A review of the law concerning forfeiture and liens

Received: 13th December, 1999

Ian Forrest

is a Partner in and Head of National Pensions Law Department of edge ellison, solicitors, and is the author of a number of articles and papers on Pension Law matters. He is actively involved in the activities of the Association of Pension Lawyers and is a member of its education and seminars committee.

Abstract With the arrival of the Welfare Reform and Pensions Act 1999 (the Act) on the statute book last November, it is timely to review the general law on the forfeiture of and liens over entitlements and accrued rights under occupational pension schemes. The Act, among other things, puts a member's pension rights under a pension arrangement beyond his trustee in bankruptcy in certain circumstances. The provisions of the Act are already wide-ranging in this respect, although there are still sets of regulations to be introduced before the Act finally becomes law in April 2001.

The provisions of the Act should complete the cordon of protection against the alienation of entitlements and rights under an 'approved pension arrangement' in contrast to what is currently a complex maze of riddles.

This paper will:

- review the general law concerning the alienation of pension rights
- describe the provisions of the Act which deal with bankruptcy
- examine the law on liens
- see where these leave us.

Keywords: *forfeiture of benefits on bankruptcy; statutory protection; personal pension schemes; excessive pension contributions; pension-sharing and divorce*

The general law against alienation

Section 91 of the Pensions Act 1995 (the Pensions Act) encapsulates the general rule against the alienation of entitlement and accrued rights¹ to benefits under an occupational pension scheme. This begs the question, why can an individual not do what he wants to do with his pension rights? Pension rights, especially in divorce cases, are invariably described as an individual's most valuable asset after the family home. However, they are not, and never have been treated as, a

property right in the conventional sense.²

Public policy has dictated that pension rights should be protected by the prohibition of dealings with them, except in certain circumstances, because they are established to provide income for members and their families on retirement and death. This goes beyond simply protecting the feckless from themselves. Governments of every hue have endorsed this policy, particularly as a minimum of one third of the accrued pension rights in an occupational pension

Ian Forrest
(edge ellison, Rutland House, 148 Edmund Street, Birmingham BR3 2JR, UK.
Tel: 0121 200 2001;
Fax: 0121 200 1991)

scheme are funded by tax relief. The present government is, of course, committed to a reduction on dependency upon state benefits, and private pensions provision is a mainstay of this policy.

There is also an economic reason. The company which establishes an occupational pension scheme, and the trustees who administer it, would not wish to fund benefits and then to have them paid to a pensioner, if the pensioner gets nothing from them. There is judicial authority for such a view in a Scottish case³ concerning pension benefits due from a millworker's pension scheme and the withholding of payment to a pensioner living in Copenhagen during World War II under the Trading with the Enemy Act 1939. Lord Cooper interpreted a forfeiture clause in the governing provisions of the scheme as the trustees stating to a beneficiary that '... this money is for your beneficial enjoyment. If the beneficial enjoyment is not to be yours, then we shall pay nothing more'. He endorsed that interpretation as a valid reason for pension benefits being forfeited.

So there is an established general principle against alienation that companies do not set up pension schemes for the benefit of members' creditors, nor is tax relief given for that purpose. However, this is a principle with exceptions to it.

The Goode Committee⁴

The Goode Committee addressed the question of whether the law provides adequate safeguards against the forfeiture of the pension rights of a member and his or her spouse.⁵

The Goode Committee confirmed that pension rights cannot be treated as a disposable asset by the member and that they cannot be alienated.⁶ It recommended that, as a matter of

consistency, pension rights should not be treated as an asset of the member in bankruptcy and that provisions should be allowed in scheme documents to terminate the member's future pension rights on his or her bankruptcy and, when the pension is due to come into payment, to make payments to the member's spouse or dependants.⁷

The Goode Committee created a strong line of argument that as it is against public policy to alienate pension rights, as a consequence pension rights are not a disposable asset and, therefore, those rights should not be treated as such when an individual becomes bankrupt.

