [1995] 2 AC 378, PC; and *Express Electrical Distributors Limited v Beavis* [2016] EWCA Civ 765 per Sales LJ at [55] and [56]. More colourfully, Munby J in *Beazer Homes Ltd v Stroude* [2005] EWCA Civ 265 at [29] held:
'Utterances, even of the demi-gods, are not to be approached as if they were speaking the language of statute.'

80 Lord Steyn in *R v Secretary of State for the Home Dept, ex p Daly* commented in a 'famous phrase' that: "In law, context is everything". Lord Nicholls has stated (extra judicially) that: " … it is always necessary to know the context in which the words were being used." '*My kingdom for a horse: The meaning of words*' (2005) 121 LQR 577 at 579 and 580. Similarly Edelman J in *Rinehart v Hancock Prospecting Pty Ltd* [2019] HCA 13 at [83]: "No meaningful words, whether in a contract, a statute, a will, a trust, or a conversation, are ever acontextual."

81 This is not a new point. See Robert Ham QC '*Trustees' Liability*' (1995) 9 TLI 21 at 22: "… this is to read too much into the use of the word 'prudence' rather than the more familiar 'care' in this context. This is just a nineteenth-century formulation of a duty of care."

82 Eg *Re Beloved Wilkes's Charity* (1851) 3 Mac & G 440, 42 ER 330 (Lord Truro), *Duke of Portland v Topham* (1864) 11 HLC 31, *Gisborne v Gisborne* (1877) 3 App Cas 300, HL.

83 Eg *Re Londonderry's Settlements* [1965] 1 Ch 918, CA; *Whishaw v Stephens; Re Gulbenkian's Settlement Trusts* [1970] AC 508 at 518; *Hartigan Nominees Pty Ltd v Rydge* (1992) 29 NSWLR 405 at 427, 428–429.

84 Pollard '*Pensions, Contracts and Trusts: Legal issues on decision making*' (2020, Bloomsbury) at 3.15.

85 Lord Hoffmann (then Hoffmann LJ) in 1994 in "*Equity and its role for superannuation pension schemes in the 1990s*" at p79 in the book '*The Evolving role of Trust in Superannuation*' (M Scott Donald and Lisa Butler Beatty eds, 2017, Federation Press, Sydney).

> "Investment powers are an example of equitable principles being supplemented by high-level statutory statements of principle which make the law, if anything, more flexible than it was before. I do not think that we need fear such reformulations.
>
> After all most of the general statements of equitable principles which we use today are simply a way of putting the matter which occurred to some Victorian judge in the course of an ex tempore judgment which his successors sought sufficiently felicitous to be worth repeating.
>
> There is nothing sacred about such formulations and I do not see why Victorian judges should be regarded as having had some special insight into the mot juste which the Australian Parliament or Professor Goode's committee or even modern judges lack. What matters is not the source of the principle but whether the judges are willing to regard it as a principle rather than try to interpret it as a black–letter rule."

Why prudence?

Why does prudence (or prudent) keep featuring as the duty of care (or part of the duty of care) for trustees in relation to investment?

Part of this may be because the words "prudence" and "prudent" sound more informative as legal terminology used for a duty of care. They perhaps seem deeper than just saying "reasonable".

There are examples of this in everyday life: Gordon Brown (when Chancellor of the Exchequer) liked to be thought of as "prudent"[86], companies are named after prudence – eg the Prudential Assurance Company. Even one of the main UK financial services regulators is called the "Prudential Regulation Authority" (PRA).

Looking further at the issue of prudence and the investment duty of care, this paper looks at six facets:

1. What does the legislation say about prudence?
2. What does "prudence" mean? – prudence as a shorthand?
3. What is a better way of describing the duty of care for investment?
4. Applying out the duty of care: context, time of decision, professionals
5. Test for pension trustees?
6. Legal claims – process/perversity – applying *Braganza*?

1. What does the legislation say about prudence?

The legislation in England and Wales contains <u>no</u> express statutory investment prudence duty on trustees. The main legislation is the Trustee Act 2000 ("TA 2000") (for non-pension trusts) and the Pensions Act 1995 (and the Investment Regs 2005) for trusts of occupational pension schemes.

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86 See eg William Keegan '*The Prudence of Mr Gordon Brown*' (2004, Wiley).

This is unlike the position in other similar trust jurisdictions, for example Jersey, New Zealand and Australia[87], where the legislation includes an express reference to "prudence" or "prudent", in what looks often to be a direct statutory codification of what was said in *Re Whiteley*[88].

As mentioned above, the funding regulations made under PA 2004 do refer to "prudent" actuarial assumptions for funding, but this is not in a direct investment context[89].

Trustee Act 2000, s1

> **Trustee Act 2000**
>
> **1.— The duty of care.**
>
> (1) Whenever the duty under this subsection applies to a trustee, he must exercise such care and skill as is reasonable in the circumstances, having regard in particular—
>
> (a) to any special knowledge or experience that he has or holds himself out as having, and
>
> (b) if he acts as trustee in the course of a business or profession, to any special knowledge or experience that it is reasonable to expect of a person acting in the course of that kind of business or profession.
>
> (2) In this Act the duty under subsection (1) is called "the duty of care".

For England and Wales, the Trustee Act 2000 codifies many duties on trustees. It includes in s1 a duty of care on the basis of a reasonableness duty – ie what is "reasonable in the circumstances".

This duty under s1 applies to investment functions, whether under the 2000 Act or otherwise (TA 2000, Sched 1, para 2). But the s1 duty does <u>not</u> apply to investment functions of trustees of an occupational pension scheme (TA 2000, s36).

The Trustee Act 2000 followed directly from a report of the Law Commission in 1999. In its report, '*Trustees' powers and duties*'[90], the Law Commission commented that this duty was intended to be a flexible default standard:

> "the Law Commission considers that, in formulating the new statutory duty, express regard should be had to the particular skills and position of the trustees, and to the circumstances of the trust.

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87 See eg the discussion of the Queensland Trusts Act 1973, s22 in *Australian Securities and Investments Commission v Drake (No 2)* [2016] FCA 1552 (Edelman J) at [324].

88 See eg the discussion of the statutory position by Hoffmann LJ in his 1994 paper *Equity and its role for superannuation pension schemes in the 1990s* (fn 2 above) at p78 as being unlikely to change the "well-understood equitable principles".

89 See text to fn 4 above.

90 Law Commission of England and Wales '*Trustees' powers and duties*' (May 1999, Law Com No 260) at 3.24 and 3.25.

Pensions Act 1995, ss33 to 36

In contrast, just five years earlier, when legislating for pension trusts, Parliament decided not to enact a specific investment duty of care on pension trustees[91]. Instead the Pensions Act 1995 (and the underlying regulations, currently the Investment Regs 2005) contain only a very limited express mention of prudence for investment. Investment process is dealt with in PA 1995, ss33 to 36 and 40 (and the regulations), but a general duty of care or duty based on prudence in relation to prudence is not expressly set out. There are various exemptions and modifications for small schemes[92].

PA 1995, s33 is headed "Investment powers: duty of care", but it does not set out a duty. Instead it prohibits any exclusion or restriction of a duty of care "under any rule of law".

> **PA 1995, s33:**
>
> **Investment powers: duty of care**.
>
> (1) Liability for breach of an obligation under any rule of law to take care or exercise skill in the performance of any investment functions, where the function is exercisable—
>
> (a) by a trustee of a trust scheme, or
>
> (b) by a person to whom the function has been delegated under section 34,
>
> cannot be excluded or restricted by any instrument or agreement.

Section 33(2) goes on to expand the meaning of excluding or restricting in s33(1).

Section 33 is not an easy section[93]. Establishing a "rule of law" in relation to care or skill in the exercise of investment functions is not as simple as looking for a statutory provision.

The Pensions Act 1995 and the Investment Regs 2005 (made under PA 1995, s36(1)) do contain specific obligations in relation to investment. To repeat the outline already given above:

a. specific requirements under the 2005 Investment Regulations[94] on the exercise of powers of investment including diversification, investment on regulated markets, restrictions on borrowing etc;
b. trustees to produce and review of a statement of investment principles (SIP)[95],
c. trustees to taking advice[96],

91 The Report of the Pension Law Review Committee (Sept 1993, CM 2342) by the Goode Committee had recommended (at 4.9.7) a statutory prudent person provision for investment based on the *Learoyd v Whiteley* and *Bartlett* judgments.

92 See Investment Regs 2005, regs 6 to 9 and 13(12).

93 See eg Pollard '*The Law of Pension Trusts*' (2013, OUP) at 14.45 and Fenner Moeran QC '*Trustee exoneration & exemption clauses and pension schemes*' (2018) Nugee Lecture.

94 The Occupational Pension Schemes (Investment) Regulations 2005 (SI 2005/3378) ("Investment Regs 2005"), reg 4.

95 PA 1995, s35(11). Supplemented by Investment Regs 2005, reg 2(3).

96 Advice on a SIP: in writing and from a person believed to be qualified and to have appropriate knowledge and experience - Investment Regs 2005, reg 2(2)(a). Advice on whether investments are suitable – PA 1995, ss36(3) and (4). The advice usually needs to be from an FSMA authorised adviser and needs to be given or confirmed in writing – PA 1995, ss36(6) and (7).

d. to consult with the employer[97],
e. restrictions or prohibitions on employer-related investment[98],
f. the need to appoint a fund manager (and other advisers)[99],

This list is likely to be joined by obligations in regulations aiming to secure "effective governance" in relation to the effects of climate change[100].

Reg 4, Investment Regs 2005

The Investment Regs 2005, reg 4 deals with the exercise of investment powers, with specific obligations on pension trustees (and fund managers). Reg 4 contains a fairly detailed list of express constraints and duties on trustees (a copy of reg 4 is set out in full as Appendix A to this paper).

IORP

Reg 4 aims to enact in the UK the obligation derived from EU law[101], in particular article 18 of the IORP directive[102]. The IORP directive on pensions was originally put in place in 2003. The key provision on investment is in article 18[103].

Article 18: Investment rules
Member States shall require institutions located in their territories to invest in accordance with the "prudent person" rule and in particular in accordance with the following rules: ….

The IORP is potentially important in the context of a prudence duty in that it expressly refers to a "prudent person" rule. But this is not expressly reflected in UK national legislation.

1. IORP is a directive, so it is not directly binding on non-governmental entities. But national law should be interpreted so far as possible to comply – eg *Marleasing*[104]

2. The IORP refers to the "prudent person' rule. But this is not expressly defined further. There is a similar prudent person rule in the Solvency II Directive (2009/138/EC)[105]:

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97 Investment Regs 2005, reg 2(2)(b). For a case on SIP consultation, see *Pitmans Trustees v The Telecommunications Group* [2004] EWHC 181 (Ch), [2005] OPLR 1 (Morritt V-C).

98 PA 1995, s40 and Investment Regs 2005, regs10 to 16. Discussed in Pollard '*The Law of Pension Trusts*' (2013, OUP) at ch 19.

99 PA 1995, s47. Mode and terms of appointment are dealt with in the Occupational Pension Schemes (Scheme Administration) Regulations 1996 (SI 1996/1715, as amended).

100 The Pension Schemes Bill 2020, currently before Parliament, will, if enacted, give power to the Secretary of State to make regulations requiring trustees of occupational pension schemes to consider climate change – see new s41A proposed to be added into PA 1995:
"Regulations may impose requirements on the trustees or managers of an occupational pension scheme of a prescribed description with a view to securing that there is effective governance of the scheme with respect to the effects of climate change."

101 Explanatory Note to the Investment Regs 2005, first paragraph.

102 Its full title is "Directive on the activities and supervision of institutions for occupational retirement provision" (Directive 2003/41/EC).

103 This is now in IORP 2 (2016/2341/EU), art 19.

104 *Marleasing SA v La Comercial Internacional de Alimentacion SA* (C-106/89) EU:C:1990:395, [1990] ECR I-4135.

105 See Charles H R Morris '*The Law of Financial Services Groups*' (OUP, 2019).

In context it seems at least arguable that the "prudent person" rule in IORP, art 18 is limited to compliance with the principles described later in the article (diversification, regulated markets etc).

The CA in *Palestine Solidarity*[106] perhaps give limited support to that view when it commented that:

> "the article places obligations on Member States to require institutions to invest in accordance with the prudent person rule as more particularly set out in Article 18(1)"

LGPS and Prudence?

The Local Government Pension Scheme ("LGPS") is a statutory pension scheme for local government employees. This is a public service pension scheme, so the IORP will have direct effect. The LGPS Investment Regulations[107] do not use the word "prudent" (nor does the Public Service Pensions Act 2013).

But the Secretary of State's binding "Guidance"[108] in 2017 does refer to prudence. It states:

> "In the context of the local government pension scheme, a prudent approach to investment can be described as a duty to discharge statutory responsibilities with care, skill, prudence and diligence."

This seems a bit circular. "a prudent approach" means act with prudence (as well as "care, skill, … and diligence")?

Exclusion of prudent person duty in Investment Regs was deliberate

Regulation 4 was clearly designed to enact the requirements under the EU directive, the IORP. But, significantly, no general "prudent person" investment duty was included in the Investment Regs 2005.

This was a deliberate decision by the then government. The government response to consultation[109] on the regulations, in October 2005, expressly confirmed that no "prudent person" principle would be included.

> **Govt response to consultation (Oct 2005):**
>
> "The term "security, quality, liquidity and profitability of the portfolio as a whole" is taken directly from the Directive, where it is used to give expression to the "prudent person principle". <u>The requirement for "prudence" is already a central feature of trust law and it is not the Government's</u>

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106 *R (Palestine Solidarity Campaign Ltd) v Secretary of State for Housing, Communities and Local Government* [2018] EWCA Civ 1284, [2019] 1 WLR 37 per Sir Stephen Richards at [35]. This point was not discussed in the subsequent appeal in Supreme Court in *R (Palestine Solidarity Campaign Ltd) v Secretary of State for Housing, Communities and Local Government* [2020] UKSC 16, [2020] 1 WLR 1774.

107 Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016 (SI 2016/946).

108 'Local government pension scheme: guidance on preparing and maintaining an investment strategy statement'. Published 15 September 2016 and last updated 12 July 2017. From Ministry of Housing, Communities & Local Government. At https://www.gov.uk/government/publications/local-government-pension-scheme-guidance-on-preparing-and-maintaining-an-investment-strategy-statement

109 For the consultation document and government response, see: https://webarchive.nationalarchives.gov.uk/20060214032048/http://www.dwp.gov.uk/consultations/2005/

> intention to place a higher duty of care upon trustees than that which already exists. By requiring that investments are made not only "in a manner calculated to" ensure the security, quality, liquidity and profitability of the portfolio as a whole, but also with regard to the scheme's expected liabilities, the regulations will focus on the matters trustees should consider when making investment decisions, rather than judging them against the outcomes of the overall investment strategy."

What is the effect of a failure to comply with ss34 to 36 (or the Investment Regs 2005)?

There is the potential for claims before the Pensions Ombudsman for maladministration or breach of law – eg Adams (March 2009) and breach may be grounds for removal as trustee by TPR (PA 1995, s3) - eg TPR re Stephen Ward (Nov 2018).

PA 1995 provides[110] for TPR to be able to impose a civil penalty (PA 1995, s10) for a breach by a trustee of s35 (SIP) or s36 (choosing investments). This means it is at least arguable that because there is an express sanction in the statute, then this means that there is no other remedy, including a claim by (say) a member for breach of statutory duty – see for example the decision of the House of Lords in *Scally*[111] (a pensions case, but involving a different statute).

2. What does "prudence" mean?

The Oxford English Dictionary[112] (OED) definition of "prudence" is that it means being sensible, taking care or caution.

> Oxford English Dictionary
>
> prudence:
>
> 1. The ability to recognize and follow the most suitable or sensible course of action; good sense in practical or financial affairs; discretion, circumspection, caution.
>
> In early use: the wisdom to see what is virtuous, seen as one of the four cardinal virtues.

Effectively the term "prudence" or being "prudent" refers to taking care and weighing up risks. So it seems it is no different to "reasonable". Some cases do refer to "reasonable and prudent"[113], seemingly implying a difference, but this is not expanded on in the judgments.

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110 See PA 1995, ss35(6) and 36(8), as substituted.

111 *Scally v Southern Health and Social Services Board* [1992] 1 AC 294, HL. But this may be impacted by the provision in PA 1995, s117 that the legislation in PA 1995, Part 1 and any relevant regulations override the provisions of the scheme to the extent that they conflict. Note also the Trustee knowledge and understanding (TKU) provisions in PA 2004, ss247 to 249B. These include a requirement for knowledge and understanding of investment matters – ss247(4)(b)(ii) and 248(5)(b)(ii).

112 The OED does also refer to an alternative meaning, involving vicars:
"4. A gathering or group of vicars. Obsolete. rare."
It is not contended that this applies in this context.

113 Eg *Cocks v Chapman* [1896] 2 Ch D 763, CA at 778, Lopes LJ referring to "reasonable care, prudence and circumspection". Cited by Brightman J in *Bartlett v Barclays Bank* [1980] Ch 515 at 532A.

Law Commission commented on this in its 1999 report on *Trustees' Powers and Duties*[114] which lead to TA 2000:

> 3.24 "Every trustee should be required to exercise such care and skill as is reasonable in the circumstances. However, the level of care and skill which is reasonable may increase if the trustee has special knowledge or skills, (or holds him or herself out as having such knowledge or skills), or if the trustee is acting in the course of a business or profession."
>
> "….. the Law Commission considers that, in formulating the new statutory duty, express regard should be had to the particular skills and position of the trustees, and to the circumstances of the trust."

The later Law Commission report in 2014 on *Fiduciary Duties of Financial Intermediaries*[115] commented:

> "3.72 There has been a move away from this traditional language of "prudence". In 2000, trustees' duties of care were put on a statutory footing in England & Wales through the Trustee Act 2000 (the 2000 Act). This implemented, with minor changes, the recommendations of the Law Commission and Scottish Law Commission in our 1999 Report on Trustees' Powers and Duties. The Act signalled a move towards "reasonableness" as the relevant standard of conduct."

Prudence does not mean risk free

Prudence or reasonableness must depend on the context of the trusts, its purposes and objects and the purposes and objects of the relevant investment power. In the investment context, this must depend on identifying the risks that the trustee is being cautious or careful about[116]. Part of the duty of care must be to use care:

- to identify the relevant risks,
- to consider their likelihood and materiality or impact; and
- to consider what can be done to mitigate or deal with those risks and at what cost.

In relation to identifying the relevant risks (and their materiality) it is, of course, clear that trustees cannot be expected to have complete foresight or understanding. This would be to impose (in retrospect) a test of perfect vision. This leads to the famous comment by Donald Rumsfeld in 2002[117]:

> "there are known knowns; there are things we know we know. We also know there are known unknowns; that is to say we know there are some things we do not know. But there are also unknown unknowns—the ones we don't know we don't know."

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114 Law Commission of England and Wales '*Trustees' powers and duties*' (May 1999, Law Com No 260) at 3.24.

115 Law Commission of England and Wales '*Fiduciary Duties of Financial Intermediaries*' (July 2014, Law Com No 350) at 3.72.

116 See M Scott Donald '*Prudence under pressure*' (2010) 4 J Eq 44 at 47 to 53.

117 On February 12, 2002 Donald Rumsfeld, then the US Secretary of Defense, answered a question at a U.S. Department of Defense news briefing about the lack of evidence linking the government of Iraq with the supply of weapons of mass destruction to terrorist groups. https://archive.defense.gov/Transcripts/Transcript.aspx?TranscriptID=2636
This is also discussed in Scott Donald's paper '*Prudence in extremis*' (Nugee Lectures 2020), accompanying this paper.

It is clear that not all risk can be avoided or mitigated. It is difficult to envisage a totally risk free investment, even from a nominal capital perspective –

- bank deposits - risk of bank and compensation scheme (in the UK the financial services compensation scheme or FSCS) collapse;
- Government gilts - risk of political change and/or government default (hopefully a low risk for the UK?)

For example, a concern about risk of a fall in equities might lead a trustee to seek what it perceives as a safer investment in (say) cash deposited at a bank. But this mitigation is not risk free: even if it preserves the nominal value of the amount, it probably does not deal well with inflation and if deposited in another currency leaves a currency exposure. In addition there remains a risk of bank failure (perhaps mitigated by state compensation funds, but even these have a risk of failure).

The courts have confirmed that the duty of care (or prudence) does not mean in relation to investment that no risks should be taken. In effect the courts apply a judgment rule – how has the trustee balanced risk with potential reward?

In 1979 in *Bartlett v Barclays Bank Trust Co Ltd*[118] Brightman J (as he then was) confirmed that trustees could take risks:

> "That does not mean that the trustee is bound to avoid all risk and in effect act as an insurer of the trust fund"

Brightman J cited Bacon V-C in the 1883 case *In re Godfrey*[119]:

> "No doubt it is the duty of a trustee, in administering the trusts of a will, to deal with property intrusted into his care exactly as any prudent man would deal with his own property. But the words in which the rule is expressed must not be strained beyond their meaning. Prudent businessmen in their dealings incur risk. That may and must happen in almost all human affairs."

Brightman J continued:

> "The distinction is between a prudent degree of risk on the one hand, and hazard on the other. Nor must the court be astute to fix liability upon a trustee who has committed no more than an error of judgment, from which no business man, however prudent, can expect to be immune"

Brightman J also cited Lopes LJ in the 1896 case *In re Chapman*[120]:

> "A trustee who is honest and reasonably competent is not to be held responsible for a mere error in judgment when the question which he has to consider is whether a security of a class authorized, but depreciated in value, should be retained or realized, provided he acts with reasonable care, prudence, and circumspection."

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118 *Bartlett v Barclays Bank Trust Co Ltd* [1980] Ch 515 (Brightman J) at 531F.

119 *In Re Godfrey* (1883) 23 ChD 483 (Bacon V-C) at 493.

120 *In Re Chapman, Cocks v Chapman* [1896] 2 Ch D 763, CA per Lopes LJ at 778.

Not a retrospective test – skill and judgment at the time

At first instance in *Nestle*[121], Hoffmann J confirmed that the duty of care needs to be considered at the time of the relevant decisions and not in retrospect. He held:

> "…in reviewing the conduct of trustees over a period of more than 60 years, one must be careful not to endow the prudent trustee with prophetic vision or expect him to have ignored the received wisdom of his time"

Later, Hoffmann LJ made a similar point about timing in his Australian paper[122] in 1994:

> "… we have an example of the flexibility of equity and its ability to adapt to new conditions. In a case in 1987 called *Re Wellcome Trust* which concerned a huge charitable trust, I committed himself to the proposition that equities were a safer form of investment than gilt-edged. It is perhaps a pity that I made this statement about six weeks before the October Black Monday on the world stock markets".

Balance risk against return: *Harries v Church Comrs* (1991)

In 1991 in *Harries v Church Comrs*[123] involved a claim in relation to the investment policy of a large charitable trust. Sir Donald Nicholls V-C held that the guiding principle for the investment power was for it "to further the purposes of the trust". It would normally further this purpose if the investments grew as much as possible. But seeking such growth must be balanced with the relevant risks. Nicholls V-C held that for investment property charity trustees should be "seeking to obtain .. the maximum return, whether by income or capital growth, which is consistent with commercial prudence".

Nicholls V-C held (at p304c):

> "Second, there is property held by trustees for the purpose of generating money, whether from income or capital growth, with which to further the work of the trust. In other words, property held by trustees as an investment. Where property is so held, prima facie the purposes of the trust will be best served by the trustees seeking to obtain therefrom the maximum return, whether by way of income or capital growth, which is consistent with commercial prudence. That is the starting point for all charity trustees when considering the exercise of their investment powers. Most charities need money; and the more of it there is available, the more the trustees can seek to accomplish."

