Pension rights on insolvency

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Abstract Personal insolvency is fairly uncommon, but the legal effects of insolvency on an individual's pension rights are unclear. This paper looks at the difficulties and attempts to identify who owns a bankrupt's pension rights. The author finds that the answer may vary according to the type of pension arrangement.

Keywords: *bankruptcy; bankrupt's estate; protective trusts; public policy; construction of protective trusts; altering protective trusts*

Introduction

Pensions law is notoriously complex. If scheme members go bankrupt, the complexities of insolvency law are added to those of pension law. The government has proposed in the recent Pensions Green Paper that these complexities be simplified, but at present the law works in an arbitrary way. This paper looks at whether pension rights form part of the assets available to creditors, and the extent to which pension arrangements can stop creditors from claiming the pension rights.

The bankrupt's estate

When an individual goes bankrupt, his or her estate automatically vests in the trustee in bankruptcy (s. 306 of the Insolvency Act 1986). The trustee in bankruptcy then manages the estate on behalf of the bankrupt's creditors.

The bankrupt's estate is defined in s. 283 of the Insolvency Act as all

property belonging to or vested in the bankrupt at the commencement of the bankruptcy, except for items for the bankrupt's personal use in his job, and items for the basic domestic needs of the bankrupt and family. In this context, 'property' is defined in s. 436 of the Insolvency Act to include money, goods, things in action, land and every description of property wherever situated and also obligations and every description of interest, whether present or future or vested or contingent, arising out of, or incidental to, property.

This comprehensive list follows closely the definition of property in the Bankruptcy Act 1914. With the new legislation, however, it became more important to explore just what was included, since property acquired after the bankruptcy no longer vested automatically in the trustee in bankruptcy.

Are pension rights included in the

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estate? The answer depends heavily on the type of pension arrangement. Some elements of pension provision are always inalienable from the bankrupt. If the bankrupt was contracted out of SERPS on the GMP basis or the protected rights basis, the element of pension which is referable to that contracted-out status is inalienable (s. 159(5) of the Pension Schemes Act 1993).

There have now also been four first instance decisions which are of relevance to deciding whether pension rights form part of the bankrupt's estate: *Re Landau*,¹ *Performing Rights Society v Rowland*,² *Re Stapleford*,³ and *Kilvert v Flackett*.⁴

Re Landau was the first of these cases, and remains the most important. The case concerned a retirement annuity contract taken out by a solicitor who subsequently went bankrupt. The contract contained an anti-assignment clause, but no protective trust. Perhaps because Mr Landau did not appear on his own behalf and the court heard arguments from an *amicus curiae*, the question as to whether the benefit of the contract formed part of the estate was not argued at length. Ferris J. noted that the words in s. 436 of the Insolvency Act were about as wide as they could be, and categorised the rights under the contract as property within the meaning of the section, since the policy comprised a chose in action. The property existed at the commencement of the bankruptcy, since at that date Mr Landau had a present right to compel future payments, and in support of that interpretation Ferris J. cited the Privy Council decision in *Kwok Chi Leung Karl v Commissioner of Estate Duty*⁵ in which Lord Oliver said: 'A chose in action is no less a chose in action because it is not immediately recoverable by action.'⁶

The decision in *Re Landau* would perhaps be subject to more question if we had not also had the decision in

Performing Rights Society v Rowland, where Robert Walker J. (as he then was) specifically approved *Re Landau* on this point. This case arose out of the bankruptcy of Kevin Rowland, lead singer and songwriter of Dexy's Midnight Runners, and concerned whether the trustee in bankruptcy retained the performing rights after the bankruptcy order was discharged. Following the decision in *Re Landau*, the court held that a present right to future enjoyment could vest in the trustee in bankruptcy as a chose in action. It followed that the performing rights remained the property of the trustee in bankruptcy even after the bankruptcy order had ended. The decision in *Re Landau* is therefore firmly established in English law. It has also been followed in the Scottish case of *Readman, Noter*.⁷

What does this mean for the various different types of pension arrangements? Those pension arrangements set up under contract or insurance policy must, following *Re Landau*, form part of the bankrupt's estate — no distinction can usefully be drawn between retirement annuity contracts and other contractual pension products *for the purposes of the Insolvency Act*. Accordingly, as well as retirement annuity contracts, all contractual pension rights such as personal pension schemes set up under contract (whether individual or group), s. 32 buy-outs, purchased life annuities, Hancock annuities and unfunded unapproved retirement benefits schemes must form part of the bankrupt's estate.