These recommendations were accepted and included in the provisions of the Pensions Act, establishing the general principle of the inalienability of rights under an occupational pension scheme. However, the provisions dealing with bankruptcy, under Sections 91(3) and 95 of the Pensions Act have not been enacted.

The general principle

The general principle of inalienability is set out in Section 91 of the Pensions Act and states that entitlements or accrued rights to a pension under an occupational pension scheme:

- cannot be assigned, commuted or surrendered
- cannot be charged or a lien exercised over them
- cannot have a right of set off exercised against them.

Subject to certain exceptions, Section 91(1) of the Pensions Act provides that any agreement to do any of these things is unenforceable so, for example, any verbal agreement or loan documentation would be void.

'Inland Revenue' Exceptions

Section 91(5) of the Pensions Act contains exceptions which are familiar from the Inland Revenue Practice Notes. These are that assignment, commutation or surrender is permissible, if the beneficiary agrees, in order to:

- provide a pension for the beneficiary's spouse or dependants; or
- acquire an entitlement to further benefits under the scheme, for example in order to obtain an escalating pension; or
- commute in order to obtain a tax-free lump sum on retirement or in exceptional circumstances of serious ill health.

There is nothing unfamiliar or contentious about these exceptions. They are consistent with the premise that benefits under a pension scheme are accrued in order to provide for a member and his or her spouse and dependants.

'Statutory' exceptions

The general principle against alienation does not prevent the Court making:

- an order under the Attachment of Earnings Act 1971⁸
- an income payments order under the Insolvency Act 1986⁹
- an order under Section 23 of the Matrimonial Causes Act 1973.¹⁰

The first two appear to be at odds with the general principle against alienation, but are distinguishable as being orders against income from the pension scheme rather than against entitlements or accrued rights under it.

This is the essential position with regard to forfeiture at the moment. Liens will be dealt with later.

The Welfare Reform and Pensions Act 1999 (The 'Act')

The Act will become law on 1st April, 2001. The Act is an extremely comprehensive piece of legislation which, apart from pensions and bankruptcy, deals with stakeholder pensions, pension-sharing on divorce and social security benefits.

It must be made clear from the outset that the Act does not extend the general principle of forfeiture to members on their bankruptcy, but provides that pension schemes will no longer be able to forfeit pension rights on a member's bankruptcy.¹¹ As a consequence, Sections 91(3), 92(2)(b), 94(3)(c) and (e) and 95 of the Pensions Act are repealed under the Act¹² and a new Section 159A is introduced to the Pension Schemes Act 1993.

Essentially the Act brings into force the recommendations of the Goode Committee that pension rights (as opposed to pension payments) should not be counted as an asset in bankruptcy. Section 91(3) of the Pensions Act covered only entitlements or accrued rights under an occupational pension scheme. The Act extends that provision on bankruptcy by statutory protection of pension rights in 'approved pension arrangements'.¹³

The provisions dealing with pensions and bankruptcy are contained in Sections 11–16 (inclusive) of the Act, although Sections 13 and 16 simply introduce the provisions into Scottish law, and paragraph 69 of Schedule 12 to the Act. They deal with:

- Section 11: approved pension arrangements
- Section 12: unapproved pension arrangements
- Section 14: introduces a new Section 159A of the Pension Schemes Act 1993 and confirms that rights under a

personal pension scheme are not forfeited on bankruptcy

- Section 15: excessive pension contributions
- paragraph 69 of Schedule 12: excessive pension contributions in pension-sharing cases.

The term ‘approved pension arrangement’ is defined widely under the Act and incorporates the following:

- an exempt approved occupational pension scheme
- a retirement benefit scheme which is being considered for tax exempt approval
- a ‘Statutory Scheme’¹⁴ which is a retirement benefit scheme¹⁵
- a retirement benefit scheme set up by a government outside the United Kingdom for the benefit, or primarily for the benefit, of its employees
- retirement annuities¹⁶
- a personal pension scheme approved¹⁷ under Chapter iv of Part xiv of the Income and Corporation Taxes Act 1988
- an annuity purchased for the purpose of giving effect to rights under an exempt approved occupational pension scheme, a relevant Statutory Scheme, a scheme set up by a government outside the UK and a personal pension scheme
- any other pension arrangement of any description which may be prescribed by regulations made by the Secretary of State — this is a catchall provision.

