R (on the application of Palestine Solidarity Campaign Ltd and another) v Secretary of State for Housing, Communities and Local Government [2020] UKSC 16

COMMENTARY BY JIA WEI LEE

In 2016, the Government issued guidance to local authorities administering the local government pension scheme ("**LGPS**") which had the effect of restricting divestments from UK defence companies and foreign countries. In response, the Palestine Solidarity Campaign, a company dedicated to campaigning in support of the rights of the Palestinian people, sought judicial review of this guidance. In *R (on the application of Palestine Solidarity Campaign Ltd and another) v Secretary of State for Housing, Communities and Local Government* [2020] UKSC 16, the Supreme Court ruled by a bare majority in favour of the PSC.

With much attention being paid to trustees' use of environment, social and governance (ESG) criteria in investing, the Supreme Court's decision may be thought to provide some important guidance as to the extent to LGPS administrators, and indeed trustees more generally, may account for non-financial factors. This was certainly the flavour of the media coverage, which at least implied that the Supreme Court had issued carte blanche for local authorities to divest on ethical grounds. An article published on Pensions-Expert.com, dated 1st May 2020, was headlined "*Supreme Court lifts ban on political investments by local council pensions*"[1], while a statement by the PSC's solicitors from 28th April 2020 said that "*LGPS members now have the freedom to pursue their own principles in respect of the role of the arms trade and foreign countries in violations of human rights around the world, when determining how their pension monies are invested.*"[2]

[1] https://www.pensions-expert.com/Investment/Supreme-Court-lifts-ban-on-political-investments-by-local-council-pensions?ct=true
[2] https://www.palestinecampaign.org/palestine-solidarity-campaign-defeats-uk-government-over-pensions-divestment/

However, the Supreme Court's decision is in fact quite limited, confined to a finding that the Government may not *restrict* LGPS investments on non-commercial grounds. It does not go as far as saying that local authorities may divest on purely ethical grounds. In that regard, the LGPS may ultimately find itself limited by the long-standing rule that pension trustees, save in particular circumstances, may not generally take account of non-financial factors.

<u>Relevant background</u>

The LGPS is a statutory occupational pension scheme established by regulations made under the Superannuation Act 1972, and having effect as if made pursuant to the Public Service Pensions Act 2013 ("**the 2013 Act**"). Unlike most other public sector schemes, the LGPS is a funded scheme. Local authorities administer 89 distinct funds, ringfenced from local authority resources, into which the local authorities (in their capacity as employer) and employees make contributions. It is therefore very similar to a normal DB pension trust.

Regulation 7 of the Local Government Pension Scheme Regulations 2013 (SI 2013/2356) ("**the 2013 Regulations**"), made pursuant to the 2013 Act, provided that a local authority must formulate an investment strategy in accordance with guidance issued from time to time by the Secretary of State. The guidance in question was issued by the Secretary of State on 15th September 2016 ("**the Guidance**").

The Guidance contained the following instruction:

> *"However, the Government has made clear that using pension policies to pursue boycotts, divestment and sanctions against foreign nations and UK defence industries are inappropriate, other than where formal legal sanctions, embargoes and restrictions have been put in place by the Government."*

The Guidance also provided, by way of summary, that:

> *"In formulating and maintaining their policy on social, environmental and corporate governance factors, an administering authority… should not pursue policies that are contrary to UK foreign policy or UK defence policy"*

It is these two passages of the Guidance that were the subject of challenge by the appellants.

The Supreme Court's decision

The Supreme Court, by a 3-2 majority, found that the Secretary of State had exceeded his powers in giving the Guidance. His power to issue regulations and guidance was limited to that which would promote the policy and objects of the Act (the Padfield principle). The majority concluded that the LGPS was not a part of the machinery of the state. Rather, it arose from the contributions of employees and employers an element of the employee's remuneration, and administering authorities ought therefore to regard themselves as "*quasi-trustees who should act in the best interests of their members*" (see [30]). Accordingly, it was in the majority's view not open to the Secretary of State to direct that authorities "*give effect to [his] own policies in preference to those which they themselves thought it right to adopt in fulfilment of their fiduciary duties*" (see [44]).