And later (at p304e) that:

> "investments should be made solely on the basis of well-established investment criteria, having taken expert advice where appropriate and having due regard to such matters as the need to diversify, the need to balance income against capital growth and the need to balance risk against return"

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121 *Nestle v National Westminster Bank Plc* (1988) 29 June, (1996) 10 TLI 113 (Hoffmann J) at 115.

122 *Equity and its role for superannuation pension schemes in the 1990s*, ch 5 in the book '*The Evolving role of Trust in Superannuation*' (M Scott Donald and Lisa Butler Beatty eds, 2017, Federation Press, Sydney) at p77.

123 *Harries (Bishop of Oxford) v Church Commissioners* [1993] 2 All ER 300 (Nicholls V-C).

Context

It is clear that the context (and purpose) of a trust is relevant to how the investment powers are to be exercised and to the relevant duty of care for trustees. The nature of the trust is clearly relevant to the relevant duty and this must be kept in mind when looking at the judicial decisions.

Most of the reported caselaw on investment duties for trusts, involves family wealth trusts. Their context is often different from that of a pension trust (or a commercial trust or charity):

- A different balance between capital and income?
- Seeking to preserve capital value?

In an age of inflation, does a duty of care or prudence mean looking at preserving the real value of capital (ie taking into account inflation)?[124]

***Drake*: Edelman J discusses issues on prudence**

In 2016 in Australia in *ASIC v Drake*[125], Edelman J (who was later promoted to join the High Court of Australia) reviewed the duty of care for a trustee in the light of the prudence wording used in previous cases. He outlined the history of the duty of care in England, citing *Speight v Gaunt* and *Re Whiteley*.

Edelman J convincingly criticized how the duty of care had been dealt with over the year, commenting that as a "flexible standard" too much had been read into the caution implicit in the use of "prudence" in *Re Whiteley*.

Edelman J identified two particular difficulties that can arise with a "prudent person" test:

1. it has been applied in an inflexible manner and by adding a "gloss" based on a need for caution – [267]. Whether an investment is "incautious" will depend on the context and circumstances – the terms of the trust instrument and the purposes of the trust – [271]; and
2. it does not distinguish between the degrees of skill required by different types of trustee – [272].

It is useful to set out Edelman J's comments in *ASIC v Drake*[126] in some detail (with emphasis added):

> *The trustee's equitable duty of care (the "prudent person" test)*
>
> .....
>
> [265] The statement of the test was, and is, intended to be flexible. As Heydon and Leeming observe, the standard "changes with economic conditions and contemporary thinking": Heydon JD and Leeming MJ, Jacobs' Law of Trusts in Australia (8th ed, LexisNexis Butterworths Australia, 2016) 356 [17-18].
>
> [266] However, <u>there are two difficulties that can arise with the application of the prudent person</u> test.

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124 See *Nestle* per Hoffmann J at 115; Hoffmann LJ in 1994 article at 76.
125 *ASIC v Drake (No 2)* [2016] FCA 1552 (Edelman J).
126 *ASIC v Drake (No 2)* [2016] FCA 1552 (Edelman J) at [265] to [273].

[267] The first difficulty is that this flexible test was often applied in an inflexible manner or by adding glosses such as a need for caution. Many of the early decisions that considered the test in England, Australia, and the United States placed great importance upon the need for caution in trust investment. For instance, in *Learoyd v Whiteley* (1887) 12 App Cas 727, 733, Lord Watson said:

> Business men of ordinary prudence may, and frequently do, select investments which are more or less of a speculative character; but it is the duty of a trustee to confine himself to the class of investments which are permitted by the trust, and likewise to avoid all investments of that class which are attended with hazard.

See also *Re Whiteley* (1886) 33 Ch D 347, 356-357 (Lindley LJ).

[268] This approach was appropriate in an era where the trust was almost invariably used as a concept for preservation of the capital of the settlor, rather than as an investment vehicle. But this requirement for caution is very difficult to apply as a single, undifferentiated test in the context of the use of trusts in an almost infinite variety of businesses and business purposes. …..

….

[271] The short point is that the refrain in the older cases about caution and avoidance of hazard, if read in isolation, suggests a duty which is abstracted from the terms of the trust instrument and the nature of the trust business. But whether an investment is incautious due to its speculative nature, or impermissibly hazardous, may be affected by the terms of the trust instrument. To give a simple example, a trust established for the purposes of speculation, with terms requiring investment in speculative ventures, requires a different assessment of hazard from a trust which requires investment in government bonds. As Gummow J said in *Breen v Wi*lliams [1996] HCA 57; (1996) 186 CLR 71, 137, describing the obligations of a trustee under a trust instrument to manage a trust business: "the trustee is required both to observe the terms of the trust and, in doing so, to exercise the same care as an ordinary, prudent person of business would exercise in the conduct of that business were it his or her own" (emphasis added).

[272] A second difficulty with a single prudent person standard of care is that it does not differentiate between the degrees of skill required by different types of trustee. As ASIC submitted, a more precise approach is that of Finn J in *Australian Securities Commission v AS Nominees Limited* (517-518):

> The standard of trustee care and caution of which I have been speaking so far does not differentiate between types of trustee. It is of general application. That standard, moreover, was settled a century ago and during a period when trust corporations were not used for the trading and investment purposes that are the commonplace in this country today. There is, in my view, a substantial question now to be answered as to whether a higher standard is not to be exacted from at least corporate or professional trustees (a) which hold themselves out as having a special or particular knowledge, skill and experience, and (b) which, directly or indirectly, invite reliance upon themselves by members of the public in virtue of the knowledge, etc, they appear so to have.

In *Bartlett v Barclays Trust Co Ltd (No 1)* [1980] Ch 515 at 534 Brightman J was prepared to impose such a higher duty of care on a trust corporation:

> "a professional corporate trustee is liable for breach of trust if loss is caused to the trust fund because it neglects to exercise the special care and skill which it professes to have."

……

If it were in fact necessary for me so to do (which it is not), I would be prepared to apply to the trustee companies in these proceedings a standard of care higher than that of the ordinary prudent businessperson.

[273] With respect, I agree with these observations.

Reckless prudence?

Being over cautious, can result in underperformance, compared to a reasonably well understood and considered (and even remunerated) risk? Over caution can be described as "reckless prudence".

Reckless prudence sounds a bit like an oxymoron[127]. Is recklessness the opposite of prudence (or care)? But the point that this makes is that, for trustees and investment, not taking risks can itself be considered in some circumstances not to be prudent/careful?

There is an early example of such an investment risk in the bible in the new testament in the 'parable of the talents'[128]. The employer asked his two servants to each look after a gold coin during his absence. One servant invested the coin and earned a good return. The other was more cautious and buried the coin in the earth for safekeeping. On the employer's return, both servants returned their coins, but the first also returned a further amount. The employer praised the first servant but castigated the second:

> "and cast ye the unprofitable servant into outer darkness: there shall be weeping and gnashing of teeth[129]".

Michael O'Higgins (then TPR Chair) in a speech[130] in 2012 made a similar point when discussing trustee powers in relation to fixing employer funding contribution levels:

> "The best support for a DB pension is a properly funded scheme supported by a strong employer. While we believe contributions should be made where they are affordable, we do not want trustees to be 'recklessly prudent' in the valuation assumptions they make and in their negotiations with employers. There will be occasions when the right thing to do for the employer and the scheme will be to invest in the growth of the sponsoring company rather than making higher pension contributions."

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127 Being reckless seems to be the opposite of prudence: "Trustees should not be reckless with trust money." Per Dillon LJ in *Nestle* [1994] 1 All ER 118 at 126c.

128 Matthew 25:24-30.

129 Not currently remedies used by the Courts or the Pensions Ombudsman.

130 Speech at the Professional Pensions Show in October 2012. Text is archived at https://webarchive.nationalarchives.gov.uk/20121030105729/http://www.thepensionsregulator.gov.uk/press/michael-ohiggins-professional-pension-show-2012.aspx
Quoted by Mark Smith at p27 in his paper '*Lessons learned from the Pensions Regulator*' (Nov 2012) at the APL 2012 annual conference.

And later in relation to investment:

> "The idea of reckless prudence I mentioned earlier also applies to investment strategy. Legislation does not require trustees to only invest in gilts. Those schemes with a strong employer underpinning pension promises may be able to afford to take more risk. Trustees should, of course, ensure they are aware of what the risks are; and that the employer can support these in the long term.
>
> I see no reason why schemes with a strong covenant, and trustees that fully understand the risks, should not continue to invest in the UK economy through the many equity or debt investment vehicles available on the market."

It seems clear that in some circumstances, not taking a greater level of risk can be considered not to be careful or prudent.

Finally on this there is a colourful comment in the Wikipedia entry on Prudence[131] that if a reluctance to take risks is "unreasonably extended to into overcautiousness, then this can become the "vice of cowardice":

> "In modern English, the word has become increasingly synonymous with cautiousness. In this sense, prudence names a reluctance to take risks, which remains a virtue with respect to unnecessary risks, but, when unreasonably extended into over-cautiousness, can become the vice of cowardice."

Caution – ie no speculation or hazard?

Given that some degree of risk taking is allowed by the duty of care (indeed can be mandated), how have the courts sought to draw the line as to when an investment decision has strayed into being a breach of the duty of care (or imprudent)?

In practice this must be a fact specific test (albeit objective rather than subjective). The context of the trust and the investment will be relevant. The courts have therefore only been able to give relatively high level tests[132], referring to a distinction between investment (on the one hand) and "speculation" or "hazard" on the other.

In *Learoyd v Whiteley*, Lord Watson considered that investments "attended with hazard" should be avoided:

> "it is the duty of a trustee to confine himself to the class of investments which are permitted by the trust, and likewise to avoid all investments of that class which are attended with hazard."

Nearly a century later in 1979 in *Bartlett v Barclays Trust*[133], Brightman J cited Lord Watson and commented:

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131 https://en.wikipedia.org/wiki/Prudence.

132 See Hoffmann J's comments in *Steel v Wellcome* on a "high level of abstraction" discussed in section 4 below.

133 *Bartlett v Barclays Bank Trust Co Ltd* [1980] Ch 515 (Brightman J) at 531H. On hazard, see also *Jones v AMP Perpetual Trustee Co NZ Ltd* [1994] 1 NZLR 690, [1995] Pens LR 53 (Thomas J) and *ASIC v AS Nominees Ltd* (1995) 63 FCR 504, [1996] Pens LR 297 (Finn J).

> "The distinction is between a prudent degree of risk on the one hand, and hazard on the other."

In Australia in 1952 in *Fouche v Superannuation Fund Board*[134] the High Court held that the making of a loan by a pension trust was a breach of trust, "by reason of its inherent nature", citing *Learoyd v Whiteley*.

Caselaw refers to hazard and speculation, but what is the dividing line between an investment that is prudent or careful and one that is hazardous or speculative?. The courts have found this difficult to define. The risk is that the distinction becomes one which is very subjective, in the eye of the beholder:

- I invest
- You save
- He speculates

Comments outside the legal sphere make this point as well. In particular comments about how buying and holding shares quoted on a stock exchange (presumably an investment) differs from gambling (presumably not).

President Theodore Roosevelt: "There is no moral difference between gambling at cards or in lotteries or on the race track and gambling in the stock market."[135]

JM Keynes in 1936 in *The General Theory of Employment, Interest and Money*[136] compared investing on a stock exchange as being similar to a casino:

> "Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done. The measure of success attained by Wall Street, regarded as an institution of which the proper social purpose is to direct new investment into the most profitable channels in terms of future yield, cannot be claimed as one of the outstanding triumphs of laissez-faire capitalism."

Pension Schemes Bill and investment risk as a crime?

Taking risks in relation to a defined benefit pension scheme is probably about to become more hazardous in itself. The Pension Schemes Bill 2020, currently before Parliament, will, if enacted in its present form, create a new criminal offence by inserting a new PA 2004, s58B called "Offence of conduct risking accrued scheme benefits".

The main element is that a person[137] does an act "which detrimentally affects in a material way the likelihood of accrued scheme benefits being received". It would seem that making investment

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134 *Fouche v The Superannuation Fund Board* [1952] HCA 1, (1952) 88 CLR 609 (Dixon CJ, McTiernan and Fullagar JJ) at [20] (p637).

135 President Theodore Roosevelt "Message to Congress on Worker's Compensation" 31 January 1908

136 Keynes 1936, p159.

137 The primary offence is not limited to trustees or employers or persons associated with them.
In addition, if a body corporate is guilty of the offence, then if the offence was committed with the consent or connivance of, or was attributable to any neglect on the part of, a director, manager, secretary or similar officer, each of them can also be convicted – PA 2004, s309(1).

decisions could, in retrospect, have that effect if the investments do not achieve the return hoped for. Or conversely if the decision is too cautious?

It will be the case that other elements need to be proved for there to be an offence, including that the person knew or ought to have known that the act would have that effect (but this may be relatively easy to show in relation to investment decisions).

The main limiting factor for an offence is the third requirement that "the person did not have a reasonable excuse for engaging in such conduct". This is framed as an objective factual test (which is likely to be a decision for a jury[138]). In practice a pension trustee will usually be able to show that it was acting on professional advice in relation to investment, and in which case the risk of prosecution (let alone conviction) may well be reduced.

It remains an intriguing example of potential criminalisation of negligent (rather than intentional or reckless[139]) conduct and may well have a sobering effect on trustees (and others, including advisers).

Proposed new section in PA 2004 s58B Offence of conduct risking accrued scheme benefits

(2) A person commits an offence only if—

(a) the person does an act or engages in a course of conduct that detrimentally affects in a material way the likelihood of accrued scheme benefits being received (whether the benefits are to be received as benefits under the scheme or otherwise),

(b) the person knew or ought to have known that the act or course of conduct would have that effect, and

(c) the person did not have a reasonable excuse for engaging in such conduct.

(3) A reference in this section to an act or a course of conduct includes a failure to act.

Meaning of prudence or prudent

The terms prudent or prudence in this context each sound like a well defined concept in terms of a legal test.

But in fact they are very high level and ill defined. Their application depends greatly on the particular context.

The terms are perhaps most useful as a shorthand for "duty of care" or instead of "reasonably" or "cautiously". Perhaps, as a concept, they are best treated as a "twitter" shortcut.

There are similar multiple meaning problems with other concepts, for example, "best interests", "good faith", and "fiduciary duty" – each much used, but often without further explanation.

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138 *R v G* [2009] UKHL 13.

139 Contrast the government response to green paper (Feb 2019) "Government Response to the Consultation on Protecting Defined Benefit Pension Schemes – A Stronger Pensions Regulator" which referred to a crime only in relation to wilful or reckless behaviour:
"The Government plans to move forward with proposals for new criminal offences for wilful or reckless behaviour in relation to a pension scheme, and for failure to comply with a CN…."
https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/777758/response-protecting-defined-benefit-pension-schemes.pdf

3. Reasonableness is a better way of describing the duty of care for investment?

Trustee Act 2000, s1

Section 1 of the Trustee Act 2000 (already set out above) codified the common law duty of care for trusts other than occupational pension schemes, based on such care and skill as is "reasonable in the circumstances".

As noted above, in its report, '*Trustees' powers and duties*'[140], the Law Commission preferred this formulation to the use of the term "prudent" or "prudence", but felt that ultimately this was just a codification of the common law terminology, with little difference between the terms.

Directors: CA 2006 codifying the common law:

Six years later, a similar approach can be seen for directors in the 2006 codification of the law in the Companies Act 2006 ("CA 2006") relating to the duty of care owed by directors to their company.

The test used in CA 2006, s174 does not refer to "prudence" but refers to "reasonable care, skill and diligence of a "reasonably diligent person".

> 174 Duty to exercise reasonable care, skill and diligence
>
> (1) A director of a company must exercise reasonable care, skill and diligence.
>
> (2) This means the care, skill and diligence that would be exercised by a reasonably diligent person with—
>
> > (a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company, and
> >
> > (b) the general knowledge, skill and experience that the director has.

The Law Commission later commented that the use of "prudence" reflects traditional language. As mentioned above, in its report in 2014 on *Fiduciary Duties of Financial Intermediaries*[141] commented:

> "3.72 There has been a move away from this traditional language of "prudence". In 2000, trustees' duties of care were put on a statutory footing in England & Wales through the Trustee Act 2000 (the 2000 Act). This implemented, with minor changes, the recommendations of the Law Commission and Scottish Law Commission in our 1999 Report on Trustees' Powers and Duties. The Act signalled a move towards "reasonableness" as the relevant standard of conduct."

4. Applying the duty of care: context, advice, professionals

How then do the courts apply the duty of care (or prudence) in relation to investment?

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140 Law Commission of England and Wales '*Trustees' powers and duties*' (May 1999, Law Com No 260) at 3.24 and 3.25.

141 Law Commission of England and Wales '*Fiduciary Duties of Financial Intermediaries*' (July 2014, Law Com No 350) at 3.72.

In 1987 in *Steel v Wellcome*[142], a case on judicial approval for a widening of the investment power, Hoffmann J commented that the duty of care was at a "very high level of abstraction", but that being more specific (either in legislation or court judgments) will run the disadvantage of trying to apply to all trusts and also dealing with the circumstances at the time of the decision. Hoffmann J held:

> The general prudence principles in *Bartlett* and *Whiteley* … "put the matter at a very high level of abstraction and neither the courts nor the legislature have been content to leave it there"
>
> "It is inherent in such attempts to express an abstract canon of prudence in more concrete terms that they will suffer from two disadvantages. First, that they will necessarily have to be expressed as general rules applicable to all trusts which therefore cannot discriminate easily between individual circumstances…..
>
> Secondly, the rules will represent what was thought to give effect to the prudence principle at the time when they were enacted or formulated by the courts. With changes in economic circumstances they may cease to give effect to that principle and may indeed contradict it. There is therefore always a tension, increasing as time passes, between the prudence principle and the more concrete rules which have been laid down from time to time."

An undemanding standard

Prudence has been held to be an "undemanding standard". In *Nestle*[143] Leggatt LJ held:

> "… by the undemanding standard of prudence the bank is not shown to have committed any breach of trust resulting in loss."

Look at standards at the time

The level of expertise required by the duty of care depends on the standards of the time. In *Nestle*[144], Dillon LJ referred to the need to consider the duty of care by reference to the "economic and financial conditions of that time" and commented that too much weight should not be placed on court decisions from the previous century. Dillon LJ held:

> "Mr Nugee QC for the bank rightly stressed the duty of a trustee to act prudently. The best known formulation of this is in the judgment of Lindley LJ in *Re Whiteley. ….*
>
> "This principle remains applicable however wide, or even unlimited, the scope of the investment clause in a trust instrument may be. Trustees should not be reckless with trust money. But what the prudent man should do at any time depends on the economic and financial conditions of that time—not on what judges of the past, however eminent, have held to be the prudent course in the conditions of 50 or 100 years before. It has seemed to me that Mr Nugee's submissions placed far too much weight on the actual decisions of the courts in the last century, when investment conditions were very different."

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142 *Steel v Wellcome Custodian Trustees Ltd* [1988] 1 WLR 167 (Hoffmann J).

143 *Nestle v National Westminster Bank Plc* [1994] 1 All ER 118, CA per Leggatt LJ at 142g.

144 *Nestle v National Westminster Bank Plc* [1994] 1 All ER 118 CA per Dillon LJ at 125j and 126c.

“Extremely flexible standard”

At first instance in *Nestle*[145], Hoffmann J, after citing Lindley LJ in *Re Whiteley,* referred to the duty of care (prudence) as being an “extremely flexible standard” and varying with the times. Hoffmann J held[146]:

> “This is an extremely flexible standard capable of adaptation to current economic conditions and contemporary understanding of markets and investments. For example, investments which were imprudent in the days of the gold standard may be sound and sensible in times of high inflation. Modern trustees acting within their investment powers are entitled to be judged by the standards of current portfolio theory, which emphasises the risk level of the entire portfolio rather than the risk attaching to each investment taken in isolation.
>
> ….
>
> But in reviewing the conduct of trustees over a period of more than 60 years, one must be careful not to endow the prudent trustee with prophetic vision or expect him to have ignored the received wisdom of his time.”

Context: Consider all the circumstances

The duty of care in TA 2000, s1 makes express reference to the need to consider the relevant context. It refers to what is “reasonable in the circumstances”.

The Trustee Act 2000 followed directly from a report of the Law Commission in 1999. In its report, ‘*Trustees’ powers and duties*’[147], the Law Commission commented that this duty was intended to be a flexible default standard:

> “the Law Commission considers that, in formulating the new statutory duty, express regard should be had to the particular skills and position of the trustees, and to the circumstances of the trust.

This clearly means the context of:

- the trust
- the times
- the trustee

Advice

Part of the duty of care will mean that trustees are usually expected to obtain and consider proper advice, for example on investment matters[148]. But there may be circumstances where the trustees

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145 *Nestle v National Westminster Bank Plc* (1988) 29 June (Hoffmann J), later reported in (1996) 10 TLI 113, [2000] WTLR 795.

146 (1996) 10 TLI 113 at 115.

147 Law Commission of England and Wales ‘*Trustees’ powers and duties*’ (May 1999, Law Com No 260) at 3.24 and 3.25.

148 Eg *Cowan v Scargill* [1985] Ch 270 (Megarry V-C) at 289C “the duty to seek advice on matters which the trustee does not understand, such as the making of investments”, *Martin v City of Edinburgh* 1988 SLT 322, [1989] Pens LR 9 (Lord Murray) at 334H, *Nestle v National Westminster Bank Plc* [1994] 1 All ER 118, CA per Dillon LJ at 123j “It is inexcusable that the bank took no step at any time to obtain legal advice as to the scope of its power to invest in ordinary shares”; *Harries v Church Comrs* [1993] 2 All ER 300 at 304e “having taken expert advice where appropriate”.

(or one of them) are sufficiently competent in an area that separate advice is not needed – see eg the family trust case *Daniel v Tee*[149]*.* Taking advice can help in the trustees meeting their duty of care to take proper account of relevant factors[150].

Similarly the statutory process under TA 2000[151] and, for pension trusts, PA 1995 and the Investment Regs 2005 include requirements for separate advice[152].

In *Cowan v Scargill*[153], Megarry V-C cited Lindley LJ in *Re Whiteley* that trustees owed a duty to act prudently, and held:

> "That duty includes the duty to seek advice on matters which the trustee does not understand, such as the making of investments, and on receiving that advice to act with the same degree of prudence."

Megarry V-C held that honesty and sincerity are not the same as prudence and reasonableness:

> "This requirement is not discharged merely by showing that the trustee has acted in good faith and with sincerity. Honesty and sincerity are not the same as prudence and reasonableness. Some of the most sincere people are the most unreasonable; and Mr. Scargill told me that he had met quite a few of them. Accordingly, although a trustee who takes advice on investments is not bound to accept and act on that advice, he is not entitled to reject it merely because he sincerely disagrees with it, unless in addition to being sincere he is acting as an ordinary prudent man would act."

Portfolio theory/prudent person rule

As noted above, in the 1880s and after, the implied class list of authorised investment was much more restrictive than it is now. In effect, in the "prudent man of business" test in *Re Whiteley* the courts opted for a very cautious approach looking at each investment on an investment by investment basis.

But 130 years later this has changed to a portfolio test, for example the IORP "prudent person test" as set out in art 18 of the original IORP and discussed above.

In *Nestle*[154]*,* Hoffmann J held that

> "Modern trustees acting within their investment powers are entitled to be judged by the standards of current portfolio theory, which emphasises the risk level of the entire portfolio rather than the risk attaching to each investment taken in isolation."

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149 *Daniel v Tee* [2016] EWHC 1538 (Ch), [2016] 4 WLR 115 (Richard Spearman QC).