Section 11(1) of the Act states that when a bankruptcy order is made against a person, any rights of his under an approved pension arrangement do not become an asset in bankruptcy. This is an absolute provision.

There are exceptions contained in

Section 11. Sections 11(4) and (5) of the Act provide for circumstances:

- where a person has pension rights under an occupational pension scheme
- for which an application for exempt approval has been made to the Inland Revenue
- but where no decision has yet been reached.

If exempt approval is still being sought on the date that a bankruptcy order is made against a person and the Inland Revenue subsequently decides not to grant it the bankrupt’s pension rights in the scheme vest in the trustee in bankruptcy, subject to regulations made under Section 12 of the Act.

Similarly, there are exceptions under Sections 11(6) to (8) of the Act:

- where the Inland Revenue issues notice withdrawing either tax exempt approval from an occupational pension scheme or approval from a personal pension scheme
- after a bankruptcy order is made
- but the effective date for the withdrawal of approval is before the date of the bankruptcy order itself
- then any rights which the bankrupt has in the pension scheme will vest in the trustee in bankruptcy
- again subject to regulations made under Section 12 of the Act.

The reason why these exceptions in Sections 11(4) and (5) and in Sections 11(6) to (8) are subject to Section 12 of the Act is that, as already mentioned, Section 12 deals with unapproved pension arrangements and, of course, when approval is withdrawn from an approved pension arrangement, it becomes an unapproved pension arrangement.

As a consequence, all is not lost to the

bankrupt by withdrawal of approval because Section 12 of the Act sets another hurdle for the trustee in bankruptcy to clear before the bankrupt's pension rights can be deemed to have become part of his estate.

Unapproved pension arrangements

Regulations made under Section 12 of the Act will enable the rights of a member of an unapproved pension arrangement to be protected in the same way as a member's rights under an approved pension arrangement are protected by Section 11 of the Act, but only in prescribed circumstances. The definition of an 'unapproved pension arrangement' will be set out in regulations to the Act; it will not simply be any arrangement not covered by the definition of 'approved pension arrangement'.

The intention of Section 12 is to cover the circumstances where the other income, whether or not pension benefits, which the bankrupt will receive is inadequate to meet his reasonable needs and those of his dependants.

Broadly under Section 12 regulations will provide:

- that a member's rights under an unapproved pension arrangement may be excluded from his estate by Court order or under the terms of a qualifying agreement made between the bankrupt and his trustee in bankruptcy; and
- the scope of a 'qualifying agreement',¹⁸ the circumstances in which it applies and the requirements attaching to it.

The Court's decision will be made on the basis of a means test, taking account of each bankrupt's individual

circumstances and those of his family and how much their needs are met by other sources of income.

Forfeiture has not been extended to cover a member's bankruptcy in order to avoid giving an unfair advantage to those with unapproved arrangements. Benefits cannot be forfeited under an arrangement approved under the Act, and so the use of unapproved arrangements as a safe haven for the bankrupt's assets has been proscribed.

That is all very well but, by distinguishing between approved and unapproved arrangements, the Act fails to address two fundamental issues. First, it does not prevent funds being sent offshore beyond the reach of the trustee in bankruptcy. Secondly, and perhaps more importantly, it fails to take account of why an individual puts money into an unapproved pension arrangement, simply because his circumstances are such that he is subject to the Inland Revenue salary cap. This reduces the protection of pension rights in bankruptcy to a lottery; if the bankrupt is a member of an approved pension arrangement, his benefits are absolutely safe; if not, he has no guarantee.

Excessive pension contributions made by a bankrupt

Section 15 of the Act and paragraph 69 of Schedule 12 to it give the trustee in bankruptcy the power to recover excessive contributions.