What about pension arrangements set up under trust? As Ferris J. noted, the wording of s. 436 of the Insolvency Act could scarcely be wider. It is hard to see how any category of trust interest is not covered by the words 'every description of interest, whether present or future or vested or contingent, arising out of, or incidental to, property'.

Section 283 of the Insolvency Act defines the estate as 'the property belonging to or vested in the bankrupt'. Contingent trust interests, such as interests in pension schemes, do not vest, and one does not naturally describe a contingent interest as belonging to someone. However, to take such a limited interpretation would ignore the very wide words of s. 436 of the Insolvency Act which could never be given their full meaning if such a restrictive interpretation of s. 283 were taken.

In the case of personal pension schemes in particular, it is most unattractive to draw a distinction between those personal pension schemes set up under trust and those set up under contract. This unattractiveness is still greater when one appreciates that in practice a court would presumably if necessary infer that a trust subsisted in relation to a personal pension scheme set up under contract, on the principles set out in *Barclays Bank v Quistclose*.⁸

In just about every conceivable case involving a pension arrangement set up under trust, there would be a parallel contract with the bankrupt's employer or with a personal pension provider, in which case the trustee in bankruptcy could establish that there was a chose in action of the type noted in *Re Landau*.

For all these reasons, it seems clear that pension arrangements set up under trust form part of the bankrupt's estate. This point has apparently been considered by the courts. In *Re Stapleford*,⁹ the court followed exactly this line of argument. According to the only report available¹⁰ Deputy High Court Judge Michael Crystal QC concluded that the benefits accruing to a bankrupt under three occupational pension schemes were a bundle of rights that together conferred a legal interest in the schemes on the bankrupt. None of the

schemes contained protective trusts and all three were contracted in. This case is of limited value since there is no transcript, but is perhaps an indication that the suggested approach is the correct one.

On that basis, exempt approved retirement benefits schemes, free-standing additional voluntary contribution schemes, funded unapproved retirement benefits schemes and personal pension schemes set up under trust all form part of the bankrupt's estate.

So, do all forms of pension provision form part of the estate? The final case of those listed earlier, *Kilvert v Flackett*, suggests otherwise. Mr Flackett was a dentist who went bankrupt. His pension came into payment before he was discharged from bankruptcy, and the trustee in bankruptcy claimed the lump sum in its entirety under s. 310 of the Insolvency Act. Mr Flackett argued that only a part of the lump sum should be treated as income or that only part should be released to the trustee in bankruptcy. It was conceded by both parties that the lump sum was subject to s. 310. The judge held that the lump sum had the character of income and ordered all of it to be paid to the trustee in bankruptcy.

Section 310 is only concerned with after-acquired property, and property which forms part of the bankrupt's estate is not caught by this section at all: this was one of the points established by *Re Landau*. Any discrepancy between the cases is apparent rather than real. *Kilvert v Flackett* concerned a statutory scheme, the NHS Pension Scheme. One of the statutory terms specifically excluded the benefits accrued under it from vesting in the trustee in bankruptcy's hands on bankruptcy.¹¹ It highlights that statutory schemes can make their own rules, and many do. This is the one category of

pension provision that can fall outside the bankrupt's estate.

There are some loose ends. As Andrew Powell has previously noted,¹² when the s. 32 buy-out was introduced in 1981, the government was quite clear that the trustee in bankruptcy should not be able to access such funds. Since then, insolvency law has changed. There is no longer the same principle of relation back which used to operate, which allowed the trustee in bankruptcy to claim after-acquired assets as if they formed part of the estate, so the point has acquired greater significance.

The government appears to have become less certain. Section 91(3) of the Pensions Act 1995 (which is not in force) would introduce new provisions into the Insolvency Act excluding interests under an occupational pension scheme from the bankrupt's estate. This section will be superseded if the Pensions Green Paper's recommendations are implemented, but the fact that it was thought worthwhile to enact this provision indicates at the very least that the DSS was unsure about the position.

It is noteworthy that s. 159(5) of the Pension Schemes Act 1993 and its predecessor s. 48(3) of the Social Security Pensions Act 1975 specifically reserved the position of the guaranteed minimum pension entitlement. The failure to enact an equivalent provision for other parts of the pension entitlement is suggestive.

Andrew Powell has also highlighted a practical problem. If pension rights form part of the bankrupt's estate, it is difficult to value the member's interest for the trustee in bankruptcy to realise as a capital sum. In fact, this problem is more apparent than real. The trustee in bankruptcy can only take the benefit of the pension scheme in exactly the same way as the member could have done. It will make no difference if the

bankruptcy is discharged before the pension comes into payment — any future payments will still be made to the trustee in bankruptcy, see for example *Performing Rights Society v Rowland*.