150 *Scott v National Trust* [1998] 2 All ER 705 (Robert Walker J) at 717. See Pollard '*Pensions, Contracts and Trusts: Legal issues on decision making*' (2020, Bloomsbury Professional) at 42.11 and ch47.

151 TA 2000, s5. Previously, see Trustee Investments Act 1961, ss6(2) and (3).

152 Advice on a SIP: in writing and from a person believed to be qualified and to have appropriate knowledge and experience - Investment Regs 2005, reg 2(2)(a). Advice on whether investments are suitable – PA 1995, ss36(3) and (4).

153 *Cowan v Scargill* [1985] Ch 270 (Megarry V-C) at 289C.

154 *Nestle v National Westminster Bank Plc* (1988) 29 June, (1996) 10 TLI 113 (Hoffmann J) at 115. See also Hoffmann LJ in his 1994 paper *Equity and its role for superannuation pension schemes in the 1990s*, (fn 2 above) at p77. On portfolio theory, see M Scott Donald '*Prudence under pressure*' (2010) 4 J Eq 44 at 54 to 56; Paul Ali '*Hedge fund investments and the prudent investor rule*' (2003) 17 TLI 74; and Emma Ford 'Trustee investment and modern portfolio theory' (1996) 10 TLI 102.

The size of the fund being invested is also relevant to the investment duty of care, in particular the use of a portfolio theory[155].

A similar process applies in the US under American Uniform Prudent Investor Act[156].

It is noticeable that the reported cases against trustees involving family wealth trust mainly concentrate on the trustee underperforming in their investment role, often because they did not focus more on investment in shares instead of fixed interest or government bonds at times of inflation or significant capital growth. Examples are:

- not having enough equities: *Nestle*[157], *Re Mulligan*[158]; or
- too many of the wrong sort of equities: *Daniel v Tee*[159]

Diversification

Considering the impact of diversification is now seen to be part of the duty of care (or prudence). Diversification was mandated as part of the obligations under the Trustee Investments Act 1961 and the later TA 2000 and Investment Regs 2005[160].

But there is not an absolute duty to diversify – only to consider the merits of diversification. Some pension trusts are in effect not diversified in some respects – for example a trust that is invested mainly with one insurer (or investment trust), even though the underlying economic investments may still be diversified.

Same test as for directors' duties

How do the duties of care on trustees compare with those on directors? This is relevant for two reasons

- to look at the development of the common law duties of care and skill; and
- where the trustee is a trust company, to consider the duties of the directors.

Prudence was initially used as the standard for directors as well – *Overend Gurney*[161]. But later this reduced to a more subjective "good faith" standard – *Re City Equitable Fire Insurance*[162].

155 See eg Lord Nicholls '*Trustees and their broader community: Where Duty Morality and Ethics Converge*' (1995) 9 TLI 71 at 76.

156 See eg John H. Langbein '*The Uniform Prudent Investor Act and the Future of Trust Investing*' [1996] 81 Iowa L Rev 641 at 646. On the then proposed IORP, Ruth Goldman '*The Development of the 'prudent man' concept in relation to pension schemes*' (2000) 5 Jnl of Pens Management 219.

157 *Nestle v National Westminster Bank Plc* [1994] 1 All ER 118, CA.

158 *Re Mulligan (Deceased); Hampton v PGG Trust Ltd* [1998] 1 NZLR 481 (Panckhurst J).

159 *Daniel v Tee* [2016] EWHC 1538 (Ch), [2016] 4 WLR 115 (Richard Spearman QC).

160 Trustee Investments Act 1961, s6(1)(a); TA 2000, s4(3)(b); Investment Regs 2005, reg 4(7).

161 *The Overend & Gurney Co v Gibb* (1872) LR 5 HL 480 per Lord Hatherley LC at 486-487. Cited in *ASIC v Cassimatis* [2020] FCAFC 52 at [127].

162 *Re City Equitable Fire Insurance Co* [1925] Ch 407 (Romer J). Cited in *ASIC v Cassimatis* [2020] FCAFC 52 at [133].

Given the entrepreneurial and trade/risk taking purpose of many (most?) companies, prudence (old style) was seen as too cautious. In more recent times, see, for example, the trio of Australian cases: *Daniel v Anderson*[163]; *ASIC v Drake*[164]; and *ASIC v Cassimatis*[165].

This was reflected in the statutory codification of the duty of care owed by directors in the Companies Act 2006, s174 (Duty to exercise reasonable care, skill and diligence), set out above

As mentioned above, in *ASIC v Drake*[166] in 2016 Edelman J commented that a test based on prudence was "difficult to apply as a single test" in modern conditions:

> "Whether an investment was incautious due to its speculative nature, or impermissibly hazardous, might be affected by the terms of the trust instrument. The requirement to avoid hazardous investments which was appropriate in an era where trusts were almost invariably used for the preservation of capital was difficult to apply as a single test in the context of the use of trusts for an almost infinite variety of businesses and business purposes."

For trustee companies, it is clear that generally the directors owe the relevant duties to the trustee company, and not direct to the beneficiaries of the trust of which the company is trustee.

A director can be liable in relation to a breach of duty:

- To beneficiaries, if he or she dishonestly assists in a breach of trust by the company; or
- To trustee company, if a breach of duty by the director to the company – eg claim by a liquidator (or perhaps by a new trustee) - *HR v JAPT*[167] and *Gregson v HAE*[168]. As to the level of duty, see *Bishopsgate Investment Management*[169] and *ASIC v Cassimatis*[170].

5. Test for pension scheme trustees?

Having worked out that referring to a duty of "prudence" does not give much insight, even for family wealth trusts, where do commercial trusts such as pension schemes fit in?

It would generally be possible for a trust instrument to specify a duty of care for investment matters (rather than an exemption provision, which as discussed above for pension schemes may be over-ridden by PA 1995, s33) – see the discussion of the difference between exemption and duty framing provisions in *ASIC v Drake*[171]. However a specific duty of care may well be difficult to frame and seems to be, in my experience, unusual.

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163 *Daniels v Anderson* (1995) 16 ACSR 607 (NSW CA: Clarke, Sheller and Powell JJA).

164 *ASIC v Drake (No 2)* [2016] FCA 1552 (Edelman J).

165 *Cassimatis v ASIC (No 8)* [2016] FCA 1023, 336 ALR 209 (Edelman J), upheld on appeal [2020] FCAFC 52.

166 *ASIC v Drake (No 2)* [2016] FCA 1552 (Edelman J) at [268].

167 *HR v JAPT* [1997] OPLR 123 (Lindsay J).

168 *Gregson v HAE Trustees Ltd* [2008] EWHC 1006 (Ch), [2008] 2 BCLC 542 (Robert Miles QC). Discussed in Pollard '*The Law of Pension Trusts*' (2013, OUP) at ch 5.

169 *Bishopsgate Investment Management Ltd v Maxwell (No 2)* [1994] 1 All ER 261, CA.

170 *Cassimatis v ASIC (No 8)* [2016] FCA 1023, 336 ALR 209 (Edelman J), upheld on appeal [2020] FCAFC 52.

171 *ASIC v Drake (No 2)* [2016] FCA 1552 (Edelman J) at [277] to [280], citing Donaldson J in *Kenyon, Sons & Craven Ltd v Baxter Hoare & Co. Ltd* [1971] 1 WLR 519, 522-523.

The caselaw still refers to "prudence" or "prudent" - eg *Daniel v Tee*[172]. But most of the reported cases are about private wealth trusts. Some cases are not, eg: *Cowan v Scargill*[173] (pension trust) and *Harries v Church Comrs*[174] (charitable trust).

Some caselaw indicates the same duties for pension trusts as for family wealth trusts – see eg *Cowan v Scargill*[175], where Megarry V-C basically agreed with the plaintiffs, but it does not seem to have been argued on either side that "prudence" was not a suitable test.

In *Nestle*[176] at first instance, Hoffmann J commented that family trusts have different considerations to unit trusts:

> "… the investment considerations in family trusts such as this were different from those in unit trusts. I agree …"

Similarly in *ASIC v Drake*[177] (as already cited above), Edelman J contrasted family trusts with commercial trusts.

In practice it is probably too late to argue that it is inappropriate to refer to a "prudence duty" for pension trusts, given the decision in *Cowan v Scargill*[178] and the terms of the IORP. But in context, it seems that prudence just means take reasonable care – taking into account the context of the pension trust.

6. Legal claims – process/perversity – applying *Braganza*?

Referring to a duty of care by reference to terms such as "prudence" and "prudent", seems to do no more than mean "careful". It may historically imply aspects of being "cautious" as well, but this seems unhelpful.

So effectively the duty of care means that the trustee must consider and weigh up the potential risks and rewards.

Assuming the investment is authorised, this looks more like a process test. Did the trustee board:

- follow the statutory process (SIP etc)
- take reasonable steps to identify the relevant risks and rewards;
- take advice? (statutory requirement);
- consider the relevant factors set out in legislation (eg liquidity, diversification) or otherwise reasonably considered to be material?

Effectively: this involves the trustee acting carefully and weighing up risks, but with an objective outcome element if the ultimate decision was one that no reasonable trustee would have reached (a perversity test).

172 *Daniel v Tee* [2016] EWHC 1538 (Ch), [2016] 4 WLR 115 (Richard Spearman QC).
173 *Cowan v Scargill* [1985] Ch 270 (Megarry V-C).
174 *Harries (Bishop of Oxford) v Church Commissioners* [1993] 2 All ER 300 (Nicholls V-C).
175 *Cowan v Scargill* [1985] Ch 270 (Megarry V-C).
176 *Nestle v National Westminster Bank Plc* (1988) 29 June, (1996) 10 TLI 113 (Hoffmann J) at 116.
177 *ASIC v Drake (No 2)* [2016] FCA 1552 (Edelman J) at [271].
178 *Cowan v Scargill* [1985] Ch 270 (Megarry V-C).

No reasonable trustee?

In order to bring a claim for a breach of trust it seems clear that often a beneficiary will need to show that the trustee board makes a decision that no reasonable/prudent trustee would make - *Nestle* and *Daniel v Tee*[179].

The burden of showing that there was not a proper investment rests on the claiming beneficiary: *Shaw v Cates*[180].

In *Nestle*[181] at first instance (Hoffmann J), citing an expert witness, agreed with a description of there being a range of opinions:

> "The difficulty -- perhaps sheer impossibility -- of satisfying both [tenant for life and remainderman] is reflected in the fact that there is no such thing as an authentic 'proper balance'; although it will be easy enough to say that a fund is unbalanced in extreme cases there must be a wide band in the middle, so to speak, where there is room for a genuine difference of opinion. An opinion on this subject will reflect the view taken of the present state of the market, the prospects for both fixed-interest stocks and equities in the future and the present and future circumstances of the beneficiaries. Clearly an equation containing so many variables is not going to resolve itself into an inevitable solution.
>
> That is in my judgment the right way to approach the problem."

In *Nestle*[182] in the Court of Appeal Staughton LJ held that the claim should be dismissed because beneficiary could not show that the trustee made a decision which "no prudent trustee would have followed":

> "However, the misunderstanding of the investment clause and the failure to conduct periodic reviews do not by themselves, whether separately or together, afford Miss Nestle a remedy. They were symptoms of incompetence or idleness—not on the part of National Westminster Bank but of their predecessors; they were not without more breaches of trust. Miss Nestle must show that, through one or other or both of those causes, the trustees made decisions which they should not have made or failed to make decisions which they should have made. If that were proved, and if at first sight loss resulted, it would be appropriate to order an inquiry as to the loss suffered by the trust fund."
>
> "I am inclined to agree with Professor Briston that there should have been diversification in the 1950s, rather than from 1960 onwards. But I cannot accept that failure to diversify in that decade was a course which no prudent trustee would have followed."

In 2000 in *Wight v Olswang (No 2)*[183], Neuberger J equated a claim against a professional trustee as needing to be considered in the same way as a negligence claim – was the decision something that could be reasonably done? Neuberger J held:

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179 *Daniel v Tee* [2016] EWHC 1538 (Ch), [2016] 4 WLR 115 (Richard Spearman QC).

180 *Shaw v Cates* [1909] 1 Ch 389 (Parker J) at 395.

181 *Nestle v National Westminster Bank Plc* (1988) 29 June, (1996) 10 TLI 113 (Hoffmann J) at 116.

182 *Nestle v National Westminster Bank Plc* [1994] 1 All ER 118, CA per Staughton LJ at 133j.

183 *Wight v Olswang (No 2)* [2000] Lloyd's Rep PN 662 (Neuberger J) at 665. In *Daniel v Tee* [2016] EWHC 1538 (Ch) at [43], Richard Spearman QC pointed out that although the decision of Neuberger J in *Wight v Olswang* was overturned on appeal, the Court of Appeal made no criticism of Neuberger J's "no reasonable trustee" test.

"whether or not that was something which a trustee, complying with the test laid down by Lord Watson, could reasonably have done"

"This substantially equates the position of a trustee facing a claim for breach of trust in connection with an investment decision with that of a professional man, such as an accountant or solicitor, facing a claim for professional negligence. In *Saif Ali v Sydney Mitchell & Co* [1980] AC 198 Lord Diplock said this at 218C–D: 'Those who hold themselves out as qualified to practise … professions, although they are not liable for damage caused by what in the event turns out to have been an error of judgment on some matter upon which the opinions of reasonably informed and competent members of the profession might have differed, are nevertheless liable for damage caused by their advice, acts or omissions in the course of their professional work which no member of the profession who was reasonably well-informed and competent would have given or done or omitted to do.'

This was followed in 2016 in *Daniel v Tee*[184] by Richard Spearman QC:

"[163] ….. "such a decision is one which no trustee, complying with the duty to act prudently which is laid down in the authorities, could reasonably have made."

A Wednesbury/Braganza test

So the investment duty of care (or prudence) looks to be very similar to the well known two limb *Wednesbury*/*Braganza* test[185]:

- Process: due consideration of what ought to be considered (relevant factors); and
- Outcome: not perverse - "no reasonable decision maker"

But with a glance at proper purpose too – aim of investment is to be prudent, not take undue risks?

The process element is not subjective – it is not enough that the trustee considered that it was acting carefully and considering what it thought were the proper factors. In *Cowan v Scargill*[186], Megarry V-C commented on this:

"This requirement is not discharged merely by showing that the trustee has acted in good faith and with sincerity. Honesty and sincerity are not the same as prudence and reasonableness."

This has recently been cited by the Supreme Court in *Lehtimäki v Cooper*[187]

184 *Daniel v Tee* [2016] EWHC 1538 (Ch), [2016] 4 WLR 115 (Richard Spearman QC).

185 *Associated Picture Houses v Wednesbury* [1948] 1 KB 223, CA and *Braganza v BP Shipping Ltd* [2015] UKSC 17, [2015] 4 All ER 639. See further on this Pollard '*Pensions, Trusts and Contracts: Legal Issues on Decision Making*' (2020, Bloomsbury Professional).

186 *Cowan v Scargill* [1985] Ch 270 (Megarry V-C) at 289.

187 *Lehtimäki v Cooper* [2020] UKSC 33 per Lord Briggs at [232].

Expert evidence needed for a challenge?

If there is a challenge, about a failure to invest properly then the claimant will normally need expert evidence in relation to the alleged failure by the trustee, in particular to establish any loss, by showing what would have been the position had the trustee invested properly[188].

In *Nestle*[189], Leggatt LJ held that expert evidence would be needed to show any loss:

> "The appellant therefore had to prove that a prudent trustee, knowing of the scope of the bank's investment power and conducting regular reviews, would so have invested the trust funds as to make it worth more than it was worth when the appellant inherited it. That was a matter for expert evidence. In the result, there was evidence which the judge was entitled to accept and did accept that the bank did no less than expected of it up to the death of the testator's widow in 1960."

But expert evidence may not be needed if the failure is "glaring and obvious"[190].

Overview on use of "prudence"

1. What does the legislation say?
    - No express mention of prudence mentioned
2. What does "prudence" mean? – prudence as a shorthand?
    - Take care, consider risks
3. Is there a better way of describing the duty of care for investment?
    - Apply reasonableness standard
4. Applying the duty of care:

    context, time of decision, professionals

5. Test for pension trustees?
    - yes
6. Legal claims – process/perversity – applying *Braganza*?
    - Need evidence of loss; no reasonable trustee would have acted

Describing investment duty of care as involving "prudence" does not give much (any?) help on the nature of the duty of care. The duty looks the same as reasonableness test. The duty on trustees is similar to the development of that on company directors.

"prudence" or "prudent" gives a mixed message

Use of the term "prudence" is perhaps fine as a short-hand, but it is necessary to understand this and keep it in mind.

A pension trustee needs to consider level of risk and reward in the context of the scheme. This means that it needs to take care. This involves working out the purpose of the investment and the relevant risks (eg inflation, asset return, economic prospects, pandemics etc).

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188 Proof of loss or damage is needed to complete a claim: *Nestle* [1994] 1 All ER 118, *Daniel v Tee* [2016] EWHC 1538 (Ch) and *ASIC v Drake (No 2)* [2016] FCA 1552 (Edelman J) at [302] to [312].

189 *Nestle v National Westminster Bank Plc* [1994] 1 All ER 118, CA per Leggatt LJ at 141h. On experts, see M Scott Donald '*Prudence under pressure*' (2010) 4 J Eq 44 at 51.

190 Eg *Sharp v Blank* [2019] EWHC 3096 (Ch) (Norris J) at [632].

The legislation and TPR guidance point toward the need for advice and consultation.

In practice a pension trustee following the statutory investment processes is unlikely to be in breach of its duty of care (or prudence). The trustee should

- properly instruct advisers about risk level etc (usually this will emerge from the SIP)
- Consider and monitor advice
- Document reasons for investment strategy

There remains a potential breach if the investment decision is perverse (no reasonable trustee) or contrary to statutory process. But for a damages claim, the onus of proof is on the claimant to show a loss has resulted.

Appendix A – Investment Regs 2005, reg 4

4.— Investment by trustees

(1) The trustees of a trust scheme must exercise their powers of investment, and any fund manager to whom any discretion has been delegated under section 34 of the 1995 Act (power of investment and delegation) must exercise the discretion, in accordance with the following provisions of this regulation.

(2) The assets must be invested—

> (a) in the best interests of members and beneficiaries; and
>
> (b) in the case of a potential conflict of interest, in the sole interest of members and beneficiaries.

(3) The powers of investment, or the discretion, must be exercised in a manner calculated to ensure the security, quality, liquidity and profitability of the portfolio as a whole.

(4) Assets held to cover the scheme's technical provisions must also be invested in a manner appropriate to the nature and duration of the expected future retirement benefits payable under the scheme.

(5) The assets of the scheme must consist predominantly of investments admitted to trading on regulated markets.

(6) Investment in assets which are not admitted to trading on such markets must in any event be kept to a prudent level.

(7) The assets of the scheme must be properly diversified in such a way as to avoid excessive reliance on any particular asset, issuer or group of undertakings and so as to avoid accumulations of risk in the portfolio as a whole. Investments in assets issued by the same issuer or by issuers belonging to the same group must not expose the scheme to excessive risk concentration.

(8) Investment in derivative instruments may be made only in so far as they—

> (a) contribute to a reduction of risks; or
>
> (b) facilitate efficient portfolio management (including the reduction of cost or the generation of additional capital or income with an acceptable level of risk), and any such investment must be made and managed so as to avoid excessive risk exposure to a single counterparty and to other derivative operations.

(9) For the purposes of paragraph (5)—

> (a) an investment in a collective investment scheme shall be treated as an investment on a regulated market to the extent that the investments held by that scheme are themselves so invested; and
>
> (b) a qualifying insurance policy shall be treated as an investment on a regulated market.

(10) To the extent that the assets of a scheme consist of qualifying insurance policies, those policies shall be treated as satisfying the requirement for proper diversification when considering the diversification of assets as a whole in accordance with paragraph (7).

(11) In this regulation

“beneficiary”, in relation to a scheme, means a person, other than a member of the scheme, who is entitled to the payment of benefits under the scheme:

“derivative instrument” includes any of the instruments listed in [paragraphs (4) to (10) of Section C of Annex 1 to Directive 2014/65/EU] of the European Parliament and of the Council on markets in financial instruments;

“regulated market” means—

(a) a regulated market within the terms of Council Directive 93/22/EEC on investment services in the securities field;

(b) a regulated market within the terms of [Directive 2014/65/EU]; or

(c) any other market for financial instruments—

(i) which operates regularly;

(ii) which is recognised by the relevant regulatory authorities;

(iii) in respect of which there are adequate arrangements for unimpeded transmission of income and capital to or to the order of investors; and

(iv) in respect of which adequate custody arrangements can be provided for investments when they are dealt in on that market;

“technical provisions” has the meaning given by section 222(2) of the 2004 Act (the statutory funding objective).

Prudence *in extremis*

M Scott Donald

The trustees of pension funds in the United Kingdom and Australia are responsible for administering the retirement savings of millions of individuals. This paper examines those responsibilities specifically in the light of three contemporary challenges: the existential threats of climate change and viral pandemic, and the development of cryptocurrencies. It identifies that that the nature of the uncertainties in each case is different, and that consequently the approach expected of pension fund trustees in relation to each is also different. It further identifies that prudent administration of a fund in the face of these distinctive uncertainties requires attention not only to the investment strategy of the fund, but to the governance structure and processes of the trustee itself.

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Introduction

The tapestry of legal rules which constitute pensions funds[191] in the United Kingdom and Australia are extremely complex. The rights, duties and liabilities of all involved are defined with great care in a variety of formal documents, supplemented by the increasingly invasive regulatory regimes applied in each jurisdiction.[192] Despite this, there is something about trusteeship even in the pension fund context that transcends these intricate rules and regulations; an immanent paternalism[193] embodying ideals of wisdom and cautiousness instantiated most vividly in the aphorism that trustees must 'act prudently.'

Enter the existential threats of 2020: most notably climate change and COVID-19, and also the challenges of the cyber economy. Each of these represents a risk with which pension fund trustees must engage. Consideration of these threats permits the derivation of a more nuanced understanding of the role played by pension fund trustees in mediating between the realities of modern investment markets and the needs and interests of fund members (and, in the case of DB schemes, fund sponsors) as the distinctive nature of the threats highlight the multi-faceted notion of the broader concept of risk with which prudence is concerned.

This paper undertakes that task. It maps in outline the historical evolution of the law's approach to regulating trustee investments, from narrow court lists begrudgingly expanded from time to time to accommodate ever more 'risky' investment types, to attention to the adverse effect of inflation, the

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191 Where possible, the term 'pension fund' is used in this paper to connote both the trust-based occupational pension schemes in the United Kingdom and the APRA-regulated superannuation funds in Australia. The more specific descriptors are used where reference to only one or the other is intended.

192 The main statutes upon which the regulatory superstructure is built in the respective jurisdictions are the *Pensions Act 1995* ('*Pensions Act*') and the *Pensions Act 2004* in the United Kingdom and the *Superannuation Industry (Supervision) Act 1993* (Cth) ('*SIS* Act') in Australia.

193 The use of the descriptor 'paternalism' here to connote the normative type is in no way intended to suggest a gender dimension to this discussion but rather reflects historical (if unfortunate) usage; see Stephen J Ware, 'Paternalism or Gender-neutrality' (2020) 52 *Connecticut Law Review* (forthcoming).

virtues of diversification and the importance of the best interests of beneficiaries. These accumulating insights into what today would be considered prudent invest practice by pension fund trustees are then, in Part Two, related to the threats identified above: climate change, COVID-19, and the cyber economy.