Section 15 of the Act amends the Insolvency Act 1986 by replacing Sections 342A to 342C (as Section 95 of the Pensions Act would have done, if it had been brought into force). Paragraph 69 of Schedule 12 deals with pension-sharing on divorce and bankruptcy and adds new Sections 342D, E and F to the Insolvency Act 1986.

If, on a member's bankruptcy, the

trustee in bankruptcy believes that excessive contributions have been made to either an approved pension arrangement or an unapproved pension arrangement, he can apply to the Court for an order to recover those excessive contributions.¹⁹

The burden of proof is upon the trustee in bankruptcy. He must satisfy the Court that the member's rights under the arrangement are to an extent derived from the excessive contributions and that the excessive contributions have 'unfairly prejudiced the individual's creditors'.²⁰

The Court must consider:

- whether the contributions were made to the arrangement in order to put assets beyond the reach of the individual's creditors
- whether the value of the contributions was excessive in the bankrupt's circumstances when those contributions were made.²¹

If the Court is satisfied that excessive contributions have been made, it 'may make such order as it thinks fit for restoring the position to what it would have been, had the excessive contributions not been made'.²²

The order may:

- require the arrangement to pay an amount to the trustee in bankruptcy
- reduce the benefits payable from the arrangement to the individual and the benefits to which his spouse and dependants may be entitled
- require the costs of the pension arrangement supplying information for the purposes of the Court case to be met.²³

If the trustee in bankruptcy has made his application and the Court is satisfied with the test that excessive contributions have unfairly prejudiced creditors, how is

the amount to be paid by the pension arrangement to be calculated?

The Act makes it clear that the repayment will be the lesser of:

- the amount of the excessive contributions
- the current value of the bankrupt's pension rights under the arrangement;²⁴ regulations will determine how 'value' is calculated.²⁵

Consequently, the bankrupt may still gain by having made excessive contributions and obtaining the benefit of investment returns on them.

On those rare occasions where the value of the contributions exceeds the value of the pension rights, it is expected that the amount recovered will be restricted to the cash equivalent transfer value. This will be one of the provisions set out in regulations to be drafted between the time of writing and 1st April, 2001.

Trustees of occupational pension schemes and insurance companies have, of course, a difficulty in reducing the value of pension rights. This is recognised in the Act which provides that the order, made for the arrangement to pay an amount to the trustee in bankruptcy, must also provide for a corresponding reduction in the bankrupt's rights under the arrangement.²⁶

Pension-sharing and bankruptcy

As already mentioned, the Act will bring into force the new pension-sharing provisions.²⁷ It is dealt with here in the context of an individual who becomes bankrupt after his divorce and after pension-sharing has been arranged.

Subject to certain time limits, financial settlements in divorce can be unscrambled if the settlement is found by a Court to have been transacted at an

undervalue or as a preference. In this regard 'undervalue' refers to an asset transferred for less than full value and 'preference' means an asset given to one creditor in preference to another.

Consequently, each deprives creditors of funds which otherwise would have been theirs.

Paragraph 69 of Schedule 12 to the Act introduces new Sections 342D, E and F to the Insolvency Act 1986 under which if, after a couple divorce and share the pension, he then becomes bankrupt and a Court has ruled that his pension rights are based on excessive contributions, the pension share awarded to his former spouse, or a part of it, may be available to his trustee in bankruptcy.

The agreement or order for pension-sharing can only be unscrambled if:

- the Court is satisfied that the order or agreement was made at an undervalue or amounted to a preference²⁸
- the pension rights of the bankrupt at the time of the pension-sharing were attributable to excessive contributions²⁹
- even after recovery of the bankrupt's full pension share, excessive contributions are outstanding³⁰
- the transfer to the former spouse could not have been made from other than excessive contributions.³¹

So, if a Court order is made against the transferee's benefits, what may be paid?

