Axminster Ruling (*Punter Southall Governance Services v Hazlett*)

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What's important about the Axminster case?

It sheds new light on how to deal with historic underpayments in defined benefit (DB) occupational pension schemes. Some of the ruling clarifies and confirms what we learned from the *Lloyds* case in 2018, which was decided by the same Judge. The received wisdom about forfeiture provisions has been overturned but in a way that generally ends up, by a different route, back at the same member-friendly position. We expect trustees will continue dealing with corrections proactively in the same way they have in the past, but the ruling also contains a new and hard-nosed legal analysis that shows what would happen in the event of hostile litigation. This could have an unexpected impact on member recovery.

Surely trustees should just pay the right benefits?

A trustee's duty is to pay "the right amounts to the right people at the right time". It sounds simple but DB schemes are complicated and trustees sometimes pay too little, for many years. It might be due to data errors, it might be due to misunderstanding the legal entitlements. Scheme rules aren't always clear. When new legal requirements come along, the effect on the rules may be even less clear.

Across the pensions industry we tend to be pretty forgiving. Members rarely claim – how would they know, if the issue was so complicated that professional administrators got it wrong? That means there isn't much case law. And that means we don't approach the issues in a legalistic way. If errors come to light, DB schemes usually 'do the right thing' and correct them. When they don't correct them there needs to be a good rationale.

The *Axminster* ruling gives us more guidance on what a legalistic approach would look like. It will enable trustees to make more informed decisions.

What was the Axminster case about?

The case is called *Punter Southall Governance Services Limited v Hazlett* and it relates to the Axminster Carpets Group Retirement Benefits Plan. The employer became insolvent many years ago. The scheme has been grappling with PPF entry which is challenging when the benefit entitlements are uncertain. There were problems with pension increases, GMP equalisation and Barber windows. Many familiar issues about the interpretation and validity of pension increase changes had arisen and the trustee needed to establish what benefits were actually due. The parties reached a compromise on the main points before the hearing. The Judge reviewed the compromise in some detail and approved it, as well as making some '*Re Benjamin*' orders that help to bring certainty by allowing assumptions of fact that can't be proven. There were however still a number of specific questions about how to work out the arrears due. Most of the 87-page judgment therefore relates to the open issues on limitation, forfeiture and arrears.

What are the headline points for other schemes?

- Forfeiture rules, which exist in most DB schemes, can no longer be ignored (as long as the drafting works).
- At first sight forfeiture rules limit arrears to the past six years. But they usually give trustees discretion, and there is a strong nudge towards using any discretion in members' favour, in other words choosing not to forfeit the older instalments. It depends on who was at fault, the trustees or the member. For trustees who are also members that issue is a little more complicated. Rules with no discretion would have to be applied.
- Interest may be required by the rules. If not, *Lloyds* said it applies to sex discrimination claims (because of EU law), at base plus 1% simple. *Axminster* said the same rate is payable on compensation for breach of trust.
- Trustees are required to correct underpayments if they accept that there are in fact errors. In practice we expect trustees will want to pay the full arrears with interest in the same way they have done in the past. This will usually be justifiable because it is prudent to assume that if members would frame a formal legal claim in the way most beneficial to them.
- The issues, and the solutions, will vary from one scheme to another depending on the scheme's history and the 'drafting lottery' as to the terms of its rules.

Are we stuck with the forfeiture rule we've got?

Probably not. Trustees may want to make the rule clearer, or introduce more discretion, or confine it to winding-up. Alternatively, introducing a new forfeiture rule would have seemed questionable before *Lloyds*, but *Axminister* shows that it is possible. A new rule for active members was considered to be valid, despite being detrimental, and despite a restriction preventing amendments if they "would diminish" the benefits already accrued.

How are we supposed to use discretion about forfeiture?

Most forfeiture clauses are either discretionary, or mandatory with a discretion to restore the benefit. When trustees use discretion they must consider relevant factors.

Axminster makes clear that paying the full benefit should be the starting point, where the members had no reason to know that there were underpayments, and the trustees were themselves open to criticism. There is no hard and fast rule but the relevant factors include:

- the fact (if it is the fact) that the underpayment was not the fault of members;
- whether the members could reasonably have been expected to make claims sooner;
- the legal advice;
- the administrative difficulties.

The Judge commented that there were powerful reasons to exercise the power to restore the full benefit, helpfully saying also that "what is required is a rational and proportionate response".

When are trustees at fault?

Not paying the correct benefits is in principle a breach of duty, although trustees who have done their best are well protected in law.

Member is responsible

If the member gave the wrong information or failed to keep in touch (missing beneficiaries) the trustees aren't responsible but an underpayment still has to be put right. If trustees have a choice, they can apply forfeiture to limit the arrears to six years, but they don't have to.