The analysis in the paper identifies that although the strategic risk management strategies customarily identified with prudent trusteeship; careful research, diversification and insurance, are potentially relevant to the existential threats of 2020, the extreme nature of these risks highlights that more is required. Specifically, the paper argues that close attention to the governance processes of the overall institution that is the pension fund is required. Meta-decisions around scheme (or 'product') design, internal delegations and information management are crucial, as are ongoing tactical strategies such as member communication, if pension fund trustees are to navigate the treacherous waters thrown up by these extreme circumstances, and to apply the lessons from that experience in the (hopefully) calmer waters beyond.

Part I: The evolution in traditional conceptions of risk in trust law

The early history of the Chancery Court's view of investment risk has been very capably mapped by legal historians.[194] Chastened by the experience of the South Sea Bubble, history tells us, Chancery created restrictive lists of property types suitable for investment by trustees.[195] These lists influenced generations of equity lawyers and their clients and became the foundation on which a succession of statutory initiatives in both the United Kingdom and Australia were based.

The evolution of the law of trusts' approach to risk contains a number of points of inflection. Not only do those points of inflection remind us of the relevance, pivotal to the Court of Appeal's decision in *Nestle v National Westminster Bank*,[196] of contemporary know-how in informing the standard of prudence expected of a trustee when investing fund assets, the sensibilities that the points of inflection manifest illuminate the multi-faceted nature of the investment risks with which pension fund trustees necessarily engage on behalf of members.

The expanding list of 'authorised' investments[197]

The first point of inflection was the extension over the course of the nineteenth century of acceptable investments beyond gilts, which carried an express government guarantee on interest payments,[198]

194 See for instance Chantal Stebbings, *The Private Trustee in Victorian England*, (Cambridge University Press, 2002); Joshua Getzler, 'Fiduciary investment in the shadow of financial crisis: Was Lord Eldon right?' (2009) 3 *Journal of Equity* 219. In the US, but considering a wider range of jurisdictions, see Bevis Longstreth, *Modern Investment Management and the Prudent Man Rule*, (OUP, 1987).

195 Getzler, ibid, 229 - 232.

196 *Nestle v National Westminster Bank plc* [1994] 1 All ER 118, 126 (Dillon LJ).

197 Although for the most part these were default rules, applicable when trust instruments were silent, there are cases where the court has applied the prudence gloss even where the express provisions of the trust would appear to have permitted the type of investment; see, for instance, *Re Braithwaite* (1882) 21 Ch D 121; *Crook v Smart* (1872) 11 SCR (NSW) Eq 121; *Bridges v Shepherd* (1921) 21 SR (NSW) 220. Moreover, as the discussion below describes, locating a specific investment within the list of authorised investments has often not been the end of the story.

198 *Howe v Earl of Dartmouth* (1802) 7 Ves 137; 32 ER 56; *Wadeson v Duke* (1817) 1 Cooper T Cottenham 160; 47 ER 794. Notably much government debt in this period was in the form of 'consols' (short for consolidated annuity), which were perpetual in nature and therefore were not designed to return the investors capital upon maturity; Stebbings, above n 4, 133. The United Kingdom government redeemed all consols still in circulation in 2015.

and investments in real property, the familiar store of capital for much of the United Kingdom's elite to securities the return from which was dependent on commercial success. As Getzler notes, in 1746 the Lord Chancellor, Lord Hardwicke, held that:

> Neither South-sea stock nor Bank stock are considered as a good security, because it depends upon the management of the governors and directors, and are subject to losses.[199]

That aversion to commercial risk gradually gave way over the nineteenth century to the demand for capital arising from the later stages of the Industrial Revolution and the burgeoning Empire. As Getzler notes, the list of 'authorised investments' (ie those in which a trustee could invest even in the absence of express authorisation in the governing deed) was successively expanded by statute between 1859 and 1900 to include government backed stocks in the enterprises such as the East India Company, debentures and preference shares of established railway companies, securities of public utility and municipal corporations and ultimately colonial and dominion government stocks and utilities.[200] Lest this seem relatively unadventurous by modern standards it must be remembered that railway, bank and insurance company insolvencies were far more common in the United Kingdom in the nineteenth and early twentieth centuries than in the period since the Depression of the 1930s.[201] Indeed it was not until 1961 as a result of the *Trustee Investments Act 1961* that trustees in the United Kingdom were finally empowered by statute (as opposed to by the investment power under the trust instrument) to invest in equities generally, and even then it was only on a constrained basis.[202]

Further encouragement for the extension of the list of statutorily-authorised investments was the acceptance that any duty a trustee may have had to preserve trust assets had to take into account the real (ie inflation-adjusted) value of the property.[203] Although inflation was a sporadic problem in the nineteenth century in the United Kingdom, it emerged as a concerted risk requiring trustee attention in the middle decades of the twentieth century,[204] often because of the impartiality required of trustees as between life tenants and remaindermen. The relevance of inflation more generally, and specifically to pension schemes, was identified by Blackett-Ord V-C in *Mason v Fairbrother.*[205]

The acceptance of investment risk as an antidote to the erosive effects of inflation marks another important development in the evolution of the law's attitude towards risk. Implicitly it recognises that some risks can be expected, on average and over time, to earn a reward. The most obvious example of this is equity risk, upon which the functioning of capitalism depends. Equally, however, some risks possess no fundamental reason for reward. Not reading the fine-print in an investment

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199 Getzler, above n 4, 231, quoting *Trafford v Boehm* (1746) 3 Atkyns 440; 26 ER 1054, 1056.

200 Getzler, above n 4, 232-4.

201 Indeed so hazardous were some of these enterprises that historians of the accounting profession identify the railway mania of the 1840s as one of the watershed moments in its development; Andrew Odlyzko, 'The collapse of the Railway Mania, the development of capital markets, and the forgotten role of Robert Lucas Nash' (2011) 21 *Accounting History Review* 309.

202 Parts I, II and III of the First Schedule to *Trustee Investments Act 1961*, since repealed. For a discussion, see Leolin Price, 'Trustee Investments Act, 1961' (1961) 6 *The Modern Law Review* 738.

203 Price, ibid, 738.

204 *Trustees of the British Museum v Attorney General* [1984] 1 All ER 337, 339, 340 (Megarry V-C); *Riddle v Riddle* (1952) 85 CLR 202, 223 (Williams J).

205 [1983] 2 All ER 1078.

contract is a good example of such a risk. These risks might be termed due diligence risks, although the potential sources of risk are obviously not limited to failures in due diligence, as that term is understood in the legal profession. Although a trustee might be encouraged to harness equity risks in pursuit of a trust's objective, it would seldom, be prudent to accept due diligence risks unless the costs of doing so clearly outweighed the benefits.[206]

The most recent point of inflection in the evolution occurred in the middle 1980s. That was the recognition, informed by advances in investment theory, that the riskiness of an investment could not be ascertained solely from the characteristics of the investment itself. As Hoffmann J, as he then was, found at first instance in *Nestle v National Westminster Bank*,[207] regard also had to be had for how those characteristics related to the characteristics of other investments in the trust fund: the metaphorical 'portfolio'. Diversification, then, was more than simply 'not putting all one's egg in a single basket,' the mathematics of modern portfolio theory provided a more intelligent approach – one that permitted more fine-tuned tailoring of a trust fund's, including a pension fund's, investment strategy to its tolerance for risk.

Finally, the extension of the list of authorised investments has taken been taken to something approaching its logical extreme in statutory provisions now applicable in both the United Kingdom and Australia. In both the United Kingdom and Australia pension fund trustees have statutory power to make any type of investment, subject to any contrary provisions in the instrument creating the trust. In the United Kingdom, section 34(1) of the *Pensions Act*, provides:

> The trustees of a trust scheme have, subject to section 36(1)[208] and to any restrictions imposed by the scheme, the same power to make an investment of any kind as if they were absolutely entitled to the assets of the scheme.[209]

In Australia, the *SIS Act* does not provide an express power to invest, so the trustee legislation in each State applies in default. Relevantly, therefore, section 14 of the *Trustee Act 1925* (NSW) expressly provides that:

> A trustee may, unless expressly forbidden by the instrument (if any) creating the trust—
> (a) invest trust funds in any form of investment, and
> (b) at any time vary any investment.[210]

206 For a more complete description of this distinction, see M. Scott Donald, 'Prudence under Pressure' (2010) 4 *Journal of Equity* 44.

207 1988, reported (1996) 10 *Trust Law International* 112.

208 Words "section 36(1) and to" added by the *Pensions Act 2004*. Section 36 deals with choosing investments and requires trustees to act in accordance with regulations and requires written advice.

209 A wide investment power now applies to trustees in general under section 3(1) of the *Trustee Act 2000*, but this is expressly stated not to apply to trusts of an occupational pension scheme – see s36(3). With the exception of investment in land, which is distinctively provided for in section 8 of the *Trustee Act 2000* for trustees in general, the two sections are substantially co-extensive.

210 Equivalent provisions apply on all other States and Territories; section 14, *Trustee Act 1925* (ACT), section 5, *Trustee Act 1893* (NT), section 21, *Trusts Act 1973* (Qld) , section 6, *Trustee Act 1936* (SA), section 6, *Trustee Act 1898* (Tas), section 5, *Trustee Act 1958* (Vic); section 17, *Trustees Act 1962* (WA).

Notice that these provisions have the effects of placing substantive weight on the definition of the terms ‘investment’ and ‘invest’. This invokes a line of authority, marked most prominently in recent terms by *Cook v Medway Housing Society,*[211] in which the activity of investing was defined to be:

> laying out of money in anticipation of a profitable capital or income return

In Australia this link is further encouraged by the *SIS Act* which defines ‘invest’ as being to:

> (a) apply assets in any way; or
> (b) make a contract;
>
> for the purpose of gaining interest, income, profit or gain

To date there do not appear to have been any cases in the pension fund space invoking this *SIS Act* definition. However, this latest inflection brings to the surface and makes manifest a transition of a deeper nature that has been taking place in the case law gradually over the past 150 years. That transition is the passing of the baton in the regulation of trustee investments from approaches deigning certain investments to be beyond power because of their inherently risky nature, to approaches that rest upon the discovery of a qualitative flaw in the decision-process of the trustee, usually a failure to exercise the requisite level of care. Important remedial differences that lie beyond the scope of this paper can flow from that transition.[212] In this paper, the transition is of interest because it underscores the importance of decision-making processes in modern approaches to regulating trustee investing. That said, the transition is not easy to discern in the historical record, in part because there is no clean break[213] but also because the courts’ decisions themselves have not always been clear on the point. For instance, the High Court of Australia in *Fouche v Superannuation Board*[214] in 1952 held a mortgage investment of the Board to be void *ab initio*, implicitly therefore characterising it as beyond power (the approach favoured in the earlier cases). However, the High Court cited *Learoyd v Whiteley*[215] in support of their finding, but *Learoyd v Whiteley* rests on a deficiency in care by the trustee (the approach favoured more recently) and specifically not on the vires of the investment decision.[216] Nonetheless, as the passage of the statutory provisions referred to above demonstrates, by the turn of the 20th century the evolution towards regulating trustee investment by regulating the decision process was complete.

This evolution towards relying on the duty of care might also provide a modern understanding of the familiar, but quite inscrutable, admonition that trustees are prohibited from ‘speculating’.[217]

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211 [1997] STC 90. Also *Re Wragg* [1919] 2 Ch 58, *Dominica Social Security Board v Nature Island Investment Co* [2008] UKPC 19, [21] and *Dalriada Trustees Ltd v Faulds* [2011] EWHC 3391 (Ch), [2012] 2 All ER 734 [58] - [64], (Bean J).

212 For instance, one consequence of this is that the accounts of the trustee are to be surcharged (to compensate for the breach) rather than falsified (as though the transaction never involved the trusts). See James Penner, *The Law of Trusts* (9th Edn, OUP, 2014), [11.50].

213 See for instance the *re Buckland*, in which Nathan J, as recently as 1993, approached an application for extension of a trustee’s powers of investment in relation to a charitable trust by assessing, seriatim, the respective merits of the different investment types; *Re Buckland* (Unreported judgment of the Supreme Court of Victoria, Nathan J, 11 August 1993).

214 *Fouche v Superannuation Board* (1952) 88 CLR 609.

215 *Learoyd v Whiteley* (1887) 12 App Cas 727.

216 Ibid.

217 See for instance *Speight v Gaunt* (1887) 12 App Cas 727,733, (Lord Watson); *Keys v Keys* (1898) 4 ALR 104; 20 ALT 7; *Doneley v Doneley* [1998] Qd R 602. See also section 14B, *Trustee Act 1925* (NSW).

Although the term 'speculation' is self-evidently pejorative, the challenge has always been to know precisely what that means. It has been described in the North American context as the 'prudent person's slipperiest term of art'[218] and in the more measured style typical of Anglo-Australian legal discourse as 'open to interpretation'.[219] In the early cases, the basis for the characterisation was typically unexamined – it was enough for an investment to be deemed 'speculative' for it to be regarded as inappropriate for trustee investment.[220] An understanding of the term that links it to the duty of care would appear to offer a more discerning criterion for evaluation. A trustee who carefully researches a potential investment, and thereby derives a reasoned basis for the decision, might reasonably be expected to beat the allegation that it was 'speculating.' The ultimate profitability of decision is of course unknowable at the time it is made, but the trustee's efforts in attempting to reduce the level of uncertainty through research would, it is submitted here, raise it above the standard of mere speculation.

That said, in more recent times, trustees' investment decisions have been approached from perspectives other than the duty of care. The most important of these are the 'best interests duty' (sic) and the doctrine of powers. Like the duty of care, these engage with the decision-making processes of the trustee. It is appropriate that attention should now turn to them.

Best interests

In recent times trust lawyers have been beguiled by the siren's call of the 'best interests' doctrine. Emerging from the judgment of Sir Robert Megarry V-C in *Cowan v Scargill*[221] and dismissed by some as 'unhistorical, simplistic, true in part only, and misleading'[222] it has nonetheless appealed to others as a clear principle capable of guiding trustee decision-making in the area of investment strategy.[223] Others have taken a more sanguine view,[224] reflecting a curial preference in both the United Kingdom[225] and Australia[226] for seeing the 'best interests' formula as merely a restatement of other familiar trustee duties.

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218 Michael T Johnson, 'Speculating on the Efficiency of Speculation: An Analysis of the Prudent Person's Slipperiest Term of Art in Light of Modern Portfolio Theory' (1995) 48 *Stanford Law Review* 419

219 *Re Auton and APRA* [2005] AATA 32, 14.

220 *Bethell v Abraham* (1873) LR 17 Eq 24.

221 [1985] Ch 270.

222 S E K Hulme, 'The basic duty of trustees of superannuation trusts – Fair to one, fair to all?' (2000) 14 Trust Law International 130.

223 See for instance Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Final Report*, (February 2019), 224–227. Also Pamela Hanrahan, 'A Singular Loyalty: Superannuation after the Hayne Royal Commission' (2019) 30 *Journal of Banking and Finance Law and Practice* 109.

224 Most notably Law Commission, *Fiduciary Duties of Investment Intermediaries* (2014), Chs 4 - 5. Also David Pollard, 'The shortform 'Best Interests Duty': Mad, Bad and Dangerous to Know' (2018) 32 *Trust Law International* 106 and 176; M Scott Donald, 'Best interests' (2008) 2 *Journal of Equity* 245; Geraint Thomas, 'The duty of trustees to act in the 'best interests' of their beneficiaries' (2008) 2 *Journal of Equity* 177.

225 *British Airways v Airways Pension Scheme Trustee Ltd* [2017] EWHC 1191 (Ch); *Merchant Navy Ratings Pensions Fund Trustees Ltd v Stena Line Ltd* [2015] EWHC 448 (Ch), [2015] Pens LR 239.

226 See for instance *LM Investment Management Ltd (receiver apptd)(in liq) v Drake* [2019] QSC 281, [120] (Jackson J); *Commonwealth Bank Officers Superannuation Corporation v Beck* [2016] NSWCA 218, [136] – [140], (Bathurst CJ)*; Australian Securities and Investments Commission v Australian Property Custodian Holdings Limited (Receivers and Managers appointed) (in liquidation) (Controllers*

Whatever the doctrinal provenance of the exhortation to trustees to act in their members best interests, its presence in various statutory formulations (most pertinently s52(2) of the *SIS Act* in Australia) and in regulatory discourse is inescapable. The question, then, is what it adds (if anything) in the context of trustee investment to the duties of unquestioned pedigree: the duties of care, impartiality and loyalty.

A number of principles have emerged from the cases. The members' best interests in the context of a pension fund are, in the absence of extraordinary circumstances, their best financial interests.[227] Pursuit of non-financial benefits, such as moral considerations, is ordinarily therefore not permissible. Also, it is the best interests of the members as a whole, not the interests of each member individually, that are to be pursued.[228] And finally, the test is not undertaken with the benefit of hindsight – it is based on the state of knowledge available to the trustee at the time of the decision.[229]

Less helpful is the notion, favoured by some commentators, to identify the duty with the 'process' by which the trustee came to the decision (or lack of decision) rather than the 'outcome' of that decision process. As Jagot J in *APRA v Kelaher* accepted, that distinction is 'apt to mislead'.[230] There can be, as the Court in *Mercer Superannuation v Billinghurst* noted in a slightly different context:

> no hermetically sealed boundary between process and outcome[231]

The nub of the issue, it seems, lies in what is meant by the term 'outcome.' There is a consensus in the authorities that a trustee's decision cannot be impugned on the basis of whether or not it turned out to be profitable (although in a purely practical sense it is likely to influence prospective litigants). As Lindley LJ noted in *Re Chapman*, a trustee is not:

> a surety, nor is he an insurer; he is only liable for such wrong done by himself, and loss of trust money is not per se proof of such wrong. There is no rule of law which compels the Court to hold that an honest trustee is liable to make good loss sustained by retaining an authorized security in a falling market, if he did so honestly and prudently, in the belief that it was the best course to take in the interests of all parties. Trustees acting honestly, with ordinary prudence and within the limits of their trust, are not liable for mere errors of judgment.[232]

So the 'outcome' in the sense of the realised profit or loss from the decision, is not determinative of breach. On the other hand, the substance of the decision arrived at is surely justiciable. So if the outcome of the decision process is to invest in a particular way, or to eschew certain types of

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appointed) (No 3) [2013] FCA 1342, [464] – [476] (Murphy J); *Invensys v Austrac Investments* (2006) 198 FLR 302, [107](Byrne J).

227 *Cowan v Scargill* (1985) Ch 270, 286 (Megarry VC).

228 *Re VBN* [2006] AATA 710, [387]. See also Michael Vrisakis, 'The best interests of beneficiaries viewed as a hole' (2009) 20 *Australian Superannuation Law Bulletin* 71. David Pollard argues that the better formulation is the best interests of the trust rather than the members or beneficiaries; Pollard, above n 34, 206.

229 *APRA v Kelaher* (2019) FCA 1521, [55] (Jagot, J); *Manglicmont v Commonwealth Bank Officers Superannuation Corporation Pty Ltd* (2010) 239 FLR 159, [51] (Rein J), finding not disturbed on appeal.

230 *APRA v Kelaher*, above n 39, 57-58.

231 *Mercer Superannuation (Australia) Limited v Billinghurst* [2017] FCAFC 201, [38].

232 *Re Chapman* [1896] 2 Ch 763, 775.

investments, that 'outcome' will be reviewable by the courts for consistency with the best interests of the members (or the trust).

Finally, it is clear that the duty requires the trustee to orientate its decision-making towards the members' interests. It is possible to see this as merely the obverse of the fiduciary proscriptions that together comprise the duty of loyalty. That would be a mistake. The fiduciary proscriptions protect beneficiaries from trustees preferring specific interests or duties that compete with their interests, but that narrow set of interests and duties comprise merely a sub-set of the potential distractions a trustee may face. It is perhaps for this reason that Lord Nicolls, in discussing the best interests extra-curially in 1995, chose to link it to the purpose of the trust. He said:

> to define the trustee's obligation in terms of acting in the best is to do nothing more than formulate, in different words, a trustee's obligation to promote the purpose for which the trust was created. If the trust was created to confer financial benefits on individuals a decision not to maximise those financial benefits but to promote moral objectives on which widely differing views are held is, by definition, not to advance the purposes of the trust and, hence, is not in the best interests of the beneficiaries under that trust.[233]

This approach echoes, albeit loosely, the doctrine of powers, to which discussion turns in the next section. In that area of the law the courts have over a long period recognised the relevance a much wider notion of ancillary and improper purposes than is recognised in the classic fiduciary proscriptions.

The doctrine of powers

More reliable than the Delphic invocation of the members' best interests, but less euphonic, is the familiar obligation on trustees exercising discretionary powers to have regard for all relevant considerations and to ignore irrelevant considerations.[234] Although there do not appear to have been cases specifically applying this principle to the investment power, there is no reason to suppose it would not apply. Indeed, it is quite likely that the duty would be more intense in the case of pension funds than in some other trust contexts, especially those in which the beneficiaries are volunteers.[235] The breadth of enquiry is however not infinite. As Nettle JA noted in *Alcoa v Frost*, trustees are not:

> expected to go on endlessly in pursuit of perfect information in order to make a perfect decision. The reality of finite resources and the trustee's responsibility to preserve the fund for the benefit of all beneficiaries according to the terms of the deed means that there

233 Lord Nicholls of Birkenhead, 'Trustees and Their Broader Community: Where Duty, Morality and Ethics Converge' (1995) 9 *Trust Law International* 71, 76.

234 *Harris v Lord Shuttleworth* [1994] ICR 991 (Glidewell LJ); *Pitt v Holt* [2013] UKSC 26. See further Geraint Thomas, *Thomas on Powers*, (2nd Ed., OUP, 2012), [10.75]-[10.81]; David Pollard, *Pensions, Contracts and Trusts: Legal Issues on Decision Making* (Bloomsbury, 2020); Mark Studer, 'Modern trustee decision-making: unpacking the duty of proper consideration' (2016) 22 *Trusts and Trustees* 991.

235 By extension from the principles espoused by the High Court of Australian in *Finch*, a case involving a pension fund trustee's decision in relation to a disablement benefit; *Finch v Telstra* [2010] HCA 36 [66].

must be a limit. ... I accept that a trustee is not under an obligation to go on endlessly seeking more and more information.[236]

The question that then arises is which are the relevant considerations? Investment theory might reasonably be regarded as an important source of these. The range of considerations that contemporary investment theory would regard as relevant would include the liquidity, expected return, risk and covariance of the investment (the latter being the mathematical expression of an investments diversification potential), the overall investment objective, any income needs and the taxation treatment of any gains, losses or income. To these might be added certain governance-driven considerations, such as transparency and the availability of reliable valuations. This approach to regulating trustee investing is now echoed in both the generic trustee legislation in the Australian States[237] and in the *SIS Act*.[238] Both provide a long list of considerations required of trustees in the exercise of their investment powers, without attempting to prioritise them or condition them in any way. In contrast, in the United Kingdom the *Trustee Act* makes enigmatic reference to 'the standard investment criteria'[239] which are expressed specifically to include diversification but are otherwise not nominated.[240] The *Occupational Pension Schemes (Investment) Regulations 2005*, on the other hand, are slightly more prescriptive, including the following requirements specifically for pension fund trustees:

> (3) The powers of investment, or the discretion, must be exercised in a manner calculated to ensure the security, quality, liquidity and profitability of the portfolio as a whole …
>
> (5) The assets of the scheme must consist predominantly of investments admitted to trading on regulated markets.
>
> (6) Investment in assets which are not admitted to trading on such markets must in any event be kept to a prudent level.
>
> (7) The assets of the scheme must be properly diversified in such a way as to avoid excessive reliance on any particular asset, issuer or group of undertakings and so as to avoid accumulations of risk in the portfolio as a whole …
>
> (8) Investment in derivative instruments may be made only in so far as they—
> (a) contribute to a reduction of risks; or
> (b) facilitate efficient portfolio management.[241]

The likelihood that other considerations will be regarded as relevant in the context of a pension trust are limited. As noted briefly above, in *Cowan v Scargill* Megarry V-C found that:

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236 *Alcoa of Australia Retirement Plan Pty Ltd v Frost* [2012] VSCA 238, [60].
237 See section 14C *Trustee Act* 1925 (NSW), and equivalents in other States.
238 Section 52(6), *SIS Act*.
239 Section 4(1), *Trustee Act* 2000.
240 Section 4(3)(b), *Trustee Act* 2000.
241 Notably, although section 35, *Pension Act* and the *Occupational Pension Schemes (Investment) Regulations 2005* refer to familiar investment parameters such as risk and return, they do so only as examples of matters to be disclosed in the trustee's Statement of investment principles, not as criteria that are to be applied in decision-making. At best this establishes them implicitly as relevant criteria.