Protective trusts

Even if the pension rights would otherwise form part of the bankrupt's estate, it may be possible to set up the pension arrangement so that the member's rights determine on bankruptcy. Such a clause is known as a protective trust. In such cases, the scheme trustees normally have a discretion to continue to apply the sums to or on behalf of the member (s. 92(3) of the Pensions Act makes this a statutory power for trustees of occupational pension schemes), but the bankrupt loses the certainty of benefiting. Whether or not the pension entitlement forms part of the bankrupt's estate, the protective trust will take effect.

Such clauses are also referred to as forfeiture clauses. That expression is also used for the different provisions which may be in place to allow the pension to be reduced to compensate for debts owed to the employer. In this paper, therefore, the expression 'protective trust' is used throughout.

Traditional exempt approved schemes normally have a protective trust, as permitted by the Inland Revenue. The Revenue also allows personal pension schemes to contain a protective trust. Beyond that, protective trusts may or may not be in place.

It is quite common to find arrangements with anti-assignment clauses which do not explicitly refer to transmission on bankruptcy. The courts take a very restrictive interpretation of such clauses and unless the clause refers explicitly or by necessary implication to bankruptcy, it is most unlikely that it will

be construed as taking effect on bankruptcy — the approach taken in *Re Landau* is illustrative of this.

Is the protective trust effective?

The principles relating to protective trusts in private trusts are very well established, as follows.

1. No one can rely on protective trusts created by his own disposition as a means of defeating the claims of his creditors — that would be contrary to public policy.¹³
2. But protective trusts which were not created by the bankrupt's own disposition are different.¹⁴ There is no equivalent public policy interest in preventing third parties from attaching strings to dispositions. If the trust is in fact making payments to the bankrupt, the trustee in bankruptcy can still claim the money received in the bankrupt's hands.

Provisions in a statutory scheme or statutory approval of provisions in non-statutory schemes cannot be contrary to public policy, since Parliament has decreed otherwise.

What does all this mean in the context of pension provision? Once again, it is necessary to look at each type of arrangement in turn.

Members may have taken transfers from arrangements with a valid protective trust into another arrangement. If the first arrangement had a valid protective trust, there is no reason why the assets should not be transferred to another arrangement established by the employee with a protective trust which is valid at least to the extent of those assets, since the member has not put any assets beyond the reach of the creditors.

Arrangements to which only the individual contributes, such as the

retirement annuity contract in *Re Landau*, cannot include a valid protective trust. Any protective trust contained in the arrangement would be created by the bankrupt's own disposition and would therefore be against public policy on the general principles outlined above. The trustee in bankruptcy would gain control of the pension arrangement in its entirety. It should be stressed that the decision in *Re Landau* did not decide this point — there was no protective trust in that contract.

Arrangements to which an employer contributes exclusively might appear not to have been created by the bankrupt's own disposition. On this basis, non-contributory exempt approved retirement benefits schemes, funded unapproved retirement benefits schemes and unfunded unapproved retirement benefits schemes and personal pension schemes to which only the employer contributes could all have valid protective trusts.

In most cases, however, any contributions the employer makes are made in accordance with a contract of employment, and accordingly the pension provision forms part of the employee's deferred pay (as per *Parry v Cleaver*¹⁵ and *Barber v Guardian Royal Exchange*¹⁶). A court would probably conclude that the employer's contributions were made under contract for the employee and were to be treated as the bankrupt's property. Protective trusts would not operate against the trustee in bankruptcy with regard to such contributions.

However, a protective trust operating against a bankrupt who was receiving benefits as a dependant would be effective, since such arrangements would not have been set up by the bankrupt's own disposition.

This leaves one significant category, which is also the most common: arrangements to which both the

employer and the employee contribute. For the reasons given earlier, it is likely that there is no difference between employer and employee contributions for these purposes.¹⁷

It would appear that the protective trust is doomed to failure in almost every case. However, there may be statutory assistance for occupational pension schemes. Section 92(1) of the Pensions Act prohibits forfeiture of entitlements or accrued rights to a pension under an occupational pension scheme, but s. 92(2) specifically excludes forfeiture on bankruptcy from this. This is not as clear as one might wish, since there is no positive approval of protective trusts. However, s. 92(3) specifically envisages that forfeiture on bankruptcy will in fact occur. With a clear statutory expectation that such protective trusts can be effective, they are apparently consistent with public policy and therefore valid. However, since the provision does not specifically approve the use of protective trusts, the point is not free from doubt.