By contrast the minority considered that, although LGPS pensions were earned by members, the public interest was engaged because of the relevant authority's duty to make good any deficit in the fund using taxpayer monies. For that reason, the minority concluded that the policy and objects of the 2013 Act included the "*working out of the role of central government in relation to the newly-created schemes and in ensuring the right balance is struck between the public interest and the interests of fund members*", a purpose which embraced the issuance of the Guidance.

What did the Supreme Court *not* decide?

The Supreme Court were only concerned with the lawfulness of the Guidance. But absent such limiting instruction, it remains a largely open question whether local authorities could, in the exercise of their own powers of investment, take into account non-financial factors.

The furthest that the Supreme Court comes in this regard is to endorse the Law Commission's report titled "*Fiduciary Duties of Investment Intermediaries*" (2014, Law Com No 350). At [43], Lord Carnwath says of the Law Commission report:

> *"[This] report in turn may be seen as having settled a long-running debate as to the extent to which pension trustees could take account of non-financial factors dating back to cases such as Cowan v Scargill [1985] Ch 270 (see for example Lord Nicholls Trustees and their Broader Community: where Duty. Morality and Ethics Converge (1996) Australian Law Journal Vol 70, p 206). There appears now to be general*

acceptance that the criteria proposed by the Law Commission are lawful and appropriate. I agree."

The criteria to which Lord Carnwath was referring to was in fact adopted almost word for word in the Guidance. In particular, both the Law Commission Report and the Guidance state that non-financial factors may only be taken into account by LGPS administrators if (i) the trustees had good reason to think that scheme members would share the concern; and (ii) the decision should not involve a risk of significant financial detriment to the fund.

Taken together with the majority's observation that LGPS administrators are quasi-trustees, it seems to follow that local authorities, in making investment decisions, are bound may have regard to non-financial factors if doing so would not involve a risk of significant financial detriment.

A number of points arise from this. First, it is doubtful that the Law Commission's report has "settled" the debate over how and whether trustees are entitled to take account of non-financial factors. The rule that trustees may take account of non-financial factors if it does not involve a risk of significant financial detriment is taken from *Harries v Church Commissioners* [1992] 1 WLR 1241, at p1248. However, Sir Donald Nicholls V-C's judgment in *Harries* was specifically confined to trustees of a charity, where it would of course be perfectly sensible to take account of moral or ethical factors. But there is no suggestion in *Harries* that this rule can be extended to trusts generally, and indeed Nicholls V-C was careful to distinguish *Cowan v Scargill* [1985] Ch 270, in which Megarry V-C held that non-financial factors should very rarely be taken account of by trustees. So the Law Commissions' report is in fact based on dubious authority, and certainly cannot purport to have "settled" the debate".

Second, it is debatable whether local authorities, in the exercise of their investment powers, are subject to exactly the same fiduciary duties as ordinary trustees would be. As the minority in the Supreme Court note, taxpayers have an interest in ensuring local authorities do not run a deficit. In addition, active members are not the only beneficiaries of the LGPS (or indeed, any other pension scheme). There are other persons, such as dependants or persons interested under a members' estate, who have entitlements under the LGPS. It is therefore questionable whether it is fair to say that local authorities are entitled to take

account of ethical factors so long as *scheme members* share these concerns, given local authorities appear at least on face to owe duties to persons beyond just scheme members.

For these reasons, while the Supreme Court has provided some welcome insight into the application of the *Padfield* doctrine, one should be careful of reading too much into their judgment. Local authorities, and indeed trustees more generally, will still have to grapple with the controversial question of whether ESG criteria can be used in making investment decisions.

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