> When the purpose of the trust is to provide financial benefits for the beneficiaries, [as would be the case in a pension fund], the best interests of the beneficiaries are normally their best financial interests. In the case of a power of investment, as in the present case, the power must be exercised so as to yield the best return for the beneficiaries, judged in relation to the risks of the investments in question.[242]

This statement has been viewed as authoritative by courts in the United Kingdom[243] and Australia[244] in the intervening thirty-four years.

The requirement of 'caution'

The law's approach to trustee investing, then, has evolved continuously over the past 150 years. In contrast, the risk tolerance expected of trustees by the courts and the legislature has seen less change. It is not uncommon even in comparatively recent times to encounter curial and other references to Lindley LJ's judgment in *Learoyd v Whiteley* to the effect that:

> The duty of a trustee is not to take such care only as a prudent man would take if he had only himself to consider; the duty rather is to take such care as an ordinary business man would take if he was minded to make an investment for the benefit of other people for whom he felt morally bound to provide.[245]

Judge Woodruff's much-cited declaration in the US in *King v Talbot* elaborates this distinction:

> It … does not follow, that, because prudent men may, and often do, conduct their own affairs with the hope of growing rich, and therein take the hazard of adventures which they deem hopeful, trustees may do the same; the preservation of the fund, and the procurement of a just income therefrom, are primary objects of the creation of the trust itself, and are to be primarily regarded.[246]

However, those cases were heard in a gentler age. It is thus remarkable that as recently as 1995 (and in relation to a large-scale superannuation scheme) eminent equity jurisprude Finn J could adopt both these statements as authoritative and also approve the distinction made in obiter dicta by from Clarke and Sheller JJA in *Daniels v Anderson* in the NSW Court of Appeal in the same year:

> While the duty of a trustee is to exercise a degree of restraint and conservatism in investment judgments, the duty of a director may be to display entrepreneurial flair and accept commercial risks to produce a sufficient return on the capital invested.[247]

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242 *Cowan v Scargill*, above n 37, 286.

243 *Martin v The City of Edinburgh District Council* [1989] Pen LR 9 [28] (Lord Murray); *Merchant Navy Ratings Pension Fund Trustees v. Stena Line*, above n 35, 229 (Asplin J); *Keymed (Medical & Industrial Equipment) Ltd v Hillman* [2019] EWHC 485 (Ch), [119] (Marcus Smith J). But see further the views of the Law Reform Commission of England and Wales, below at n 65.

244 *Commonwealth Bank Officers Superannuation Corporation v Beck*, above n 36, [140] (Bathurst CJ); *APRA v Kelaher*, above n 39, [65] (Jagot J).

245 (1886) 33 Ch.D. 347, 355.

246 (1869) 40 NY 76.

247 (1995) 37 NSWLR 438, 494 (Clarke Ja and Sheller JA).

Perhaps even more surprising, the standard of care imposed upon the trustees of APRA-regulated superannuation funds by the *SIS Act* retains the conservativism found in the nineteenth centuries. The standard of care is expressed to be:

> the same degree of care, skill and diligence as a prudent superannuation trustee would exercise in relation to an entity of which it is trustee and *on behalf of the beneficiaries of which it makes investments*.[248] (emphasis added)

As the companion paper to this one, by David Pollard, describes, it is far from obvious that this conservative gloss is appropriate to modern commercial trusts, especially those with which we are concerned here: pension schemes. In this modern and peculiar context there are a variety of representations, expectations and regulatory objectives that intrude. Perhaps the most important of these, as Lord Nicolls noted in the extract quoted above[249] is the purpose of the trust itself. The assets of a trust whose very raison d etre is to serve as a mechanism for the accumulation of financial resources over the working life of individuals in anticipation that those resources will be available to the individuals to fund their expenditure in retirement cannot be left idle and uninvested. Growth of even a few percentage points each year, once costs, taxes and inflation are considered, will make a considerable difference over the forty plus years of a typical working career.

Part II: Contemporary Challenges

If the first decade of the twenty first century provided a series of reminders of Justice Putnam's famous warning, 'Do what you will, the capital is at hazard',[250] then the third decade has got off to an arguably even more memorable start. The analysis below is however not directed towards proving the suggestion that things are in some sense worse this time around. Rather the analysis deconstructs the uncertainty associated with three contemporary phenomena: climate change (and more specifically and parochially, bushfires); viral pandemics (specifically COVID-19) and the cyber-economy (specifically crypto-currencies). Each of these involve what Donald Rumsfeld might have termed 'known unknowns'.[251] That is to say, the existence of the uncertainty in each case was widely appreciated even before the risk materialised. They were not, as Mr Rumsfeld would have it,

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248 Section 52(2)(b), *SIS Act*. The standard required of trustees of Self-Managed Super Funds is even more faithful to the nineteenth century formulation, requiring the 'same degree of care, skill and diligence as an ordinary prudent person would exercise in dealing with property of another for whom the person felt morally bound to provide.'; section 52B(2)(b), *SIS Act*.

249 See n 43 above.

250 This observation, in Donald above n 16, 44, was inspired by the bursting of the dotcom bubble and the global liquidity crisis of 2007-8. Judge Putnam's quote was from *Harvard College v Amory* (1830) 26 Mass (9 Pick) 446.

251 On February 12, 2002 United States Secretary of Defense, Donald Rumsfeld, infamously answered a question at a U.S. Department of Defense (DoD) news briefing about the lack of evidence linking the government of Iraq with the supply of weapons of mass destruction to terrorist groups in the following way:
'Reports that say that something hasn't happened are always interesting to me, because as we know, there are known knowns; there are things we know we know. We also know there are known unknowns; that is to say we know there are some things we do not know. But there are also unknown unknowns—the ones we don't know we don't know. And if one looks throughout the history of our country and other free countries, it is the latter category that tend to be the difficult ones.'
https://archive.defense.gov/Transcripts/Transcript.aspx?TranscriptID=2636.

‘unknown unknowns’. However, the nature of the uncertainty in each case was (and remains) different.

The purpose of that deconstruction of the risks posed by those phenomena is to permit a close examination of the potency of the strategies traditionally associated with trustee prudence in these extreme circumstances. Although there is a myriad of legal devices available to pension fund trustees, conceptually the set of strategies is finite. At the highest level of generality, it includes research, diversification and insurance.[252] Research can eliminate certain types of uncertainty, albeit at a cost as research consumes scarce resources. Diversification, done naively, dilutes the impact of price movements on overall portfolio performance; done intelligently it exploits somewhat predictable sources of imperfect correlation to bias an investment portfolio towards (and away from) certain risks. Asset allocation is an example of intelligent diversification. Finally, insurance exchanges ongoing premiums for compensation in the event that a nominated risk eventuates. Contracts of general insurance and purchased options, whether exchange traded or over the counter, are examples of this type of risk strategy that may be employed by a trustee.

The existence and relevance of these strategies would no doubt be well understood in all pension fund boardrooms. However, the analysis below highlights the crucial role that governance structures and processes play in the question of prudence. Those structures and processes are required to ensure that the trustee has the capacity to achieve the elevated standards of care, skill and diligence required of a modern pension fund trustee. Alongside the questions of competence and expertise, so ably excavated over ten years ago by Clarke and others,[253] are questions about product design, internal delegation structures, information management and member communication. In particular, the analysis below highlights that the institutional capacity to respond and adapt decisively in a timely, but still expert, manner is crucial. The analysis also illustrates the difficulty in practice of sustaining the single-minded focus required by the best interests duty and doctrine of powers in the face of existential risks.

Climate change

The debate over whether pension fund trustees have an obligation to have regard for the impact of climate change has raged for more than a decade.[254] There are commentators who regard addressing climate change as a moral imperative of all-eclipsing importance. As things stand today, however, pension fund trustees in the United Kingdom and Australia are required to exercise their investment powers in the best financial interests of their members, and are precluded from allowing the broader interests of those members, or the interests of the community generally, to encroach

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252 Although some may suggest including hedging in this list, it does not belong on the list because it eliminates the exposure altogether (to the extent of the hedge). This conclusion is not affected by the conceptual equivalence of options and futures recognised in finance theory: Fischer Black and Myron Scholes, ‘The Pricing of Options and Corporate Liabilities’ (1973) 81 *Journal of Political Economy* 637.

253 See for instance, Gordon L Clark, Eniko Caerlewy-Smith, and John C Marshall, ‘Pension fund trustee competence: Decision-making in problems relevant to investment practice. (2006) 5 *Journal of Pension Economics and Finance* 91 and ‘The consistency of UK pension fund trustee decision-making’ (2007) 6 *Journal of Pension Economics and Finance* 67.

254 For a fascinating description of the course of the debate, see Elizabeth Harnett, ‘Social and asocial learning about climate change among institutional investors: lessons for stranded assets’ (2016) 7 *Journal of Sustainable Finance* 114.

upon their decision.[255] That said, there is now a consensus in the profession, in industry and in the academy in both the United Kingdom and Australia that pension fund trustees must have regard for the financial impact of climate change on their investment strategies.[256]

To the extent that there is a debate, therefore, it involves exactly what that legal obligation requires in practice.[257] Trustees in both jurisdictions are required to disclose the extent to which environmental factors affect their investment decision-making[258] but it seems clear that the obligation goes beyond disclosure.[259] Pertinently in that regard, the first climate-based action against a superannuation fund trustee in Australia has recently been filed, with the case due for hearing in July 2020. In the course of deciding whether to award a maximum costs order in favour of the plaintiff, Perram J of the Federal Court noted:

> 'Although it is possible that one could characterise this case as one involving the proper construction of s 1017C [of the *Corporations Act*] and the *SIS Act* together with some issues about the duties of trustees and hence as being a dry Chancery suit, I do not think that would be a fair characterisation. The case appears to raise a socially significant issue about the role of superannuation trusts and trustees in the current public controversy about climate change. It is legitimate to describe the Applicant's litigation as being of a public interest nature.'[260]

It will be interesting to see how the case develops.[261]

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255 But cf the Law Commission's surprising (to the author at least) view that pension trustees can take into account non-financial factors if:
'they have good reason to think that scheme members share the concern and there is no risk of significant financial detriment to the fund'
Law Commission of England and Wales Report, *The Fiduciary Duties of Investment Intermediaries*, (2014, Law Com No 350) at 6.57 and 6.101. This view (or a variant taken from the guidance under consideration) was also mentioned (seemingly without criticism) by the Supreme Court in *R (Palestine Solidarity Campaign Ltd) v Secretary of State for Housing, Communities and Local Government* [2020] UKSC 16, [2020] 1 WLR 1774. For criticism of this conclusion, see Philip Bennett 'Must an occupational pension scheme take into account ESG factors, even if there is a risk of financial detriment to the pension fund?" (2019) 32 *TLI* 239.

256 See for instance, Philipp Krueger, Zacharias Sautner and Laura T Starks 'The Importance of Climate Risks for Institutional Investors' (2020) 33 *Review of Financial Studies* 1067.

257 See for instance Benjamin Richardson, 'Divesting from climate change: the road to influence' (2017) 39 *Law and Policy* 325; Sarah Barker, Mark Baker-Jones, Emilie Barton & Emma Fagan, 'Climate change and the fiduciary duties of pension fund trustees – lessons from the Australian law' (2016) 6 *Journal of Sustainable Finance and Investment* 211.

258 In the United Kingdom, as a prescribed matter under section 35, *Pensions Act* and *Occupational Pension Schemes (Investment) Regulations 2005*. In Australia, pursuant to section 1013D(1) *Corporations Act 2001* (Cth), for all trustees required to provide a Product Disclosure Statement, which today accounts for almost all large scale APRA-regulated superannuation funds.

259 Thanks to David Pollard for reminding the author that the Pensions Schemes Bill 2020, currently before Parliament in the UK will, if enacted, introduce a new s41A into the *Pensions Act* that gives power to the Secretary of State to make regulations requiring trustees of occupational pension schemes to consider climate change.

260 *McVeigh v Retail Employees Superannuation Pty Ltd* [2019] FCA 14, [9].

261 The hearing is currently listed for 2 November 2020.

Australian regulators, also, are interested in the issue. In February 2020 the Australian Prudential Regulation Authority announced a plan to develop and consult on a 'climate change financial risk prudential practice guide'. The mooted guidance is apparently

> 'not intended to establish new obligations, but rather will be designed to assist entities in complying with their existing prudential requirements, including those found in Prudential Standard CPS 220 Risk Management. The cross-industry PPG, relevant to all entities, will set out APRA's views on better practice and outline prudent practices in this area. The PPG will cover areas relevant to the prudent management of climate change financial risks … including aspects of governance, strategy, risk management, metrics and disclosure.' [262]

In the United Kingdom, the Chief Executive of The Pensions Regulator announced in 2019 in relation to the government's Green Finance Strategy that:

> Climate change is no longer simply a social responsibility issue. It is a core financial risk impacting broadly across business, the economy and markets. Climate change is a risk to long-term sustainability pension trustees need to consider when setting and implementing investment strategy, while many schemes are also supported by employers whose financial positions and prospects for growth are dependent on current and future policies and developments in relation to climate change. Tackling poor standards of governance and risk management in pensions are priorities for TPR and we welcome working together with other regulators to address these challenges for pension schemes.[263]

The consensus view is that the financial impact of climate change is a long term transition in which certain types of commercial activity (most notably those involving fossil fuels or directly causing environmental degradation) will become less viable, while others (such as those involving the development of alternative energy sources) will thrive. This process is for the most part likely to be glacial by the standards of modern financial markets. Coal-powered electricity generators and petrol-fuelled cars will not be phased out overnight.

Traditional responses to risk, such as diversification and insurance, are only partially effective against this type of risk. Diversification will merely dilute its impact and the cost of insurance over specific assets will rise over time to reflect the increasing risk. Trustees can however hedge climate change risk by investing in sectors that are likely to thrive during and after the transition. Investing in technologies that replace carbon-based fuels, are an example, and there are anecdotal reports that many pension funds have made investments in such enterprises.[264] They could also eschew sectors likely to struggle, for instance by divesting themselves of investments in companies deriving income from coal mining. There are pension funds that have reportedly taken this step.[265]

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262 https://www.apra.gov.au/sites/default/files/2020-02/Understanding%20and%20managing%20the%20financial%20risks%20of%20climate%20change.pdf.

263 https://www.thepensionsregulator.gov.uk/en/document-library/statements/climate-change-joint-statement

264 See for instance Elouise Fowler, 'Funds in billion-dollar plunge on SA wind farm' (*Australian Financial Review*, December 5, 2019).

265 See for instance James Fernyhough, 'HESTA dumps coal, targets absolute net zero' (*Australian Financial Review*, June 26, 2020); Joanna Mather, 'AustralianSuper targets dirty dozen in Climate Action 100+ push' (*Australian Financial Review*, February 21, 2019). But cf Charlotte Grieve 'Super

It might be argued that the extended and uneven transition we can reasonably expect would give trustees, armed with appropriate research, the opportunity to stage their response over time. There would of course be uncertainty around the timing and extent of different elements of the transition, so the law would have to exercise some tolerance for trustee mistakes, honestly and carefully made. However, that is no different from the way in which the law would regulate many other investment strategy decisions trustees might make. It would also enable trustees with especially old members to pursue strategies tailored to the short investment horizons implicitly optimal for that demographic, and free trustees serving a younger demographic to recognise longer term considerations.

The problem is that this approach risks underestimating the governance issues involved in pension fund trusteeship in the United Kingdom and Australia. If taking action on climate risks was costless, or even profitable, it would in principle be easy for trustees to act immediately. However, in the more likely scenario in which at least some climate risk mitigation strategies are costly, either in purely financial terms or because they expose the trustee to peer group risk, trustees will have to decide when to take the different risk-mitigation measures to address the different dimensions of climate risk. This is problematic in the case of pension fund trustees because decisions which include a timing dimension are inevitably complicated by the timeframes of the individuals and groups involved in the decision. The design of governance structures, such as board and committee tenure policies, reporting and disclosure protocols and product design, all necessarily operate on the incentives of the individuals involved in the decision. Put bluntly, no one wants bad news on their watch. So there will be a temptation on Boards to defer risk-mitigating initiatives that risk temporary underperformance, or deviation from the peer group, notwithstanding that the long term interests of the institution and the members it serves are thereby compromised. This is a variation on the familiar 'tragedy of the commons', in which the incentives faced by the individuals overwhelm their incentive to cooperate, resulting in an inferior outcome for all concerned.

This is a familiar problem in the governance literature.[266] The remedy commonly prescribed in the corporate governance literature is to re-design the financial incentives received by the agents. However many of the key decision-makers in governance roles in pension funds in the United Kingdom and Australia are not directly remunerated, or at least not in a way that is related to the performance of the fund.[267] In many cases this is because they are nominees playing a representative role and remit any remuneration to the nominating body. Any change in approach to remuneration would therefore represent a dramatic shift and would need to be carefully designed and implemented to limit the extent of unanticipated ancillary effects.

There are other options that might be effective specifically in a pension fund context. Those directed toward the decision-makers personally include encouraging longer Board tenure, a proposition somewhat out of favour in corporate governance circles, staggering director appointments across multiple cycles and requiring directors to maintain a meaningful portion of their retirement savings

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giants funnel billions into fossil fuels, vote down climate push' (*Sydney Morning Herald*, February 13, 2020).

266 A summary of the literature in relation to corporate boards can be found in Michael Drew, 'The Puzzle of Financial Reporting and Corporate Short-Termism: A Universal Ownership Perspective' (2009) 19 *Australian Accounting Review* 295.

267 In Australia, see M. Scott Donald and Suzanne Le Mire, 'Independence in Practice: Superannuation Fund Governance through the Eyes of Fund Directors' (2019) 42(1) *UNSW Law Journal* 300.

in the fund after retirement from the Board. These will not solve the agency problems entirely, but may provide a decision-making environment in which the collective incentive towards short-term risk minimisation is sufficiently diffused to permit a longer-term perspective to be maintained. Finally, and at the risk of sounding cynical, institutional-level initiatives such as subscription to the various Sustainability compacts, might also make a contribution on this front.[268] They may provide confidence to trustees that peers will behave similarly, which arguably reduces the risk that the trustee's conduct or performance can be singled out by disgruntled members as sufficiently aberrant to justify the court finding that the trustee had acted in breach of its duties.

At the same time, it is becoming increasingly difficult to ignore the fact that not all climate related risks are slow-moving. Attitudes to climate change changed in Australia in the summer of 2019-20. Between September 2019 and March 2020 devastating bushfires burned largely uncontrolled over 46 million acres on Australia's eastern seaboard, an area greater than the entire agricultural land bank of the United Kingdom. There were 'only' 34 deaths directly attributed to the bushfires but most major population centres on the east coast of Australia from Brisbane in the north to Melbourne in the south were shrouded in thick smoke for weeks on end.

The bushfires represent a different form of risk for investors such as pension fund trustees. The potential for bushfires in an Australian summer was well known, and forecasts of the peculiarly adverse conditions leading into the summer of 2019-20 were commonplace.[269] However, the precise locations of the bushfires were not predictable, and the haphazardness of the damage caused seems almost capricious. Timber plantations, some partially owned by institutional investors such as superannuation funds, were in some cases wholly or partially destroyed while neighbouring plantations, equally flammable and hence vulnerable, were not. Power lines in some areas were destroyed, crippling parts of the electricity distribution network connected to the nodes directly affected by the fires, but potentially far removed from the fires themselves.

These risk events were local and devastating. In that respect, they raise similar issues to the widespread flooding experienced by the United Kingdom in 2015, and the annual toll taken by tropical cyclones in the American Panhandle, the causes of which were arguably exacerbated by human environmental impact, but not the tsunamis that devastated Indonesia's west-facing islands in 2004 and Fukushima in 2011, in which there was no human agency. No amount of research could have predicted precisely the points of incidence of the former, nor their timing, but the scientific evidence points to an increased frequency of certain type of catastrophe linked to climate change.[270]

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268 Obvious examples include subscribing to the United Nations Principles of Responsible Investment, or in Australia the Investor Group on Climate Change; http://igcc.org.au/; Responsible Investment Association of Australasia; http://responsibleinvestment.org/.

269 See for instance, Peter Hannam, 'Sydney faces a 'severe' fire season, charts show' (*The Sydney Morning Herald*, 21 August 2019); Liam Mannix, 'Record heat signals 'bad year' for bushfire threat' (*The Age*, 13 September 2019); Mathew Dennam, 'Braced for a deadly summer of fires' (*The Australian*, 29 September 2019).

270 In respect of cyclones, see James P. Kossin, Kenneth R. Knapp, Timothy L. Olander and Christopher S. Velden, 'Global increase in major tropical cyclone exceedance probability over the past four decades' Proceedings of the National Academy of Sciences Jun 2020, 117 (22) 11975-11980; DOI: 10.1073/pnas.1920849117. For bushfires, see Sharples, J.J., Cary, G.J., Fox-Hughes, P. et al. Natural hazards in Australia: extreme bushfire. *Climatic Change* 139, 85–99 (2016). https://doi.org/10.1007/s10584-016-1811-1. For flooding, see James D.Miller and Michael Hutchins, 'The impacts of urbanisation and climate change on urban flooding and urban water quality: A

Diversification, as a strategy, would have reduced the impact of such events on the total portfolio. Insurance of relevant assets, if available and contracted for by the trustee, might have ameliorated the quantum of loss. Prudence would most likely have advocated both strategies.[271] More difficult to insure against, however, was the decline in tourist volumes in regions affected by the bushfires. Although subsequently overtaken by the effects of the COVID-19 pandemic, it was evident even in March that tourism assets and businesses in south eastern Australia had suffered a major financial hit from the loss of customers over what was traditionally a peak period of activity.[272] Assets such as hotels, toll roads and transport companies would all have suffered reduced revenue, even if they were not themselves directly affected by the fires. Diversification was the only way to mitigate this risk.

It is a melancholy fact that the argument that trustees who expose their investment portfolios to these sorts of catastrophic climate risk have a heightened responsibility, as trustees, to support risk mitigating economic and environmental policies on a more general basis is no stronger than the argument in respect to the more slowly-emerging risks identified above. Trustees of pension funds must apply the assets under their administration for the benefit of their members. Ancillary considerations and benefits can be present so long as they do not pollute that single-minded focus.

COVID-19[273]

The second threat assailing trustees currently is that posed by the COVID-19 coronavirus pandemic. At the time of writing, the contagion has claimed over 500,000 lives across 213 countries[274] in approximately five months. Over 10 million individuals have tested positive for the viral infection,[275] with an unascertainable (but almost certainly large) number of persons undiagnosed. Economies across Europe, North America, Asia and Australasia have been placed in government-enforced lockdowns of varying intensity and duration. At the time of writing, the pace of infection and mortality appears to be slowing in developed economies, but not in a number of less developed economies. It is expected that GDP in developed countries will decline over 2020 by an estimated 6%.[276]

Financial markets are continuously reflecting contemporary views on the likely trajectory of these real-world effects. At their nadir in the middle March, major listed equity markets had dropped in

review of the evidence concerning the United Kingdom' (2017) 12 *Journal of Hydrology: Regional Studies* 345.