The new provisions are unclear on this and simply state that, subject to regulations making provisions about the calculation and verification of the payment,³² the maximum amount payable from the transferee's arrangement will be the lesser of:

- the amount which represents excessive contributions
- the value of the transferee's rights

derived directly or indirectly from the pension-sharing transaction; again, regulations will set out how 'value' will be calculated.³³

At this stage the regulations are unwritten. However, we can expect means-tested factors to be taken into consideration in making a calculation because, to do otherwise, could leave an ex-spouse and children in financial difficulties through no fault of their own.

Where the trustee in bankruptcy is successful in retrieving excessive contributions from an approved pension arrangement, the Inland Revenue is entitled to levy a tax charge upon those recovered contributions. It is understood, however, that the Inland Revenue is unlikely to levy such a charge in practice because it is felt that the cases of recovery of excessive contributions will be so rare as not to warrant the expense of establishing a system to deal with them.

Liens

The general principle set out in Section 91(1)(b) of the Pensions Act has already been mentioned. It provides that, subject to exceptions, an entitlement or an accrued right under an occupational pension scheme cannot be charged or a lien exercised in respect of it.

The exceptions to this are set out in Section 91(5)(e) of the Pensions Act. They allow:

- a charge, lien or set-off to be exercised against a person's entitlement or accrued right to benefits so that his employer can recover a debt arising from a criminal, negligent or fraudulent act or omission of that person; or
- a pension scheme to recover a loss caused by a trustee's breach of trust.³⁴

No charge, lien or set-off may be made against transfer credits³⁵ unless those transfer credits are attributable to employment with the same employer or an associated employer and the benefits deriving from them could have been charged or a lien or set-off exercised against them under the occupational pension scheme from which the transfer was made.³⁶

So far so good, but if there is no lien clause already in the governing provisions of the scheme, Section 67 of the Pensions Act (restrictions on powers to alter schemes) can be interpreted as preventing the introduction of such a clause.

This difficulty has been resolved by new Regulations³⁷ which extend the provisions of regulation 6 of the 1996 Modification Regulations³⁸ under which the governing provisions of a pension scheme may now be amended by the introduction of a charging, set-off and lien clause without a Section 67 Certificate having to be given.

Where does this leave us?

The new legislation is all very well, but it does leave a potential mish-mash of provisions applying on bankruptcies over the next few years. The general principle against alienation will endure and it is not anticipated that any amendment will be made to the exceptions contained in Section 91 of the Pensions Act. Subject to the Act and the regulations to it coming into force on 1st April, 2001, where an individual becomes bankrupt after 31st March, 2001 and has benefits in an 'approved pension arrangement', those benefits can no longer be forfeited but they will not become an asset in bankruptcy.

Consequently, confusion about the status of forfeiture clauses in occupational pension schemes still abounds for those

members who become bankrupt before 1st April, 2001. The uncertainty created by the decisions in *Caboche v. Ramsey*³⁹ and re: Landau (although part of the judgment will be reviewed by the Court of Appeal when it considers *Lesser v. Lawrence* (Trustee in Bankruptcy))⁴⁰ still prevail. At the moment the only certainty is that the test set by Rattee J., in *Kemble v. Hicks*⁴¹ still applies and that is to determine whether the benefits are absolute or are determinable or defeasible under the terms of the trust.

In the meantime, if an occupational pension scheme has no forfeiture clause and trustees have been concerned about whether or not one can be introduced without breaching the provisions of Section 67 of the Pensions Act 1995, help is now at hand under the new Modification Regulations⁴² mentioned above with regard to lien clauses.

As already noted, these Regulations extend the provisions of regulation 6 of the 1996 Modification Regulations.⁴³ These do this by introducing four new exemptions from the restrictions to modify occupational pension schemes. In each case, these are where Section 67 appears to act in direct conflict with certain other provisions of the Pensions Act or against Inland Revenue practice.

These four new exceptions are:

- forfeiture on grounds of bankruptcy and the introduction of a lien clause
- introduction of a bulk transfer clause
- changing the method of re-valuing earning factors
- Inland Revenue requirements to take account of tax changes which require amendments in order to retain tax exempt approval.