Trustees responsible but didn't know

If, say, the administrator was at fault, the trustees are responsible. They do not need to have known or intended that the benefit was underpaid. Whether or not the trustees should choose to use forfeiture to limit the arrears to six years could depend on whether the member was also at fault, for example if the mistake was obvious and the member took no action.

And what if the trustees did know?

In *Axminster*, the Judge clearly thought forfeiture would be wrong, and he went a stage further. He looked at whether the former trustees could be so much at fault that *their own benefits* should be treated differently from those of 'innocent' members. They had had legal advice that pension increases were being paid incorrectly; they sought consent from active members to continue the practice, without disclosing the legal advice; they minuted that the administration practice "may not be strictly in line with legal advice" but that it had always been the intention; and they obtained an indemnity from the Principal Employer. The Judge was not required to rule on their "culpability" but left little doubt that he thought they should not benefit from the various protections that gave other members full recovery.

In most correction exercises the *Axminster* facts will not be present. However there are situations where underpayments are known, particularly GMP equalisation cases where we knew for many years that some corrective action might be required but it wasn't clear that it was, or what would be required; and now that it is clear (more or less) there are good reasons why the correction project is moving very slowly. Presumably as long as trustees act in accordance with suitable advice their own benefits are protected.

So is limitation different from forfeiture?

Yes. It's also a six year period so it looks similar. But current trustees in possession of trust property have no limitation defence. That's what the Judge ruled in *Axminster* after exhaustive debate. Some lawyers are still not convinced but for practical purposes this issue now seems to be closed.

That means that limitation only arises as an issue if the liability of the current trustees is cut down on account of the period in office.

Why would liability be cut down because of the period in office?

A claim for breach of trust can only be against the party who committed the breach. Many schemes have had the same in-house corporate trustee from the outset.

If it is replaced, however, according to *Axminster* the incoming trustee is only responsible for its own actions (or inaction). It is far from clear how this applies in the case of individual trustees who change on a rolling basis.

That means a claim for breach of trust could be split where there has been a break in continuity. Former trustees have a limitation defence and they are allowed to rely on it (though it may not work if there has been "concealment"). Arrears could therefore be limited.

This is a technical issue that we would not expect to arise in practice. There are ways a member could address such a break, for example claiming an 'account' or a debt rather than compensation for breach of trust (though possibly without interest). There is also an obvious argument that an incoming trustee has a duty to identify any breaches, and so in effect it inherits past breaches that it did not remedy.

One way or another, if liability is accepted, the whole of it will normally be met by the current trustee.

What if liability is not accepted?

If trustees do not accept that there has been an underpayment, and the circumstances are such that they cannot simply continue to administer the scheme as before, they can apply to the Court. Any resulting corrections would probably be made on a breach of trust basis, paying full arrears with interest.

Most pensions litigation is 'trustee-led'. It is rare for members to bring formal legal action. Trustees would only be likely to resist if they believed the claim was unfounded.

We can see from *Axminster* that the way a member frames a claim, technically, can make a difference. Arrears might be limited due to a change in trustees; interest might not apply, or only to part of the arrears, or part of the period. In the context of hostile litigation the trustees could be expected to make use of all available defences.

Insurers or sponsors facing a claim under trustee insurance or indemnity may also look for technical arguments to reduce their exposure. But hostile situations will be few and far between.

What practical steps do you recommend?

We recommend that DB trustees consider:

- Identifying applicable forfeiture rules, including:
  - who they apply to and whether they are valid;
  - the extent of any discretions;
  - how they have been and should in future be applied; and
  - whether they are fit for purpose, including on winding-up, and/or can or should be amended.
- Whether or not there has been a past change of trustees amounting to a discontinuity that could potentially limit claims against the current trustees.
- The trustee protections currently in place and whether they are fit for purpose or whether amendments can and/or should be made.

If there is a proposal in future to replace the whole trustee board, say to appoint a sole professional trustee, or create a sole corporate trustee to replace individual trustees, checking trustee protection for outgoing trustees should be part of the project. The more formal distinction between the incoming and outgoing trustees raises some issues that are new in pensions. Should an outgoing trustee seek an indemnity from the incoming trustee? Does it have continuing insurance cover? Should the incoming trustee seek warranties from the outgoing trustee? Care will be needed to avoid unintended consequences for trustees or members.

AUTHOR

Anna Rogers

Senior Partner
+44 (0)20 7653 8961
anna.rogers@arcpensionslaw.com

PARTNERS

- Anna Copestake
- Anna Rogers
- Anne-Marie Winton
- Jane Kola
- Kate Payne
- Rosalind Connor
- Vikki Massarano

Leeds
T: +44 (0)113 467 8790

London
T: +44 (0)20 7653 8970

www.arcpensionslaw.com