271 M Scott Donald, 'Climate Change and fiduciary investors: weathering a disaster scenario' in Rosemary Lyster and Rob Verchick (eds.) *Climate Disaster Law: Barriers and Opportunities* (Edward Elgar: 2018).

272 Karen Maley, 'SMEs dealt a double blow from bushfires, coronavirus' (*Australian Financial Review*, 2 March 2020).

273 See OECD, *Retirement Savings in the Time of COVID-19* (June 22, 2020), available at http://www.oecd.org/coronavirus/policy-responses/retirement-savings-in-the-time-of-covid-19-b9740518/. Accessed on 29 June 2020.

274 https://www.worldometers.info/coronavirus/. Accessed on 29 June 2020.

275 Ibid.

276 IMF World Economic Outlook, *The Great Lockdown*, Table A1, Summary of World Output, April 2020. Accessed at https://www.imf.org/en/Publications/WEO/Issues/2020/04/14/weo-april-2020 on 29 June 2020.

value by approximately one third[277] and there has been considerable volatility in most markets ever since. Forecasts of inflation and interest rates are likewise under continuous revision.

At one level, the current financial gyrations and uncertainties are simply more intense than those which pension fund trustees ordinarily have to confront. However, threats to public health on the scale of the COVID-19 viral pandemic pose an entirely different type of challenge to the trustees of pension funds. The key uncertainty is the temporal one. Pandemics of the scale of COVID-19 have not been common in developed countries in recent decades.[278] However, they have occurred often enough in recorded history that the potential for one to occur has been widely known for some time.[279] Moreover, although the precise pathogen was not anticipated, some of its key characteristics, such as the long incubation period and extreme virulence, were anticipated well before COVID-19 demonstrated them.[280] The question would therefore seem to have been not one of "if?" a viral pandemic could occur but "when?" it might occur. Outbreaks of viral infections are common but the question of when precisely a virus with appropriate characteristics might find itself in an environment congenial to the sort of explosive growth required to create the critical mass required for runaway contagion is almost certainly impossible to predict. As it turned out, the combination of the Spring Festival and Wuhan's positioning as a high-density transportation hub together with the high virulence and long incubation of COVID-19 provided those conditions.

Once the outbreak was accurately identified as likely to develop into a pandemic, the nature of the uncertainty changed fundamentally. Unlike many other risks, the course of viral infection is amenable to quite sophisticated statistical modelling, and the public nature of the threat meant that much of the data in relation to COVID-19, and even some of the epidemiological modelling itself, was publicly available. Forecasting the spread of the disease was therefore more viable than is sometimes the case with unfolding risk scenarios.

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277 More precisely: the UK market dropped 36% (FTSE All-share, from 17 Jan – 23 Mar 2020), the Australian market dropped by 37% (ASX All Ordinaries, from 20 Feb – 23 Mar 2020). By comparison, the US market dropped 34% (S&P500, from 19 Feb - 23 March 2020); https://www.londonstockexchange.com/indices/ftse-all-share; https://www.asx.com.au/prices/charting/index.html?code=XAO&compareCode=&chartType=line&priceMovingAverage1=0&priceMovingAverage2=0&volumeIndicator=Bar&volumeMovingAverage=0&timeframe= https://us.spindices.com/indices/equity/sp-500.

278 The most notable exception is HIV which has killed an estimated 32 million people since its escalation in the 1980s; https://www.who.int/gho/hiv/en/. Most of these deaths have however occurred in Africa, beyond the risk horizon for many pension fund trustees.

279 Nor was this recognition limited to public health officials. For instance, in a series of presentations and papers in 2015, Bill Gates identified viral infection as a more potent threat to humanity than nuclear conflict; Bill Gates 'The next epidemic — lessons from Ebola' (2015) 372 *New England Journal of Medicine* 1381. Also Bryan Walsh, 'The World Is Not Ready for the Next Pandemic ' (*Time* cover, May 4, 2017). The risk that this is simply the product of confirmation bias is countered by the maintenance in many countries and over many years of pandemic-management strategies, processes and resources. For Australia, see Ralf Itzwerth, Aye Moa and C. Raina MacIntyre, 'Australia's influenza pandemic preparedness plans: an analysis' (2017) 39 *Journal of Public Health Policy* 111. Globally see WHO Report, Comparative analysis of national pandemic influenza preparedness plans (2011). Accessed at https://www.who.int/influenza/resources/documents/comparative_analysis_php_2011_en.pdf?ua=1 on 12 June 2020.

280 Ibid.

What was harder to predict was the political dimension. The scale of the threat, and its perceived immediacy successively to the developed economies in Asia, then Europe and belatedly North America, spurred an unprecedented political response in most countries. Once the differential response of governments around the world (with Sweden and New Zealand as extremes in the developed world but a spectrum of difference in between) were articulated analysts could engage fruitfully in assessing the prospect of diverging national and regional trajectories into the future.

That said, not all of the political risks to pension funds were indirect. The Australian government's decision to loosen temporarily the criteria permitting early release of superannuation for individuals suffering financial hardship as a result of the COVID-19 viral pandemic was entirely unpredictable even a few weeks before the announcement. Although widely lauded and receiving bipartisan political support, it caused some trustees considerable challenge. Data from APRA indicate that as at the time of writing seven large-scale funds were required to return cash to members in excess of 20% of their cash holdings, four in excess of $1bn. The strong likelihood that many of those seeking early release were MySuper members[281] means that the drawdown specifically on MySuper products has likely been proportionately much greater than those numbers suggest. Newspaper reports suggest that managing the investment strategies applied to the investment portfolios in the interests of all members in the face of such an unprecedented call on liquidity has proved challenging for a number of superannuation funds.[282]

Precursors to this type of discontinuous risk in domestic politics in the United Kingdom and Australia are thankfully rare. The BREXIT vote in the United Kingdom is perhaps the most salient in recent times, but before that one arguably has to wind back the clock to 1992 in the United Kingdom (the removal of Sterling from the European Exchange Rate Mechanism) and 1988 in Australia (the introduction of a tax on superannuation fund earnings) for examples. For many decision-makers in the pension fund arena, then, this type of discontinuous risk was primarily perceived to be a risk to overseas holdings especially in developing countries where political factors were often less stable. Examples include the Russian debt default of 1998, the Mexican devaluation of 1994 and the imposition of capital controls in India (2013), Argentina (2011) and Greece (2015).

That example aside, from the perspective of pension fund trustees, much of the risk associated with COVID-19 will be felt in their investment portfolios. As already noted, some will manifest in price volatility in the listed markets. It is likely that the returns to some unlisted enterprises, also, will suffer. Other threats are more complex, such as the approach taken in different jurisdictions to technical insolvency and to continuous disclosure (and the effects that will have on research strategies).

Despite the fact that pension fund trustees are strategically positioned atop one of the most information-rich environments ever created outside the public sector, it is unreasonable to assume that pension fund trustees could have used the research in global financial markets to predict the occurrence and significance of the COVID-19 viral outbreak in advance of its occurring. Nor is it likely that they could have been expected to fund research dedicated specifically to the potential, as there

281 MySuper products are products specifically designed to accept contributions on behalf of members who have not directed the trustee to invest their contributions in a particular way. See further Jeremy Cooper, 'Super for Members: A New Paradigm for Australia's Retirement Income System' (2010) 3(2) *Rotman International Journal of Pension Management* 8.

282 Gerard Cockburn, 'Early super requests near $15bn' (*The Australian*, 15 June 2020).

would be simply too many potential risks of this type to assess and monitor them all. The risk moreover is also almost certainly uninsurable. Nor would diversification have worked particularly well, given the breadth of the economic impact of the COVID-19 viral pandemic both in geographic and industry terms.

If research-based forecasting is not realistically possible, insurance is not available and diversification is ineffective to address risks of this type, the key then would seem to have been ensuring that the trustee, and the institution of which it is the fulcrum, had a capacity to decide and act in an informed, timely and decisive way. As we have seen, the challenge of anticipating and adapting to political responses is clearly also an issue in respect of climate change, but the timeframe in respect of COVID-19 has been very different, more analogous to the timeframes facing policy-makers faced with the GFC during which national governments and central banks were forced to make decisions 'on the run', as it were. A pension fund trustee's ability to respond first to the uncertainty and then to new developments in turn depends on the maintenance of governance structures and process capable of supporting the design and implementation of risk management strategies after the discovery of the outbreak and as new information became available.

It is true that pension fund trustees in both the United Kingdom[283] and Australia[284] are required to formulate and maintain business continuity strategies, but these are almost entirely directed toward the maintenance of day-to day operational processes. The requirement for workforces around the world to 'work from home' has of course raised challenges here, but there is a higher-level governance challenge also. It is a 'wicked' problem – how to ensure the decision-making processes that guide the pension fund can react to changing circumstances and accommodate unusually 'noisy' data and yet retain the balance and perspective that is prudence. Effective delegations both within the trustee and across its many service providers will be crucial. Most pension fund trustees have designated Investment Committees, but the extent of the decision-making authority of those Committees varies.[285] Some have been delegated actual decision-making authority, but many act merely as expert communication conduits to the trustee's Board, collating and curating information from the trustee's many agents and information sources. Knowing which decisions belong where will also be crucial. The involvement of a range of stakeholders on some pension fund Boards promotes the legitimacy of the decisions of those Boards,[286] but expertise and timeliness are important also. It is probably also important to recognise that a viral epidemic affects the personal well-being of decision-makers across dimensions such physical and mental health that are typically not relevant to purely financial crises. The detachment individuals can achieve in respect of financial decision-making could conceivably in some cases be undermined in this environment.

The governance challenge, moreover, extends to scheme (or 'product') design and member communication. There is a very real question whether the trustee responsible for a default option, for instance, is required by law to adjust the investment strategy of that part of the fund to reflect new beliefs about the appropriate strategy, or is rather required to remain 'true to label' on the basis that members may have formed, and crucially relied upon, expectations about the default option

283 Pensions Regulator, *Code of Practice 13: Governance and administration of occupational trust-based schemes providing money purchase benefits* (July 2016), [68].

284 APRA, *Prudential Standard SPS 232 Business Continuity Management* (November 2012).

285 In Australia, see M. Scott Donald, 'DIY or delegate? The key governance challenge for super fund boards' (2019) 31(4) *Australian Superannuation Law Bulletin* 79, 80.

286 In Australia, see Donald and Le Mire, above n 76.

based on earlier representations by the trustee as to its intended investment strategy. Alternatively, where schemes incorporate mechanisms for member investment choice, the obligation on trustees to ensure that the investment strategy is suitable for each of the members who have exercised choice may be largely circumvented, but the trustee may consider it appropriate to initiate an intensive communications campaign to assist members to exercise their choice rationally and in an informed manner.

Cyber-risk

The inclusion of cyber-risk in the list of contemporary challenges faced by the trustees of pension funds may seem an overreach, particularly as the discussion below is not directed towards the existential threat of a technological singularity arising from artificial intelligence developing beyond the point of human control.[287] Nor does the discussion below engage with the threats to financial research and markets generally posed by 'fake news',[288] nor the threat of cyber-crime in the form of identity theft[289] or ransomware attacks, although these are all genuine threats faced by the trustees of pension funds.

The focus is instead on the rather narrower issue of cryptocurrencies. A cryptocurrency is a form of virtual currency operating outside sovereign control. For some, the price volatility of cryptocurrencies represents an investment opportunity worthy of consideration by institutional investors such as pension fund trustees.[290] Moreover, despite their comparatively recent creation, courts in a number of common law countries, including the United Kingdom and Australia, have concluded that cryptocurrencies are a form of property, and are capable of being held on trust.[291]

That cryptocurrencies are capable of being held on trust does not, of itself, however, make them an appropriate investment for a prudent trustee. At one time it may have been possible to argue that cryptocurrencies deserve inclusion on an authorised list because they are simply a novel form of asset created by the innovative and creative forces of the most recent stage of capitalism. An analogy could be drawn to the gradual inclusion of company shares starting in the late nineteenth century.

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287 Nick Bostrom, *Superintelligence* (Oxford University Press, 2014).

288 Glenda Kwek, 'When flash crashes are only a tweet away' (*Sydney Morning Herald*, 26 April 2013). But cf Jonathan Clarke, Hailang Chen, Ding Du and Yu Jeffrey Hu, 'Fake News, Investor Attention, and Market Reaction' (September 1, 2019). *Information Systems Research*, Forthcoming. Available at SSRN: https://ssrn.com/abstract=3213024 or http://dx.doi.org/10.2139/ssrn.3213024 who find that the market reaction appears to price fake news accurately over both short and long term periods.

289 Duncan Hughes, 'Super fund left exposed' (*Australian Financial Review*, 20 October 2011).

290 David LeeKuo Chuen, Li Guo and Yu Wang, 'Cryptocurrency: A New Investment Opportunity?' (2018) 20 *The Journal of Alternative Investments* 16.

291 In the United Kingdom, see *AA v Persons Unknown* [2019] EWHC 3556, [2020] 4 WLR 35; *Vorotyntseva v Money -4 Limited t/a as Nebeus .com* [2018] EWHC 2598 (Ch); *Liam David Robertson v Persons Unknown* (unreported 15th July 2019, Moulder J). In Australia, see *Commissioner of the Australian Federal Police v Bigatton* [2020] NSWSC 245. In Singapore, see *B2C2 Ltd v Quoine Pte Ltd* [2019] SGHC(I) 03, [142] (Simon Thorley IJ), finding not disturbed on appeal as the Court of Appeal found no intention to create a trust and deferred discussion of the juridical nature of cryptocurrencies). In NZ, see *Ruscoe v Cryptopia Ltd (in liq)* [2020] NZHC 728. See also UK Jurisdiction Taskforce, *Legal Statement on Cryptoassets and Smart Contracts* (November 2019).

Indeed it is apparently widely forgotten that fiat currencies are a relatively recent phenomenon.[292] However, the evolution away from a list-based approach towards approaches placing more weight regard to the decision-process of the trustee traced earlier in this paper renders such that argument obsolete. Regard must instead be had for how a trustee might properly employ such an asset in a portfolio.

The starting point is to look for some positive reason why cryptocurrencies might be included in a portfolio. The potential for cryptocurrencies to increase in value very quickly, and to also to fall precipitously is well known. The problem for pension fund trustees is that the lack of transparency surrounding the 'market' for cryptocurrencies would make it hard for a trustee to justify a decision to invest. That is to say, although the court is likely to accept the proposition that it is the subjective belief of the trustee in the potential gains to be had from investment (whether in terms of expected returns or diversification) that is important, the trustee will need to have some defensible basis for the view it has taken on the cryptocurrency asset if it is to discharge the obligation to exercise care and diligence in the exercise of its investment power. There is a very real risk that any investment made without such a basis will be found to have engaged in speculation.

Price volatility is, of course, now no obstacle to trustee investment, even if the volatility associated with many cryptocurrencies is extreme.[293] The mathematics of portfolio optimisation underpinning modern portfolio theory demonstrate that so long as the volatility is not perfectly correlated with that of other investments in the portfolio, it will offer diversification opportunities. However this argument fails for the same reason that the returns-focused argument fails – a trustee would need to be able to demonstrate some basis for the observed, or forecast correlation, on which the strategy was based, and none do far exists.

Finally, there is a risk that cryptocurrencies would fail the due diligence test. There can be no basis for assuming that the acceptance of vulnerable custody arrangements will attract an investment return. Indeed, there are good reasons to suspect precisely the opposite. Custody, in the sense of proof of title, of cryptocurrencies is arranged through the creation of private keys that enable the 'owners' of cryptocurrency assets uniquely to transact those assets. Notwithstanding the formidable encryption technology deployed to provide security of this process, it has proved vulnerable in at least two ways. The first is where hackers steal the keys from online wallets designed to store them, as famously happened with Coincheck in 2018.[294] US$530m worth of cryptocurrency held on behalf of individuals was reportedly stolen. The second is even more basic: human fallibility. Private keys recorded electronically by an investor can be stolen digitally by hackers. When 'air-gapped', the device or document can simply be physically stolen. There have also been anecdotal reports of

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[292] Barry Eichengreen, 'From Commodity to Fiat and Now to Crypto: What Does History Tell Us?' NBER Working Paper No. 25426 (January 2019). Scottish readers in particular will be bemused by some non-Scots' belief that only government-owned banks can today issue legal tender. Although strictly true even in Scotland, in fact, as the Committee of Scottish Bankers notes:
'no banknote whatsoever (including Bank of England notes!) qualifies for the term 'legal tender' north of the border and the Scottish economy seems to manage without that legal protection.' https://www.scotbanks.org.uk/banknotes/legal-position.html, accessed 29 June 2020.

[293] For instance, the price of Bitcoin, perhaps the most prominent cryptocurrency, fell by 50% and then rebounded to its earlier levels in the months of February to May, 2020.

[294] Joyce Moullakis, 'You can't hack your way in' to crypto vault' (*Australian Financial Review*, 16 July 2018).

investors losing their private keys,[295] or of dying without leaving their keys to the estate,[296] with the result that the cryptocurrency asset becomes unclaimable. Cryptocurrencies are of course not unique in having some of these vulnerabilities, and in time it may be that institutions capable of eliminating these risks may develop. However, until such time, it is hard to avoid the conclusion that cryptocurrencies in their current incarnation would seldom, if ever, be a prudent investment for a pension fund trustee.

Concluding comments

Engaging with the uncertainty in investment markets is intrinsic to the role of pension fund trustees. The success of the occupational pensions systems in both the United Kingdom and Australia depends to a considerable extent on those trustees doing so effectively. Climate change, the COVID-19 viral pandemic and crypto-currencies have provided especially intense challenges for pension fund trustees in recent times. Each in its own way manifests different types of uncertainty. The three phenomena therefore represent a fertile set of case studies, providing distinctive perspectives into the multi-faceted nature of the risks with which modern pension fund trustees must engage on behalf of members. The first two case studies in particular demonstrate that the time dimension is crucial. They demonstrate that incisive research, careful diversification and targeted insurance can all assist in the management of certain types of risk, but that the management of risk in continuous, real time requires trustees to maintain governance structures and processes that permit timely re-appraisal and adaptation to events as they unfold. The case against trustees investing in cryptocurrencies is of a more traditional sort; until such time as the transparency around them improves a pension fund trustee will struggle to demonstrate that it has exercised its power of investment carefully were it to include cryptocurrencies in the fund's investment strategy. Together, they are a reminder that risk is not something that can be completely mathematised – uncertainty comes in many shapes and sizes and a flexible outlook and institutionalised capacity to respond is required of trustees if they are to engage with it effectively.

295 Juliet Samuel, 'IT worker throws out key to £4.8m with the rubbish' (*The Times*, 28 November 2013).

296 Tom Knowles, '£145m cryptocurrency password goes to grave' (*The Times*, 5 February 2019).

Talking about tax

Michael Furness QC, Robert Ham QC and Jonathan Davey QC

<u>"Payments" and "Discoveries": *Clark v HMRC* [2020] EWCA Civ 204</u>

Jonathan Davey QC

Introduction

1. In the recent decision of *Clark v HMRC* [2020] EWCA Civ 204 ("***Clark***") the Court of Appeal ("**CA**") gave valuable guidance on two important issues relevant to the taxation of registered pension schemes: (i) the meaning of the word "*payment*" for the purposes of the phrase "*unauthorised member payment*" within section 160 of the Finance Act 2004 ("**FA 2004**"); and (ii) the question of what comes within the scope of a "*discovery*" assessment made by HMRC under section 29 of the Taxes Management Act 1970 ("**TMA 1970**"). This paper, which accompanies a talk given as part of Wilberforce's 2020 Nugee series of pensions lectures, explores these two issues as dealt with in *Clark*.

Backdrop to CA's *Clark* decision

2. Prior to the matter coming before the CA (Lord Justice Henderson, Lord Justice Bean, Lady Justice Davies), the case had been heard by the First-tier Tribunal ("**FTT**") (Judge Berner) and the Upper Tribunal ("**UT**") (Mr Justice Arnold). The facts as found by the FTT, and adopted by the UT and CA, in short, were as follows.

3. The case concerned a set of pre-planned arrangements entered into by Mr Clark known as "*the pension transfer plan*". The purpose of the arrangements was to enable Mr Clark to access his pension monies for personal investment. This was against the backdrop of Mr Clark being unhappy with the returns which he had received from his Suffolk Life self-invested personal pension ("**SIPP**") and his desire to invest in the London property market. The arrangements were designed to generate an "*authorised surplus payment*" (section 177 FA 2004) that would not be subject to tax on the basis that the pension scheme administrator in question was offshore and thought to be outside the charge to UK corporation tax. The monies would then be made available to Mr Clark via a BVI company of which Mr Clark was a director, Cedar Investment Management Limited ("**CIM**").

4. The scheme involved a number of steps. Two key steps were as follows: first, the transfer of £2 million (the "**Suffolk Life Transfer**") from Mr Clark's Suffolk Life SIPP into what was purported to be a registered pension scheme known as the Laversham Marketing Limited pension scheme (the "**Laversham Pension Scheme**"); secondly, the transfer of £2 million (the "**Laversham Transfer**") by the Laversham Pension Scheme to Laversham Marketing Limited ("**LML**"), which was a company incorporated in Cyprus which had established the Laversham Pension Scheme. As a result of the remaining steps within the scheme, which included the receipt of monies by CIM, and the provision of loans to Mr Clark thereafter, Mr Clark was able to invest the monies profitably in the London property market.

5. A further important ingredient in understanding the CA's decision in *Clark* is the FTT's finding that the trusts of the Laversham Pension Scheme were void for uncertainty. This followed the judgment of Rose J in the case of *Re LPA Umbrella Trust, Pensions Regulator v A Admin Ltd* [2014] EWHC 1378 (Ch), where member benefit provisions defined in like terms to those used in the Laversham Pension Scheme documentation were found to be void for uncertainty.

6. That finding was important because in circumstances where the Laversham Pension Scheme was void, it was held to follow by the FTT that the Suffolk Life Transfer only ever conveyed bare legal title to the money, with an immediate resulting trust arising by operation of law. Neither the UT nor the CA interfered with that finding, with the latter citing a passage from *Lewin on Trusts* (nineteenth edition) at 8.002 (*Clark* at [37]): "*A resulting trust arises by operation of law if a person makes a disposition of property upon trust but no trusts are effectively declared…*"

7. Thus, the position was as follows. There had been a transfer from the Suffolk Life SIPP bank account to the Laversham Pension Scheme bank account; and then from there to the LML bank account; and then from there to the CIM bank account; and then from there to Mr Clark, who put the money to work buying and selling property in Mayfair. But the fountainhead from which all of this stemmed, the Suffolk Life Transfer, had only ever passed legal title, not beneficial title.

Relevance from a tax point of view

8. The reason that the focus on the Suffolk Life Transfer, and the finding that the Suffolk Life Transfer passed only legal title, was of significance from a tax point of view was twofold.

9. First, a charge to income tax known as an "*unauthorised payments charge*" (section 208 FA 2004) arises if a registered pension scheme makes an "*unauthorised member payment*"; that is to say, a payment to or in respect of a member which is not within the list of "*authorised member payments*" under section 164 FA 2004. Therefore, if the Suffolk Life Transfer constituted an "*unauthorised member payment*" then, on the face of things, an "*unauthorised payments charge*" was due (Issue 1 below).

10. Secondly, the focus on the Suffolk Life Transfer gave rise to the question of whether that particular transfer fell within the scope of the "*discovery*" assessment which had been made by HMRC (Issue 2 below).

