Financial institutions
Energy
Infrastructure, mining and commodities
Transport
Technology and innovation
Life sciences and healthcare

NORTON ROSE FULBRIGHT

Pensions

Bankruptcy and pensions

Briefing

August 2016

Summary

In our June 2016 update, we reported on recent conflicting High Court decisions relating to pensions and bankruptcy. In this briefing we examine in detail the current legal position on whether a bankrupt member's undrawn pension benefits can be the subject to an Income Payments Order (IPO) under section 310 of the Insolvency Act 1986 (IA 1986) and thus be available to the trustee in bankruptcy (TIB) to meet the member's liabilities to creditors.

Background

When an individual becomes bankrupt and a TIB is appointed, all assets to which the individual is beneficially entitled vest automatically in the TIB, as the bankruptcy estate. The TIB's function is to realise the value of the assets in the bankruptcy estate and to effect distribution to the bankrupt's creditors in settlement of his debts. If an individual's pension is in payment at any point between the date of the bankruptcy order and its discharge, it may be brought within the bankrupt's estate if the TIB applies to the court for an IPO from the Court. The IPO could compel the bankrupt to pay some or all of that income to the TIB for inclusion in the bankruptcy estate.

The extent to which an individual's pension benefit can be accessed by the TIB is dependent on

- The type of pension scheme (registered with HMRC, or unregistered)
- Whether excessive pension contributions have been made
- Whether the pension is in payment, or is a deferred or postponed pension.

Unregistered pension scheme treatment

A bankrupt's pension benefits held under an unregistered pension scheme will automatically vest in the TIB and can be used by the TIB to pay the individual's creditors. However, if the unregistered scheme is the individual's sole or main pension scheme, he can apply to the Court for it to be excluded. The Court will make an order to allow such exclusion only if it considers that the needs of the individual and the individual's family are not adequately met from other pension arrangements.

Excessive contributions to a registered scheme

A TIB can apply to the Court where excessive contributions have been made to a registered pension scheme, under section 342A(1) of the IA 1986 and section 15 of the Welfare Reform and Pensions Act 1999 (the WRPA 1999). In order to grant such an order, the Court needs to be satisfied that excessive contributions have unfairly prejudiced creditors under section 342A(1)(b) of the IA 1986. The Court will consider whether the purpose of excessive contributions was to attempt to put assets beyond the reach of the bankrupt's creditors.

Pension in payment, deferment or postponement

As noted above, the TIB can apply for an IPO in respect of income the bankrupt is receiving during the bankruptcy process. This includes any pension payments the bankrupt may be receiving. There has been uncertainty as to whether a deferred or postponed pension can be the subject of an IPO and this question lay at the heart of the recent conflicting High Court cases of *Raithatha v Williamson* [2012] (Raithatha), *Horton v Henry* [2014] (Horton) and *Hinton v Wotherspoon* [2016] (Hinton).

The conflicting case law

Raithatha

In *Raithatha*, the High Court ruled that an IPO could be made not just where the bankrupt was in actual receipt of the pension income, but also where the bankrupt had an entitlement to elect to draw the pension but had not exercised that option at the time of the application.

Before *Raithatha*, pension benefits which were not in payment were generally regarded as protected from creditors as, under the WRPA, a bankrupt's rights under a registered arrangement do not vest in the TIB. However, the Court held that as the bankrupt had reached the scheme's minimum pension age, although he continued to work, the pension could be considered as income and therefore form part of his bankruptcy estate and thus be available to repay creditors. The Court considered that as a matter of policy, an undrawn pension could be the subject of an IPO, as otherwise it would be difficult to justify creating two categories of pension payment, one of which would be exempt if the bankrupt did not elect to receive it. As this election is a factor wholly within the control of the bankrupt, it could be used as a means of avoiding paying creditors.

The decision resulted in a successful application by the TIB for a Court order compelling the bankrupt to elect to draw his previously undrawn pension and then to apply that income towards satisfying his bankruptcy creditors.

As a result of the decision in R*aithatha*, it appeared that undrawn pension scheme benefits were no longer safeguarded from a bankrupt's TIB and creditors. The *Raithatha* judgment was a warning to all individuals with substantial pension pots, which had, until then, been considered beyond the reach of the TIB. A bankrupt who reached the scheme's minimum pension age, even when he was still employed and working, with no intention of taking his pension, could be forced to access pension savings to pay off creditors where he was entitled to draw benefits but chose not to. Leave to appeal the High Court decision was granted, but the appeal was not progressed as the parties reached a confidential settlement. The full potential impact of the decision therefore remained unclear and it was unsurprising that only two years later, another case came before the High Court on the same issue, on which a different decision was reached.

Horton

In *Horton*, the bankrupt had four personal pension policies, all of which fell outside the bankruptcy estate because, although they were not held under an occupational pension scheme, they were held under a registered arrangement. As in *Raithatha*, the bankrupt was not in actual receipt of pension benefits from the registered scheme, but was entitled to draw his pension and had not chosen to exercise that option. During the bankruptcy, the TIB applied for an IPO seeking a share of lump sum payments and income from the pensions.