Before 6th April, 1997, s. 78(3)(b) of the Pension Schemes Act 1993 permitted the forfeiture of short-service benefits by reference to bankruptcy in occupational pension schemes. Protective trusts in schemes of that vintage must therefore have been effective until that date. Are those protective trusts still valid even though there is no longer specific statutory authority?

In the New Zealand case of *Aitchison v NZI Life Superannuation Nominees Limited*,¹⁸ a trustee in bankruptcy sought to set aside a protective trust in a personal pension scheme. At the time the personal pension scheme had been set up, protective trusts had specific statutory authorisation, but that legislation was repealed at a later date. The court held that the protective trust was still valid. It

had been set up at a time when it was lawful to do so and the repeal of the legislation did not retrospectively invalidate it. This approach appears logical, and should be followed if a court concludes that a protective trust was not automatically sanctioned by s. 92 of the Pensions Act.

These considerations arise *only* if the scheme is an occupational pension scheme. Identifying occupational pension schemes, however, is not always straightforward. Pre-funded pension provision developed its current forms from the tax reliefs given to pension arrangements. Twenty-five years ago, the Revenue was the only body which monitored pension arrangements. It had (and still has) its own regulatory regime and its own definitions.

The Department of Social Security then decided that pension provision had social implications and set down new legislation for occupational pension schemes. Unfortunately, it did not adopt the Revenue's definitions. Instead it came up with its own definition of an occupational pension scheme. This definition is similar, but not the same as, the Revenue's definition of a retirement benefits scheme.

The definition of occupational pension scheme is found in s. 1 of the Pension Schemes Act 1993:

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

There must be a connection with a

description or category of employment, benefits must be payable on one or more of termination of service, death or retirement and there must be 'qualifying service' (this term is undefined), but otherwise any form of pension provision appears to be caught by this definition. There is no need for the arrangement to have been set up by the employer.

The natural meaning to be given to 'qualifying service' is service performed by employees in the relevant category or categories of employment which entitles them to receive pension provision, and that was the approach adopted by Hart J. in *City of Swansea v Johnson*.¹⁹

Most types of pension provision can be easily categorised into either occupational pension scheme or non-occupational pension scheme. All employers' approved schemes, unapproved schemes and statutory schemes must qualify as occupational pension schemes. Equally clearly, retirement annuity contracts, purchased life annuities and individual personal pension schemes do not.

It is, however, unclear whether a group personal pension scheme is an occupational pension scheme. The categories of personal pension scheme and occupational pension scheme are usually seen as alternatives, and that was Hart J.'s approach in *City of Swansea v Johnson*. But the definition of occupational pension scheme is very broad and does not explicitly exclude all personal pension schemes. The natural meaning of qualifying service would include qualifying service for a group personal pension scheme. When one considers the role of a group personal pension scheme, there are good reasons for concluding that it is an occupational pension scheme.

The s. 32 buy-out and the free-standing additional voluntary contributions scheme both have their

origins as exempt approved retirement benefits schemes, but are very different from conventional schemes of that type. The second of these seems to be a non-occupational pension scheme, despite its tax treatment, because the benefits which it provides are not tied to termination of service with one employer, there is no concept of qualifying service with any one employer and the benefits can be drawn independently of the pension from the employer's occupational pension scheme.

The rights in a s. 32 buy-out are in substitution for those under an occupational pension scheme and the member cannot add to the sums invested. A court may well conclude that the s. 32 buy-out is sufficiently close to the occupational pension scheme rights to constitute an occupational pension scheme itself. This question should not need an answer, since s. 32 buy-outs are most unlikely to contain a protective trust.²⁰

Can a protective trust be invalid on other grounds?

Confusingly, there is an entirely different trust law basis on which a protective trust can be invalidated, which is also sometimes referred to as a matter of public policy (although that is a misnomer). If a protective trust purports to forfeit entitlements which have vested, it is ineffective, since the vested entitlement cannot be taken away.

The recent case of *Re Scientific Investment Pension Plan (No. 2)* or *Kemble v Hicks*²¹ provides a comprehensive study of the case law in this area. Having reviewed the case law, Rattee J. concluded that the position is as follows:

- '(a) A forfeiture clause purporting to forfeit an absolute interest in possession in the event of alienation will be void.