Issue 1: meaning of "payment"

11. HMRC contended that the Suffolk Life Transfer was an "*unauthorised member payment*". This was on the basis that the Suffolk Life Transfer did not fall within the list of "*authorised member payments*" under section 164 FA 2004 (for example, the payment of a pension or the making of a recognised transfer (i.e. one to another registered pension scheme)) and there was no requirement that an "*authorised member payment*" pass beneficial title.

12. Mr Clark, on the other hand, contended that the Suffolk Life Transfer was not an "*unauthorised member payment*". The reason that the Suffolk Life Transfer was not an "*unauthorised member payment*" was because the transfer made was never a "*payment*" at all. The reason it was never a "*payment*" at all was because for something to constitute a "*payment*", legal and beneficial interest had to pass, and that had not occurred in the case of the Suffolk Life Transfer.

13. Those two opposing positions were advanced against the backdrop of the provisions of FA 2004; in particular, sections 160(2)(a) and 161(1)-(2), which concern the meaning of "*payment*". Section 160(2)(a) FA 2004 provides: "*In this Part "unauthorised member payment" means – (a) a payment by a registered pension scheme to or in a respect of a person who is or has been a member of the pension scheme which is not authorised by section 164*". Section 161(1)-(2) FA 2004 provides: "*(1) This section applies for the interpretation of this Chapter. (2) "Payment" includes a transfer of assets and any other transfer of money's worth.*"

14. It was common ground that these and related statutory provisions left room for argument over which of the parties' positions on the meaning of "*payment*" was correct, and therefore consideration was given to the relevant case law.

15. Prior to *Clark* it had commonly been considered that such case law as there was on the meaning of "*payment*", dealing with the position under predecessor legislation to FA 2004, provided a degree of support for each of the two opposing views (paragraphs 11 and 12 above). Two important cases in such regard were: *Hillsdown Holdings plc v Inland Revenue Commissioners* [1997] STC 561 ("***Hillsdown***"), where the court (Arden J) took the view that a transfer which failed to pass beneficial title was <u>not</u> a "*payment*"; and *Venables v Hornby (Inspector of Taxes)* [2002] EWCA Civ 1277 ("***Venables***"), where the court (Court of Appeal, leading judgment of Chadwick LJ) took the view that a transfer which failed to pass beneficial title <u>was</u> a "*payment*".

16. What the CA's judgment in *Clark* helpfully brings out is that in considering *Hillsdown* and *Venables* (and other relevant cases) appreciation of context is crucial.

17. *Hillsdown* concerned section 601 of the Income and Corporation Taxes Act 1988 ("**ICTA 1988**"), which dealt with the charge to tax on payments to employers under the pre-FA 2004 regime. Factually, what was being considered in *Hillsdown* was a payment by a scheme to an employer to reduce a surplus, which, on the face of things at least, was permitted, and if tax was due under section 601 ICTA 1988 it was against that backdrop and on that premise. Also of significance was the fact that by the date of the hearing before Arden J the funds had been repaid. The court held that since no beneficial interest had passed there had been no "*payment*" and therefore no tax was due.

18. *Venables*, on the other hand, concerned section 600 ICTA 1988, which dealt with the charge to tax on unauthorised payments to employees. By contrast with the facts of *Hillsdown*, in *Venables* what was being considered was a payment to a member, which was being analysed on the premise that it was not permitted, and had not been repaid prior to the hearing. If tax was due under section 600 ICTA 1988, it was against that backdrop. Given that, according to the CA in *Venables*, section 600 ICTA 1988 had been enacted precisely in order to deal with circumstances

where an unauthorised transfer had occurred, it followed that the transfer in question did fall within the scope of the section. As Chadwick LJ put it in *Venables* at [33]: "*…the charge to tax under section 600 of the 1988 Act arises only where the payment is unauthorised and in breach of trust. If an unauthorised payment is to be treated as no payment at all, the section is self-defeating. That cannot have been Parliament's intention.*"

19. Having considered *Hillsdown*, *Venables* and other authorities, as well as further context setting FA 2004 provisions, the CA in *Clark* found that the key FA 2004 provisions fell to be analysed in essentially the same way as the ancestor provisions considered in *Venables.* The CA could find nothing in the particular wording of sections 160-161 FA 2004 which prevented a transfer from being a "*payment*" in the absence of beneficial interest passing, and, so far as regards the policy behind the "*unauthorised payments charge*" arising on the occurrence of an "*unauthorised member payment*", as Henderson LJ put it (*Clark* at [62]): "*the charge to tax would become self-defeating if it did not apply to cases where the payment was made in breach of trust or for any other reason did not transfer beneficial title*".

20. An additional and related building block in the CA's analysis in *Clark* was what the court called the "*practical, business reality of the transaction*"; that is to say, the facts on the ground, including the pension transfer plan considered as a whole, the buying and selling of real property, the passage of time of several years, and the fact that as at the time of the hearing before the CA the funds had still not been returned. The CA stated (at [82]):

> "*The question whether a "payment" is made for these purposes should be answered by looking at the practical, business reality of the transaction, including any composite transaction of which the payment forms part. If the intended purpose and effect of the transactions is that money leaves the scheme and is placed at the free disposal of the member, the mere fact that the money may be subject to an equitable obligation to restore it to the scheme will not prevent it from being a "payment" in the ordinary sense of that word. To conclude otherwise would deprive the charge to tax of effect in many of the most egregious cases where it is most needed*."

21. The CA considered what the "*natural reaction*" of someone unconnected with the case would be on being told that a person who had obtained funds in order to buy and sell property in Mayfair, and had done so, had, it turned out, never received a "*payment*" in the first place (*Clark* at [40]). The natural reaction, in the CA's view, was that the "*no payment*" analysis could not be right.

22. So *Clark* is now the latest word on the meaning of "*payment*" in the context of the taxation of registered pension schemes. Whether it turns out to be the last word on the subject may depend upon whether future case law shows *Clark* to (i) have provided much needed clarity, capable of straightforward application, or, alternatively, (ii) constitute an example of the CA disregarding longstanding principles of equity in order to reach a conclusion which they felt was right from a merits point of view.

23. Significantly, it should be noted that the CA's decision does appear to leave open the door for a different approach if the facts were to be markedly different from those in *Clark*. The CA stated at [86]: "*different considerations may arguably arise in cases where an unauthorised payment is*

inadvertently or carelessly made, and the member concerned takes prompt and effective steps to restore it to the fund before any assessment is made by HMRC." Those words may prove to be of importance going forward in relation to cases where it is inadvertence rather than design which brings the possibility of an "*unauthorised payments charge*" into play.

Issue 2: "discovery" assessments

24. The FTT's finding that the trusts of the Laversham Pension Scheme were void for uncertainty (paragraph 5 above) caused attention to shift in the task of ascertaining whether the arrangements entered into by Mr Clark included an "*unauthorised member payment*" giving rise to an "*unauthorised payments charge*".

25. This was because the initial candidate for the "*unauthorised member payment*" had been the Laversham Transfer (paragraph 4 above), but in circumstances where the Laversham Pension Scheme turned out not to be a registered pension scheme at all, with an immediate resulting trust back to the Suffolk Life SIPP on the occurrence of the Suffolk Life Transfer (paragraph 4 above), it become common ground that if there was an "*unauthorised member payment*" then it had to be the Suffolk Life Transfer.

26. As well as giving rise to the substantive question of whether a transfer not passing beneficial interest could be a "*payment*" at all (Issue 1 above), the recognition that the Suffolk Life Transfer should be the focus of attention also gave rise to the administrative/procedural question of the parameters of the discovery assessment which had been issued by HMRC (Issue 2).

27. The topic of discovery assessments is a large one, and the various issues to which they give rise are numerous. This paper confines itself to dealing with the particular issue that was live in *Clark*, namely that of the parameters of a discovery assessment and specifically the nature of the concept of discovery.

28. By way of context, if a tax return is filed on time, HMRC has 12 months from the date of filing in which to issue a notice of enquiry if it wishes to investigate further whether the right amount of tax is being assessed (with that time limit being extended if a tax return is filed late or is later amended). Once the time limit for opening an enquiry has expired, or an enquiry which had been opened is closed, the taxpayer's liability for the relevant tax year is generally regarded as final. In those circumstances, HMRC can only demand a further tax payment by raising a "*discovery*" assessment.

29. The relevant legislative provision is section 29 TMA 1970. As in force at the time of *Clark*, section 29(1) TMA 1970 provided:

> "*(1) If an officer of the Board or the Board <u>discover</u>, as regards any person (the taxpayer) and a year of assessment –*
>
> > *(a) that any income which ought to have been assessed to income tax, or chargeable gains which ought to have been assessed to capital gains tax, have not been assessed, or*

(b) that an assessment to tax is or has become insufficient, or

(c) that any relief which has been given is or has become excessive,

the officer or, as the case may be, the Board may, subject to subsections (2) and (3) below, make an assessment in the amount, or the further amount, which ought in his or their opinion to be charged in order to make good to the Crown the loss of tax." (emphasis added)

30. The term "*discover*" (underlined in the above quotation) has been part of the tax related legislative landscape in this country for many years but never statutorily defined. Although the vein of case law dealing with its meaning goes back well into the nineteenth century (with *Clark* at [96]-[98] providing a useful route into the relevant authorities), what *Clark* helpfully makes clear is the crucial point that the term "*discover*" – the concept of discovery within section 29 TMA 1970 – is essentially <u>subjective</u> in character. To speak of HMRC making a discovery is to describe an HMRC officer coming to a conclusion based on the information that the officer has. The essence of the position is articulated by Henderson LJ in *Clark* at [106] as follows:

"***the scope of the assessment, and of any appeal from it, must be defined by the <u>subjective discovery</u> that the assessing officer has made.*** *That is the only assessment which the officer has jurisdiction to make, and the scope of the assessment, as opposed to the arguments which may be used to support it, cannot in my view be extended by virtue of the appeal process*".

31. Thus, the scope of an assessment is delimited by the subjective "*discovery*" made, and the fact that "*discovery*" in this context is fundamentally subjective in character means that what an HMRC assessing officer says in correspondence with the taxpayer really does matter. In *Clark* the issue was whether the discovery assessment correspondence passing between the assessing officer and the taxpayer's representatives established that, in investigating the arrangements into which Mr Clark had entered, HMRC was only focussed on the second of the two transfers rather than the first, i.e. the Laversham Transfer rather than the Suffolk Life Transfer (paragraph 4 above). That mattered because if the scope of HMRC's "*discovery*" was not such as to include the Suffolk Life Transfer then no tax was due because it was agreed that the Laversham Transfer, the only other candidate for an "*unauthorised member payment*", was, as it turned out, not capable of being an "*unauthorised member payment*" (paragraphs 24-25 above), and therefore was not capable of giving rise to an "*unauthorised payments charge*".

32. Ultimately, the CA found that, properly interpreted, the HMRC assessing officer's relevant correspondence was broad enough to encompass the Suffolk Life Transfer, and therefore there was an enforceable tax liability. The CA held (*Clark* at [108]):

"*it is an inescapable inference that officer Sidhu had this wider picture [i.e. including the Suffolk Life Transfer] well in mind when she made the assessment, and on the proper construction of the letter her "discovery" extended to any loss of tax in 2009/10 occasioned by an unauthorised member payment made to or in respect of Mr Clark, arising from the* *series of transactions beginning with the transfer of assets into the [Laversham Pension Scheme].*"

33. Therefore, as well as providing a clear statement as to the intrinsically subjective character of *"discovery*", *Clark* also provides a good illustration of the fundamental importance of paying close attention to detail in considering exactly what HMRC is asserting in any relevant correspondence. If the transaction in question does not fall within the scope of the particular "*discovery*" made, then the basis for the charge to tax will be absent (*Clark* at [106] (above)).

34. To reiterate, the topic of discovery assessments is a large one, and this question of the scope of a "*discovery*" is not the only one which falls to be considered if advising your clients in this area. Other relevant questions (not specifically in point in *Clark* and beyond the scope of this paper) include:

    - Has the discovery gone "*stale*"? That is to say, has HMRC sat on the information which it holds for too long with the result that the window of opportunity to assert a "*discovery*" and issue a discovery assessment has passed? For a recent discussion of the concept of staleness in relation to discover assessments, see *Beagles v HMRC* [2019] UKUT 380 (TCC).

    - Are other conditions for issuing a discovery assessment present or absent (sections 29(3)-(5) TMA 1970)? For a discovery assessment to be made, unless the loss of tax has been brought about by carelessness or deliberate action by the taxpayer or a related person, then HMRC will need to be able to show that HMRC could not reasonably have been expected, on the basis of the information available at the expiry of the period in which an enquiry could have been opened, or on closure of any enquiry, to be aware of the facts leading to the potential loss of tax.

Conclusion

35. As *Clark* illustrates well, close attention to detail is crucial when advising clients in the area of the taxation of registered pension schemes – both in considering, substantively, the proper analysis of transactions that have occurred or might be in contemplation, and, administratively, the precise location of the goal posts in dealings between the taxpayer and HMRC.

<u>The tax treatment of arrears of benefits and interest on those arrears.</u>

Michael Furness QC

1. This paper looks at the tax treatment of the payment of arrears of pensions and other benefits, and interest payable on those arrears. Granted the complexities of administration which can arise in occupational pension schemes, the need to compensate members by way of arrears payments and interest is fairly common. One would expect that the position under the tax code would be straightforward, but it is not. While for the most part sensible conclusions can be reached as to the proper treatment of such payments, not all of them have been explicitly sanctioned in HMRC guidance, and there are some areas of genuine difficulty. This paper does not examine the position of arrears of payments due to GMP equalisation.

2. I begin by looking at arrears of pension payments. There are three situations in which arrears can arise:

    (1) Where a pension comes into payment later than it should have done (eg because of difficulties in tracing the pensioner concerned).

    (2) Where a pension has been paid in the past at a level which is lower than that at which the pensioner is actually entitled (which may arise due to administrative error, or because it becomes clear that the rules provide for a more generous level of benefit than the trustees realised).

    (3) Where the scheme is amended to increase benefits, and the increase is back-dated to a time prior to the date of the amendment.

    Each of these situations give rise to two main issues: (a) what is the tax consequence for the scheme if the payment is made and (b) how is the payment to be taxed in the hands of the pensioner? I will begin by looking at the position of the scheme.

3. From the scheme's perspective, the question is whether the payment of the arrears is an authorised payment. If it is not, then the penal tax consequences of the unauthorised payments regime (see below) will kick in. This regime will also impose a penal tax charge on the member who receives the payment, which is discussed below. FA 2004 provides a comprehensive list of authorised member payments in section 164(1):

    164 Authorised member payments

    (1) The only payments a registered pension scheme is authorised to make to or in respect of a person who is or has been a member of the pension scheme are—

    (a) pensions permitted by the pension rules or the pension death benefit rules to be paid to or in respect of a member (see sections 165 and 167),

    (b) lump sums permitted by the lump sum rule or the lump sum death benefit rule to be paid to or in respect of a member (see sections 166 and 168),

    (c) recognised transfers (see section 169),

    (d) scheme administration member payments (see section 171),

(e) payments pursuant to a pension sharing order or provision, and

(f) payments of a description prescribed by regulations made by the Board of Inland Revenue.

4. In the case of arrears, the first port of call must be paragraph (f) and The Registered Pension Schemes (Authorised Payments – Arrears of Pension) Regulations 2006/614. Regulation 2 provides as follows:

(1) Where a registered pension scheme pays to a member of the scheme an amount representing accrued arrears of pension, paragraph (2) applies.

(2) Paragraph (3) applies to so much of the payment mentioned in paragraph (1) as-

(a) does not exceed the amount accrued during the period-

(i) ending with the date on which he became entitled to the pension ("the actual start date"); and

(ii) beginning with the earliest date from which the member could, at the actual start date, have required the scheme administrator, in accordance with the rules of the scheme, to make a payment of arrears of pension; and

(b) constitutes taxable pension income within section 579B of ITEPA 2003.

(3) The amount to which this paragraph applies is a payment of a prescribed description for the purposes of section 164(f).

Regulation 2(4) says that "entitled to a pension" has the same meaning as in section 165(3), which provides that a person is entitled to a pension "when the person first acquires an actual (rather than a prospective) right to receive the pension".

5. On first reading these regulations make no sense at all. Paragraph (1) is framed in broad terms, but paragraph (3) is what confers on the arrears the status of an authorised payment, and paragraph (2) says that only so much of the sum described in paragraph (1) as fulfils the conditions laid down by paragraph (2) will fall within paragraph (3). In order to fall within paragraph (2) the payment must not exceed the amount accrued in a period which ends with the date on which the member first becomes entitled to the pension ("the actual start date"), and starts with the earliest date from which the member could, at the actual start date have required the payment of his pension under the rules. At first sight it appears impossible for any arrears ever to fall within this period because, *ex hypothesi*, arrears will only <u>start</u> to accrue as from the date when the member becomes entitled to the pension, whereas the paragraph says they must accrue during a period which <u>ends</u> on that date.

6. The explanatory note to regulation 2 makes sense of the nonsense because it says that regulation 2 "prescribes a payment of arrears of pension which have accrued, to which the member is entitled at the time <u>when the pension begins to be paid</u>". That is a difficult construction to attribute to the wording of the regulation itself, because the draftsman has firmly anchored the definition of "entitled to a pension" to the definition of that expression in section 165(2), where, it appears to mean (as one would expect) the date when the member becomes legally entitled to payment, and not some later date when the trustees actually start making payments pursuant to the entitlement (a "prospective" right to receive

a pension being the right to a pension which exists in deferment, before the right to payment has arisen). Be that as it may, HMRC clearly take the view that "entitlement to a pension" does not arise until the trustees start making payments – this view not only appears in the explanatory note quoted above, but in the following passage from HMRC's Pensions Tax Manual PTM 142000:

Where the scheme administrator was not able to trace the member in the run-up to when their benefits were due, the scheme may end up with a liability to pay an arrear of scheme pension to the member once they become actually entitled to the payment of the ongoing pension. Because of the difference between how obligations can arise under scheme rules and when the tax rules recognise an actual entitlement to the payment of pension (see PTM062800), specific provision was made in SI2006/614 to make arrear payments of scheme pensions 'authorised payments' under the tax rules.

In PTM062800 the following passage appears:

If delays in becoming entitled to scheme pension (PTM062300) occur while a member is still alive, the 'Arrears of Pension' Regulations 2006 - SI 2006/614 (PTM142000) specify when pre-entitlement arrears may be authorised. (Only scheme pensions are covered by this provision since other kinds of pension provision do not present the same difficulty).

7. The application of the Arrears Regulations is therefore one of some difficulty. Arguably, in operating them at all, HMRC are doing so on the basis of a view of the legislation which may be wrong in law. At best, their interpretation requires a strained construction of the words used. One cannot, therefore, make any assumptions that the Regulations will be applied in any situation unless specifically covered by published guidance or a clearance decision.

8. It should be noted that where arrears resulting from the delayed commencement of a pension are only paid after the member's death, the Arrears Regulations do not apply. Instead, regulation 16 of the Registered Pension Schemes (Authorised Payments) Regulations 2009 SI2009/1171 comes into play. According to HMRC, (PTM 62800) where there is a delay in the commencement of a pension and the pensioner dies during the period of delay, there are the following obstacles to the payment of the arrears to the estate of the deceased pension:
   - no entitlement to pension will have accrued under the tax rules before death
   - further accrual is not possible after death, since there is no authorised pre-death pension that could continue under a guarantee
   - no fresh entitlement to pension can arise for the member once they have died, and
   - the 'Arrears of Pension' Regulations (which hinge upon actual entitlement arising during the member's lifetime), will not apply.

   The first proposition is again derived from HMRC's view that for tax purposes no entitlement to a pension arises until it starts to be paid. It is in order to address these obstacles that regulation 16 was introduced:

16 Payments of arrears of pension after death

(1) A payment of pension under the pension scheme to or in respect of a member who has died if—

(a) the payment is in respect of a defined benefits arrangement;

(c) the member—

(i) was not a controlling director of a sponsoring employer of this or any related scheme, and

(ii) was not a person connected to such a person; and

(d) either—

(i) the conditions in paragraph (2) are satisfied, or

(ii) where the member died on or after 6th April 2006, the conditions in paragraph (3) are satisfied.

(2) The conditions where the member died before 6th April 2006 are that—

(a) the payment represents accrued arrears of pension;

(b) the payment was allowed or required by the rules of this scheme as they stood immediately before the member died; and

(c) the existence of the rule or rules concerned would not have prejudiced approval of the scheme by the Inland Revenue or Her Majesty's Revenue and Customs.

(3) The conditions where the member died on or after 6th April 2006 are that—

(a) the payment represents accrued arrears of scheme pension the member's entitlement to which the scheme administrator had not established until after the member's death;

(b) the payment would not have been an unauthorised payment if the payment had been made immediately before the member's death and the member had been entitled to it; and

(c) the scheme administrator could not reasonably have been expected to make the payment before the member's death.

9. This rule is hedged about with anti-avoidance provisions – the drafter was clearly concerned about arrangements being manipulated to ensure that sums were deliberately withheld until after the pensioner's death. That said, the requirement that the scheme administrator could not reasonably have been expected to make payment before the member's death is capable of creating hardship where the reason the payment has not been paid is due to the negligence of the administrator. In that situation the administrator could reasonably have been expected to make the payment before death, and it adds insult to injury so far as the member is concerned if for that reason the payment to his estate is stigmatised as unauthorised.

10. It should be noted that HMRC consider that this regulation, like the arrears regulations, only applies where there has been a delay in putting the pension itself into payment, not where the pension has been in payment before death but in too low an amount. However,

requirement (3)(a) can be read as encompassing arrears derived from underpayments – it all depends on whether "the members entitlement to which" refers to "the scheme pension" or the "accrued arrears".

11. Subject to satisfying the anti-avoidance requirements in the case of a payment after death, the position on arrears arising from the late commencement of a pension is clear. They will be authorised payments under section 164(1)(f). What then of payments of arrears which represent arrears due to the under-payment of pension, rather than the late payment of the entire pension? These arrears are clearly outside the Arrears Regulations and (at least in HRMC's view) outside regulation 16 of the Authorised Payment Regulations as well. So how can they be authorised?

12. One approach might be to attempt to apply the Arrears Regulations just to that tranche of the pension which has been underpaid. In other words, to treat the underpaid element as a fresh pension starting on whatever date the arrears began. However, that is not consistent with the scheme of the legislation. However, while a registered pension scheme is in existence there can only be one scheme pension, so that where parts of a scheme pension are provided by more than one party (e.g., a pension scheme and an insurance company, or two insurance companies), the parts should be aggregated and the combined benefits treated in their totality as the single scheme pension. While sections 164 and 165 refer to "pensions" in the plural being paid to a scheme member, those sections are looking at both defined benefit and defined contribution arrangements (and of course a single scheme can provide both types of benefit to a single member). But section 165(1) is clear that no payment of pension other than <u>a</u> scheme pension may be made by a defined benefit arrangement. While that wording is not decisive (because the singular can include the plural) the fact that "pensions" in the plural is used elsewhere in the section points to the use of the singular in this context being intentional. That makes good sense, having regard to the fact that a defined benefit arrangement may provide a pension through different means – eg partly insured and partly paid by the scheme. The pension rules concerning the level of pension which is permitted to be paid can only sensibly be applied to the aggregate of all sources of the pension, otherwise completely arbitrary results could occur.

13. HMRC clearly regard a pension paid from a defined benefit arrangement from more than one source as being a single scheme pension – see RPSM09101205:

    Generally the <u>scheme pension</u> will be paid direct from the scheme by the <u>scheme administrator</u>. However, the <u>scheme administrator</u> may choose to farm out all (or part) of the scheme's liability, by purchasing an annuity contract with an <u>insurance company</u> as described above — also see RPSM09101230. The choice of <u>insurance company</u> here is purely down to the <u>scheme administrator</u>.