The bankrupt opposed the application and largely relied on the arguments advanced by the bankrupt in *Raithatha* that he was not entitled to a "payment in the nature of income" until he had elected to draw it. He claimed that he had a right only to make an election to receive the pension and that his right to make an election was excluded from his bankruptcy estate and that the Court had no power to compel him to exercise that right.

The Court held that the bankrupt's undrawn pensions could *not* be the subject of an IPO. Although the circumstances of the *Horton* application were acknowledged by the Court to be indistinguishable from *Raithatha*, it was held that *Raithatha* was wrongly decided and the Court declined to follow that decision. The Court noted that in order for the bankrupt to receive the pension income, he would have to make a number of decisions and elections. Unless and until these were made, the pension rights were uncrystallised and uncertain in value. The Court also considered that the bankrupt was not "entitled" to payments, as "entitled" suggested a reference to pensions in payment of definitive amounts that had become contractually payable, and the TIB had no right to make such elections or decisions relating to the pension as it was not part of the bankrupt's estate.

Hinton

Hinton involved a bankrupt's pension benefits under a Self-Invested Personal Pension Scheme (SIPP) which fell outside the bankruptcy estate. Again, although the SIPP benefits were not part of a occupational pension scheme, they were held under a registered arrangement. The Court in this case (in which it did make an IPO), considered the point at which a bankrupt would become entitled to pension income. The judge noted that if the bankrupt had made an election to enter drawdown but had neither actually withdrawn a lump sum, purchased an annuity, nor started to receive an income from the fund, the entitlement to income had not arisen and thus no IPO could be made. It was possible, for example, for a pension fund to be subject to an election to drawdown, without any instructions as to payment (or annuity purchase) having been given. Only once such instructions had been made was there an entitlement which could found the basis of an IPO. However, whilst helpful, the Court's comments on this aspect of the case were obiter, as the bankrupt had actually made his election and had started to receive specific and quantified payments from his SIPP.

Conclusion

As a result of the Budget 2014, and the pension flexibilities introduced from April 6, 2015, an individual with defined contribution pension savings is able to access his fund in full once he reaches age 55, provided this is permitted under the scheme rules. The impact of the new flexibilities is that for such defined contribution schemes, there will no longer be a distinction between the member's pension and lump sums (the latter also qualifying as "income"). This means even a relatively small pension fund will be an attractive target for an IPO, if *Raithatha* is followed, and the bankrupt has to make such an election.

As noted, various elections and decisions still need to be made by the bankrupt before a pension benefit crystallises. The position for occupational pension schemes is further complicated as the lump sums on commencement may be subject not only to elections and decisions by the bankrupt, but also to the discretion of the scheme's trustees. However, for a defined benefit scheme, if the decision in *Raithatha* is followed in any Court of Appeal case, this may extend even to requiring the bankrupt member to transfer their benefits out to a defined contribution scheme.

Accordingly, the decision in *Raithatha* is considered by many to be at odds with the legislative aim of protecting the benefits held in registered pension schemes from a bankrupt's estate. In addition, it is both inconsistent with the Insolvency Service guidance, and is contrary to the subsequent decisions in both *Horton* and *Hinton*. Unfortunately, all three cases were decided in the High Court, so no real precedent has been set, and a Court of Appeal case to provide such certainty is awaited.

However, despite the cases of *Horton* and *Hinton* and the criticism of *Raithatha*, the financial benefit to creditors of a successful IPO claim could make an application by a TIB, and potential pursuit of the bankrupt to the Court of Appeal, a worthwhile prospect. It is therefore to be hoped that such an appeal will be made sooner rather than later, so that clarity on this issue will be available.

Contacts

If you would like further information please contact:

Peter Ford
Partner, London
Tel +44 20 7444 2711
peter.ford@nortonrosefulbright.com

Lesley Browning
Partner, London
Tel +44 20 7444 2448
lesley.browning@nortonrosefulbright.com

Norton Rose Fulbright

Norton Rose Fulbright is a global law firm. We provide the world's preeminent corporations and financial institutions with a full business law service. We have 3800 lawyers and other legal staff based in more than 50 cities across Europe, the United States, Canada, Latin America, Asia, Australia, Africa, the Middle East and Central Asia.

Recognized for our industry focus, we are strong across all the key industry sectors: financial institutions; energy; infrastructure, mining and commodities; transport; technology and innovation; and life sciences and healthcare.

Wherever we are, we operate in accordance with our global business principles of quality, unity and integrity. We aim to provide the highest possible standard of legal service in each of our offices and to maintain that level of quality at every point of contact.

Norton Rose Fulbright US LLP, Norton Rose Fulbright LLP, Norton Rose Fulbright Australia, Norton Rose Fulbright Canada LLP and Norton Rose Fulbright South Africa Inc are separate legal entities and all of them are members of Norton Rose Fulbright Verein, a Swiss verein. Norton Rose Fulbright Verein helps coordinate the activities of the members but does not itself provide legal services to clients.