- (b) So will be such a clause which purports similarly to forfeit a life or other limited interest in possession, which is not, on the true construction of the instrument creating it, made determinable in the same events as those in which the forfeiture is expressed to operate.
- (c) On the other hand, there is nothing objectionable about such a forfeiture clause which purports to defeat a future interest in the event of purported alienation before it falls into possession, or to create a gift over in the event in which an income interest in possession is, on the true construction of the trust instrument, expressed to be determinable.'

The wording of the protective trust in question provided that:

'if any Member or other person shall either wholly or partially assign or charge any present or future benefit arising under the Plan or attempt or purport to do so or if any other act shall be done or event shall happen whereby the same if belonging absolutely to the Member or other person would be vested in or payable to or charged in favour of any other individual firm or company the Member or other person shall forfeit all rights whatsoever to such benefit.'

Rattee J. held that the words 'if belonging absolutely to the Member' presupposed that the benefits concerned did not in fact vest absolutely in the member, and so on its true construction the protective trust was an initial qualifier of the member's interest and not an attempt to forfeit an absolute interest. Accordingly, the protective trust was valid. He distinguished *Re Smith*,²² where substantively identical wording had been held ineffective to qualify the bankrupt's trust entitlement under a will, on the basis that that case had been concerned with capital interests which vested on the date of death of the testator, while the

present case concerned pension instalments which could practicably be determined.

While this distinction is sustainable in a multi-member scheme, it is not easy to sustain in a single-member scheme or policy where there are no other potential beneficiaries.

Introducing or amending protective trusts

For new schemes, therefore, there is a model protective trust which can be adopted. Existing schemes with defective protective trusts, however, cannot effectively rectify them in relation to past service rights in any circumstances. This conclusion is reached by applying *Kemble v Hicks*. If members already have an indefeasible right to past service pension rights, then it is impossible for those rights to be taken away from them without their agreement, and any amendment to that effect will be void. If, on the other hand, the members give their agreement, then they will have taken a decisive step to put the pension assets beyond the control of creditors and that agreement will be struck down in accordance with the principles followed in *Re Brewers Settlement*. The members are caught on Morton's fork.

For future service there is no such problem, and subject to any restrictions on the power of amendment, the rules can be altered to introduce or amend the protective trust.

Proposals for the future

In the Pensions Green Paper, the government reveals plans to simplify the whole area of pension rights on insolvency. It proposes that all forms of approved pension provision should be taken outside the remit of the trustee in bankruptcy, but to give the trustee in

bankruptcy the power to apply for the return of excessive contributions. On the other hand, unapproved pension provision would be brought within the bankrupt's estate, and protective trusts would be invalidated.

It remains to be seen if these plans will come to fruition. In the meantime, practitioners must pick their way through the random complexities. Any simplification of this area of the law would be greatly welcomed.

References

- 1 [1997] 3 All ER 322.
- 2 [1997] 3 All ER 336.
- 3 Unreported.
- 4 *The Times*, 3rd August, 1998.
- 5 [1988] STC 728.
- 6 *Ibid.*, p. 732.
- 7 So far unreported.
- 8 [1970] AC 567.
- 9 Unreported, and apparently without a transcript having been taken.
- 10 *Insolvency Intelligence*, 1998, 11, p. 63.
- 11 This point is not apparent from the transcript, and the author is grateful to Ian Greenstreet for drawing it to his attention.
- 12 Handout from a seminar by Andrew Powell,
- delivered to the Association of Pension Lawyers, 15th July, 1998.
- 13 See for example *Re Brewers Settlement* [1986] 2 Ch 503.
- 14 See for example *Lockyer v Savage* 93 ER 959.
- 15 [1970] AC 1.
- 16 [1990] ICR 616.
- 17 If employer contributions are not to be treated as employee contributions for this purpose, *Mackintosh v Pogose* [1985] 1 Ch 505 suggests that the protective trust would be partially valid. This case concerned a post-nuptial settlement to which both the husband and wife contributed assets, under which the husband was granted a life interest, containing a protective trust on bankruptcy. The husband went bankrupt, and the trustee in bankruptcy sought to set aside the protective trust. The court held (without detailed consideration of the matter) that the protective trust was valid so far as it related to the property contributed by the wife. By analogy, money contributed by any party other than the employee can be property protected by a protective trust.
- 18 [1995] PLR 7.
- 19 Unreported.
- 20 On 1st July, 1994, s. 32 buy-outs were taken out of the regime for exempt approved retirement benefits schemes. It should, however, make no difference when the policy was written in relation to the question whether s. 32 buy-outs are occupational pensions schemes.
- 21 A so-far unreported English decision following *Ramsay v Caboché* 119 ALR 215 (an Australian decision).
- 22 [1916] 1 Ch 369.