    Treating the underpaid amount as a separate pension might also cause problems with the requirement (discussed below) that a scheme pension must not reduce from one year to the next.

14. It is, in any event, clear from the tenor of HMRC guidance quoted elsewhere in this paper, and from correspondence seen by the writer, that HMRC do not accept that the Arrears regulations can be applied just to the tranche of pension in arrears. It is therefore necessary to find another basis for authorising the payment of arrears.

15. Turning back to the list of authorised member payments in section 164(1), the obvious basis for authorisation, at least while the recipient member is still alive, is that they are payments of "pensions permitted by the pension rules to be paid to or in respect of a member" within section 164(1)(a). The author is aware of at least one case where HMRC have accepted in correspondence that this is the correct analysis. The other possible basis of authorisation would be "scheme administration member payments". These are discussed below in the context of interest payments – as that discussion shows it is pretty clear that compensation for arrears of pension do not fall within this heading, and certainly HMRC do not think they do.

16. However, the seemingly straightforward justification based on arrears being payments of pension conceals a problem, because to get within section 164(1)(a) the payment must comply with "the pension rules". The pension rules are set out in section 135. The potential problem arises because the only pension which a defined benefit scheme can provide is a "scheme pension" (rule 3) and paragraph 2(3)(b) of the Schedule 28 provides that a pension is only a "scheme pension" if:

    "the rate of pension payable at any time during any 12 month period is not less than the rate of pension payable at the relevant time"

    "The relevant time" is the beginning of any twelve-month period. In other words, it is not permissible to reduce the rate of a scheme pension from one year to the next. If a sum representing several years' worth of arrears is paid in a single year, the likelihood is that the amount of pension in that year will exceed the amount paid in the following year. So the question is whether the "rate" of pension in the following year is less than the rate of pension paid in the year in which the arrears are paid. If it is, then the pension rules will be breached.

17. While it is reasonable to suppose that a breach of the pension rules in this way will attract some sort of tax sanction as an unauthorised payment, it is unclear quite what the consequences of a pension breaching the pension rules in this way might be. One would hope that it just so much of the pension received in a year which exceeded the amount received in the following year would be treated as an unauthorised member payment. But it could be that what becomes unauthorised is the entire payment made in the following year.

18. In order to pay an amount of arrears as "pension" it is therefore necessary to establish that the payment of a sum of pension arrears in respect of earlier years in a particular twelve-month period does not increase the "rate" of the pension payable - ie it is necessary to show that the rate is the underlying rate, and is not impacted by a one-off arrears payment. One might argue, simplistically, that the true rate of the pension is the amount provided for under the rules for the year in question, and any amount paid in addition to that in a given year is to be disregarded for the purpose of ascertaining the rate for the year. But that approach overlooks the fact that to be authorised the arrears must not only be categorised as being payment of a pension, but payment of a pension which is "permitted by the pension rules".

It is hardly consistent with that requirement that the arrears payment be left out of account when determining whether the pension rules are complied with. More generally, the legislation does not place reliance on the rules when determining the status of payments. To allow the rules to determine what pension payments do or do not count for the purpose of computing the annual "rate" would open the way to abuse and avoidance.

19. One therefore needs an analysis which allows the arrears to be taken into account for the purpose of computing the "rate" of pension, but in a way which does not breach the pension rule against pensions which reduce from one year to the next. That means, for the purpose of determining the rate of a pension, attributing the arrears to the years in which they should have been paid, and not all to the year in which they were actually paid. That analysis is permissible because Employment income is taxable on an earnings, rather than a receipts, basis (ITEPA 2003 section 18) and this approach is specifically applied to pension income by ITEPA section 571. That principle underpins HMRC guidance on the topic in the Employment Income Manual at paragraph EIM74103:

    <u>Accruals basis</u>

    Where the amount of pension income charged to tax is the full amount accruing in the tax year (see EIM74101), the amount to be charged is the amount to which the pensioner is entitled in the tax year.

    <u>Arrears of pension</u>

    If a pension provider discovers a long-standing underpayment of pension, the underpayment is calculated and paid in a single sum. The provider is required to operate PAYE on the lump sum, which may give rise to higher rate liability for a pensioner who is usually a basic rate taxpayer. The pensioner should contact the tax office and supply a schedule showing the years to which underpayments are attributable. HMRC will spread the payments back over the relevant years and recalculate liability. Underpayments in the earlier years may be set-off against the resulting over-payment in the year of the lump-sum payment.

20. So, the tax treatment of the arrears proceeds on the basis that they are attributable to the past years in which they arise, so the rate of pension in the year in which they are paid is not affected by the amount of the arrears.

21. Note, however, that this analysis means that "arrears" will not qualify for this treatment if created retrospectively – if a contractual compromise or the exercise of a power of amendment purports to increase levels of pension with effect from a date prior to the compromise or exercise being made, it will not be possible to analyse them as having been earned in earlier years. Any "arrears" in respect of the period of retrospective increase will only be earned at the point at which the compromise or exercise of power is actually effected.

The consequences of payments arising from a compromise

22. Where the trustees simply discover that a pension has been underpaid in the past, and pay the arrears in full, the above analysis is straightforward to apply. But in many cases there is a dispute over the past level of pension, and that dispute is resolved by a Court approved compromise. Suppose, for example, that the scheme is amended to say that for service after 1 January 2000 pensions are to accrue at 1/80 of final pensionable salary, whereas for service

before that date they accrued at 1/60 of final pensionable salary. Suppose that an issue arises as to the validity of the deed of amendment, which is compromised before the Court on the basis that pensions based on service from 1 January 2000 will be computed on the basis of a 1/70 accrual rate. On any view this level of payment is not authorised by the scheme – the scheme either authorises 1/60 accrual or 1/80. If the correct position is that the deed is valid, then accrual in excess of 1/80 is unauthorised, and is not a payment of arrears at all. Are HMRC bound to accept the outcome of the compromise?

23. I am not aware of any guidance on this topic, but as a matter of general principle my view is that HMRC would not be justified in taking that position. There are two strands of authority which point to that conclusion. The first is a series of cases which say that the tax treatment of damages recovered in litigation is determined by the nature of the claim on which the damages claim is based. Thus, where damages are awarded in part as compensation for damage to a capital asset and in part as compensation for loss of profits while the capital asset was being repaired, the former are treated as a capital receipt and the latter as a trading receipt - see *London and Thames Haven Oil Wharves Ltd v Attwooll* [1967] Ch 772. Where an element in damages represents compensation for late payment, that element is taxed as interest - see *Riches v Westminster Bank Ltd* [1947] AC 390*.* The same approach applies where sums are recovered by way of compromise, rather than under a judgment.

24. The second line of authority is one which holds that where taxpayers in an arm's length transaction, undertaken in good faith (and not for tax avoidance motives), attribute a price to an asset, or apportion a price between different elements of a transaction, neither HMRC nor the taxpayers can subsequently seek to have the transaction taxed on the basis of a different value, or apportionment (*Stanton v Drayton Commercial Investments Ltd* [1983] 1 AC 501, *Spectros International Plc v Madden* [1997] STC 114).

25. Taken together, these authorities suggest that where parties agree that a claim for a higher pension should be compromised, and that part of the compensation payable should be treated as arrears of that pension, then HMRC must accept that the payments (both prospective payments and the payments on account of arrears) are payments of pension.

The Treatment of Interest on arrears

26. If a member is entitled to the payment of arrears, he will almost certainly also be entitled to interest on those arrears. Interest for late payment of a pension is not itself a payment of pension – not as a matter of ordinary language, and certainly not as a matter of tax law, which taxes pensions and interest under distinct charging provisions.

27. The only heading under which interest payments can be justified as authorised member payments under section 164(1) is as scheme administration member payments (section 164(1)(d)). These are dealt with under section 171, which is in the following terms:

(1) A **"scheme administration member payment"** is a <u>payment</u> by a registered pension scheme to or in respect of a person who is or has been a member of the <u>pension scheme</u> which is made for the purposes of the administration or management of the <u>pension scheme</u>.

(2) But if a payment falling within subsection (1) exceeds the amount which might be expected to be paid to a person who was at arm's length, the excess is not a scheme administration member payment.

(3) Scheme administration member payments include in particular—

(a) the payment of wages, salaries or fees to persons engaged in administering the pension scheme, and

(b) payments made for the purchase of assets to be held for the purposes of the pension scheme.

(4) A loan to or in respect of a person who is or has been a member of the pension scheme is not a scheme administration member payment.

(5) Regulations made by the Board of Inland Revenue may provide that payments of a description specified in the regulations are, or are not, scheme administration member payments.

No regulations have been made under subsection (5), so in order to qualify the payment has to be made "for the purpose of the administration or management of the pension scheme." It has to be said that the guidance given by HMRC on this issue in the PTM (para PTM143300) is somewhat equivocal. Modest payments by way of compensation for "distress or inconvenience or other non-financial loss", of the sort which an ombudsman might order, are accepted as being within the scope of scheme administration payments. It is, however, stressed that each case will be fact specific. Interest payments are not mentioned at all. That said, although they represent financial rather than non-financial loss, interest payments appear to be of the same nature as payments for distress and inconvenience, because they compensate for maladministration, and it would be absurd if they were treated as unauthorised payments, granted that the trustees will usually have no choice but to pay interest on arrears once they are found to be owing. Furthermore, HMRC accept that interest on refunds of contributions can be a scheme administration member payment (see PTM 045000), so the same should go for interest on arrears.

28. There are three arguments against interest being treated as a scheme administration payment –

Interest is payable as compensation for a legal wrong done to the member. It cannot sensibly be described as made for the purposes of the administration or management of the pension scheme.

It was clearly not intended that payments of benefits should be accommodated within this head of authorisation, so interest, which merely goes to enhance the amount of benefit paid, should not fall within it either.

The HMRC guidance is carefully restricted to modest payments by way of compensation for distress and inconvenience for non-financial loss. Its failure to refer to interest payments is therefore striking. Unlike compensation for distress and inconvenience, interest payments can amount to significant sums of money. Furthermore, interest paid on a compound basis is not something the pensions ombudsman can award, so such payments fall outside the guidance for this reason also.

While recognising the strength of these points, the bottom line surely has to be that interest payments, like the mistaken underpayment of benefits, are a fact of life in pension schemes. The tax regime must therefore cater for them being made, and the pigeon-hole of scheme administration payment seems to be the only place in which they can be accommodated.

29. Interest is taxed on an arising basis (ITTOIA 2005 section 370). HMRC guidance in Savings and Investment Manual paragraph SAIM2440 says
"Interest 'arises' when it is received or made available to the recipient. Interest has been made available if it is credited to an account on which the account holder is free to draw."

The same paragraph also observes:

"Interest on a judicial award should normally be regarded as arising on the date on which it is paid."

It is thus clear that the interest element of any arrears payments will be taxable in the year of assessment in which it is paid, and cannot be spread over earlier years.

Potential pitfalls

30. As noted above, in order to qualify as arrears of a pension, and therefore as pension payments, the arrears must actually have arisen in the past years to which it is sought to attribute them. It is possible in the course of a compromise, that some effort might be made to create arrears retrospectively, either by the retrospective use of a power to augment benefits, or by means of a contractual agreement with the members that their pensions should be treated as if they had been increased at some point in the past. The temptation to do this would be especially strong in circumstances in which it was alleged by the members that their benefits should have been augmented in the past, but were not actually augmented at all.

31. Such retrospective "arrears" would generate lump sum payments payable under the compromise. But because there was no entitlement to them during the years in which they were purportedly accrued, it is unlikely that HMRC would be prepared to treat them as attributable to those earlier years. They would therefore probably fall foul of the pension rules and would be unauthorised.

32. If the level of a member's pension was under-calculated at the point at which it came into payment, the member may have been given a maximum figure for his pension commencement lump sum which was too low. The member may want compensation for the shortfall in the tax-free lump sum he would otherwise have claimed. The payment of a lump sum is only authorised if it complies with the lump sum rule (section 164(1)(b)). The lump sum rule is in section 166(1). It requires any lump sum to fall within one of the defined categories of lump sum, of which the only one available is that of the pension commencement lump sum. There is a problem here, because there is an inflexible rule that a pension commencement lump sum must be put into payment no more than 6 months

before, or one 1 year after the member becomes entitled to it (para 1 of Sch 29). There is no obvious way around this requirement, but if it is not observed, the payment will not qualify as authorised by virtue of being a pension commencement lump sum.

The consequences of payments being unauthorised.

33. The tax consequences of making an unauthorised member payment is that the member pays an unauthorised payment charge of 40% of the payment (section 208). The scheme administrator is also liable for a scheme sanction charge (section 239), also at 40%, but credit is given against that for the tax paid by the member. But the scheme sanction charge cannot be less than 15% (section 240). So if the member pays his 40%, the administrator will pay 15%, for a total charge of 55%. There is also the possibility of an unauthorised payment surcharge if the amount or value of the unauthorised payment in a period of twelve months equals or is more than 25% of the total value of the members' entitlements under the scheme. That is unlikely to be triggered in the context of arrears payments.

34. Clearly, in the case of substantial amounts of arrears, the potential tax charges could be significant. Sometimes, however, there may be no avoiding the need to make unauthorised payments. In those circumstances it may be possible to agree a "contract settlement" with HMRC, under which the scheme pays a sum which discharges both the administrators and the members liabilities in respect of the payment. In the context of a compromise, it may also be possible to avoid the tax consequences which attach to unauthorised payments by arranging that the employer should pay those parts of the compromise which are at risk of being unauthorised direct to the members, in which case they will be liable to income tax under PAYE, but will not be unauthorised payments because they do not come out of the assets of the scheme.

***Revenue and Customs Commissioners v Sippchoice Ltd* [2020] 4 WLR 80 [2020] UKUT 149 (TCC)**

Robert Ham QC

Is tax relief available on contributions *in specie* to pension schemes? That was the essential question that the Upper Tribunal (Birss J and Judge Sinfield) had to consider in this appeal from a decision of the First Tier Tribunal (Judge Gething) [2018] UKFTT 122 (TC).

Section 188(1) of the Finance Act 2004 provides that:

> An individual who is an active member of a registered pension scheme is entitled to relief under this section in respect of relievable pension contributions paid during a tax year if the individual is a relevant UK individual for that year

The official view, reflected in the explanatory notes to the Bill that became the 2004 Act, has consistently been that that relief is available only on contributions made in cash. The explanatory notes appear to base that on the use of the word "contributions" but in the Pensions Tax Manual PTM042100 the focus is on the word "paid":

> Tax relief is given on contributions "paid" during a tax year. This means that contributions to a registered pension scheme must be a monetary amount, for example, in cash, cheque, direct debit and bank transfers.

By the time the matter came before the Upper Tribunal the focus had, however, shifted back somewhat, with counsel for the Crown accepting that "paid" is a flexible concept but suggesting that, at least where the direct object of the verb is the thing being paid, the natural meaning of the word "paid" is the payment of money. If someone said, "I paid contributions", the natural inference would (it was argued) be that the person was referring to a payment of money.

It is certainly the case that in order to give relief it is necessary to find an amount, because otherwise the relief could not be quantified. But it does not necessarily follow that the contribution must be paid in cash and it is very questionable whether the use of the word "paid" in and of itself means that only cash is eligible for relief. It is a perfectly natural use of language to refer to a payment in kind, and in one case it was, for example, held in a different context that bonuses were "paid" to directors where they were provided by the company in the form of platinum sponge held in a bank.

However, PTM 024100 goes on to qualify the basic proposition that contributions must be paid in cash:

> it is possible for a member to agree to pay a monetary contribution and then to give effect to the cash contribution by way of a transfer of an asset or assets …
>
> There must be:
>
> - a clear obligation on the member to pay a contribution of a specified monetary sum, say £10,000. This needs to create a recoverable debt.
> - a separate agreement between the scheme trustees and the member to pass an asset to the scheme for consideration.

> If the scheme agrees, the cash contribution debt may be paid by offset against the consideration payable for the asset. This is the scheme effectively agreeing to acquire the asset for its market value.
>
> If the asset's value is lower than the contribution debt the balance will be paid in cash.
>
> If the cash contribution debt is not created, then the transaction is the acquisition of an asset by the scheme and not a contribution.

Relying on this, shares, commercial property and even intellectual property rights have been contributed to pension schemes in many cases and for the first 10 years after the legislation came into effect tax relief was routinely given.

Now, it has to be said that the procedure envisaged by PTM 024100 is artificial, and all the more so in the case of a SIPP where the member is in control of investment. But it is in line with previous authority in other contexts. As the FTT pointed out at [35]

> There is ample judicial authority on what constitutes a contribution paid in the context of contributions to legal entities such as a company and there is no requirement for the company to receive the subscription monies and then buy services with the cash from the subscriber of the shares. Instead the company can issue shares as fully paid and for the contributor's obligation to pay for the shares to be off-set against an obligation of the company to pay the contributor for goods and services. This is a long-established principle. There is no reason why it cannot also apply to contributions to a SIPP.

Support for this at the highest level is to be found in *Ooregum Gold Mining Company of India Limited v Roper* [1892] 1 AC 125, 136 *per* Lord Watson:

> A company is free to contract with an applicant for its shares; and when he pays in cash the … amount or nominal amount of the shares allotted to him, the company may at once return the money in satisfaction of its legal indebtedness for goods supplied or services rendered by him. That circuitous process is not essential. It has been decided that under the [Companies] Act of 1862 shares may be lawfully issued as fully paid up for considerations which the company has agreed to accept as representing in money's worth the nominal value of the shares. I do not think any other decision could have been given in the case of a genuine transaction of that nature where the consideration was the substantial equivalent of full payment of the shares in cash.

In other words, the law does not insist on circuity of action. Why should the same not apply here?

However, in or about 2016 HMRC began to refuse relief for *in specie* contributions to SIPPs. It said it had become concerned that (a) proper processes were not being followed and (b) more exotic assets such as IPRs were being overvalued resulting in costs to the taxpayer. According to press reports, since April 2016 most if not all scheme administrators have had tax relief refused and at least 26 SIPP providers have been affected.

One of the schemes in question was the Sippchoice scheme.

In summary, the facts were that four individuals applied to become members of a SIPP provided by Sippchoice, each signing a form agreeing to be bound by the trust deed and rules of the SIPP and by the contractual terms and conditions agreed between the member and Sippchoice. The rules provided that contributions made by a member could only be paid in money or by a transfer of assets *in specie* in satisfaction of an obligation by the member to pay a monetary amount by way of contribution. Each application was accepted.

At the same time as making the application, the individual completed a document headed "Sippchoice Bespoke SIPP Contribution Form". Section D of that form headed "In-specie contributions" was in the following terms:

PLEASE COMPLETE THE FOLLOWING SECTION ONLY IF YOU WISH TO MAKE AN IN-SPECIE CONTRIBUTION

Declaration to Sippchoice Ltd	I propose to make a net contribution to the SIPP and this notification constitutes an irrevocable and binding obligation to make this contribution.
Proposed net contribution	£68,324 (net)
Agreement	I understand that by signing this declaration I am creating a legally binding and irrevocable obligation to make the specified contribution and that it will not be possible to change my mind even if, for whatever reason, I am unable to proceed with the asset transfer that was originally envisaged.

Sippchoice acknowledged receipt saying that by signing the declaration the member created a legally binding and irrevocable obligation to make the contribution. The individual replied saying the contribution would be made by way of an *in specie* transfer of 760,846 shares in a named company. The reply went on to say

> The contribution being made will be the value of the assets mentioned above. I understand that the value may change and that there are rules that must be adhered to with regards to a change in value.
>
> I agree that if the value decreases, I will pay a monetary amount into the scheme to bring the contribution up to the value quoted in my first letter. I understand that you, in your role as scheme administrator, are legally bound to pursue this payment from me.

A claim for tax relief was refused.

The First Tier Tribunal (Judge Gething) allowed an appeal by the SIPP administrator against a refusal for RAS but the Upper Tribunal in turn allowed an appeal by RAC. It held that, construed in context, the phrase "contributions paid" meant paid in money and did not encompass settlement by transfer of non-monetary assets even if the transfer was made in satisfaction of an earlier obligation to contribute money.

So according to the Upper Tribunal PTM 024100 is wrong: it is <u>not</u> possible for a member to agree to pay a monetary contribution and then to give effect to the cash contribution by way of a transfer of an asset or assets. As the Tribunal put it at [42]:

> An agreement to accept something other than money as performance of an obligation to pay in money does not convert the transfer of shares (or other assets) into a payment in money. It is difficult to see why legislation relating to pension contributions should

> distinguish between and provide different tax treatments for transfers of assets in place of payments made under a contractual obligation and transfers of assets in place of payments made freely at the option of the payer.

It rejected HMRC's argument that PTM did not mean that a transfer of assets could be substituted for monetary payment. But as the Tribunal explained (correctly) statements in HMRC's manuals are merely HMRC's interpretation of the law in their internal guidance and they do not have the force of law. The task of the courts and tribunals is to interpret the legislation in accordance with the ordinary principles of construction described above and if they conclude that the legislation bears a different meaning to that found in the HMRC manual, the legislation must be preferred.

The Tribunal accepted that, read in isolation, "paid" might cover non-monetary payments. But the decisive factor was this would mean that the provisions of section 195 of the 2004 Act about eligible shares made no sense and this informed the way contributions "paid" in section 188 should be read. Section 195 deals with "eligible shares" *i.e.* shares acquired under SAYE option schemes and shares appropriated to individuals under share incentive plans and provide that references to contributions paid are to include contributions made in the form of the transfer by the individual of eligible shares within a permitted period of 90 days. This would make no sense if transfers of shares were already within section 188.

The Upper Tribunal's approach incidentally removed the supposed "valuation problem" identified by HMRC that there was no mechanism for valuing *in specie* contributions in the legislation.

There has been no application for permission to appeal to the Court of Appeal, and it is understood that the reason for that is that there is not enough at stake to justify a further appeal. One would have thought, however, that the criteria for permission to appeal would clearly have been satisfied.

What are the consequences of the decision?

Under section 192 of the 2004 Act basic rate tax is treated as deducted by the member and is recoverable by the scheme administrator from HMRC. Where HMRC has paid the tax treated as deducted to the SIPP administrator it will have to recover it.

But it does not follow from the decision in Sippchoice that the assets contributed *in specie* are returnable to the member. To get them back the member will have to invoke the equitable mistake jurisdiction described in *Pitt v Holt* [2013] UKSC 26, which involves showing not only a causative mistake but also that it is unconscionable for the SIPP to retain the assets transferred in. And there is an argument that to the extent that there is a contractual element it is necessary to go further and establish a fundamental mistake: see *The Great Peace* [2002] EWCA Civ 1407.

Even if the member can get the assets back this may amount to an unauthorised payment as discussed in Jonathan Davey's talk with consequent tax liabilities.

Meanwhile the assets are in the scheme and any returns from them will be free from income tax and capital gains tax. If (say) those assets are shares disposed of at a gain in due course this is attractive. But this may indirectly trigger a lifetime allowance charge, which does not seem to be right in principle where there has been no tax relief going into the scheme.

Coming back to the decision in *Sippchoice* itself on the Upper Tribunal's view of the law this does not arise but the Tribunal's obiter conclusion was there was no contractual obligation to pay £68,324 in money to Sippchoice: on a true analysis of the transaction the member’s promise was to make an *in specie* contribution not a monetary payment.

The question has been asked whether the taxpayer could have relied on a legitimate expectation founded on the statement in the manual. That is a matter for judicial review rather than a tax appeal and there was no application for judicial review, but the authorities show how difficult it is to challenge HMRC on public law grounds. It is necessary to show frustrating a legitimate expectation is “so unfair as to the amount to an abuse of power”. There are few cases which can establish that on the basis of representations made in general material such as HMRC manuals prepared to guide HMRC staff rather than to provide guidance to taxpayers.

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