Under amended regulation 6 of the Modification Regulations,⁴⁴ an amendment introducing a forfeiture clause on bankruptcy will not require a

Section 67 Certificate. However, this is not the end of the matter because that clause, if introduced, will still have to be drafted properly to be effective in order to meet the test in *Kemble v. Hicks*.⁴⁵

In the meantime we can only hope that, where the Courts are asked to deal with cases like *Caboche v. Ramsey* and re Landau, they are influenced by looking at the provisions of the Act and the intentions and purposes behind it.

References

- 1 'accrued rights' — the rights which have accrued to or in respect of a member of an occupational pension scheme for future benefits under the scheme determined as if he had opted to terminate pensionable service at the rate of calculation: section 124(2)(a) of the Pensions Act 1995.
- 2 Pensions Law and Practice — Robin Ellison at 20.002.
- 3 *Textile Pensions Trust Ltd v. Custodian of Enemy Property* (Scotland) (1947) SLT 323 at page 326.
- 4 Report of the Pension Law Reform Committee (HMSO 1993).
- 5 Ibid 4.14.18.
- 6 Ibid 4.14.20.
- 7 Ibid 4.14.21.
- 8 Ibid Section 91 (4)(a).
- 9 Ibid Section 91 (4)(b).
- 10 Ibid Section 166(5)(b).
- 11 Section 14 of the Welfare Reform and Pensions Act 1999.
- 12 Ibid Schedule 13.
- 13 Ibid Section 11(2).
- 14 As defined in Section 612(1) of the Income and Corporation Taxes Act 1988.
- 15 Ibid Section 590.
- 16 Ibid Chapter iii of Part xiv.
- 17 Ibid Section 630.
- 18 Section 12(3) of the Welfare Reform and Pensions Act 1999.
- 19 Section 342A(1) of the Insolvency Act 1986 as amended by Section 15 of the Welfare Reform and Pensions Act 1999.
- 20 Ibid Section 342A(2).
- 21 Ibid Section 342A(6).
- 22 Ibid Section 342A(2).
- 23 Ibid Section 342B(1).
- 24 Ibid Section 342B(4).
- 25 Ibid Section 342C(4).
- 26 Ibid Sections 342B(5) and (6).
- 27 Sections 24–48 of the Welfare Reform and Pensions Act 1999.
- 28 Sections 342D(1) and (2) of the Insolvency Act 1986 as inserted by paragraph 69 of Schedule 12 to the Welfare Reform and Pensions Act 1999.
- 29 Ibid Section 342D(4).
- 30 Ibid Section 342D(6).
- 31 Ibid Section 342D(7).
- 32 Ibid Section 342F(6).
- 33 Ibid Section 342F(6).
- 34 Section 91(5)(e) of the Pensions Act 1995.
- 35 Ibid Section 91(5)(d).
- 36 Regulation 3 of the Occupational Pension Schemes (Assignment, Forfeiture, Bankruptcy, etc). Regulations 1997 SI 1997/785.
- 37 The Personal and Occupational Pension Schemes (Miscellaneous Amendments) Regulations SI 1999/3198.
- 38 The Occupational Pension Schemes (Modification of Schemes) Regulations SI 1996/2517.
- 39 *Caboche v. Ramsey* (1992) 25 ATR 61.
- 40 Re: Ivan Aubrey Landau (A Bankrupt) (1997) PLR 25.
- 41 Re: the Trusts of the Scientific Investment Pension Plan, *Kemble v. Hicks* (1998) 3 All ER 154.
- 42 The Personal and Occupational Pension Schemes (Miscellaneous Amendments) Regulations SI 1999/3198.
- 43 The Occupational Pension Schemes (Modification of Schemes) Regulations SI 1996/2517.
- 44 Ibid.
- 45 In this respect please see 'Indemnities, exonerations, liens and bankruptcy — some drafting points?' by David Pollard, *British Pension Lawyer* No 78, October 1998.