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10 March 2022
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By Email

Dear [redacted]

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Funding sources to meet trustee liabilities

You have asked us to consider a series of questions related to the ways in which an RSE licensee might seek to meet liabilities it incurs from maladministration of the trust for which it is responsible. This letter outlines our answers to those questions. It does so from a general perspective. That is to say, it does not reflect matters, such as the drafting of a fund's deed, the terms of any contracts of trustee indemnity insurance, or any AFSL or RSE licence conditions that are peculiar to specific RSE licensees or their funds. These may in specific circumstances give rise to legal outcomes different from those we outline below.

We consider each of your questions in turn:

1 What are the different mechanisms by which a trustee may meet its liabilities arising from maladministration of the trust?

RSE licensees may incur liabilities from their maladministration of the trust[1] in three main directions:

i. to the fund by way of remediation (for breach of a general law or statutory duty); and/or

ii. to former members by way of remediation (for breach of a general law or statutory duty); and/or

iii. the Commonwealth, a State or other governmental body (for contravention of a civil or criminal provision).

RSE licensees are also likely to incur legal costs in defending allegations in relation to any of these, and may be required by the court or by a regulator to expend money on systems development, training or similar as part of any regulatory remediation.

There are a range of sources from which an RSE licensee may, in appropriate circumstances, be able to meet some or all of these liabilities. Some of the distinctions between the sources are quite subtle, but, as part 2 describes below, the distinctions are consequential. Most importantly, in the list of sources below, a – d are examples

[1] We have used the phrase 'maladministration' expansively to connote conduct that contravenes civil or criminal statutory provisions or breaches of trust obligations or gives rise to liability under contract or tort (for instance for misrepresentation). For a summary description of how those various sources of liability can arise, see M Scott Donald, 'Parallel Streams? The roles of contract, trust, tort and statute in superannuation funds and managed investment schemes' 2020 14 *Journal of Equity* 151.

[redacted]

involving the application of monies directly from the fund, and e – g are examples involving the application of the trustee's own money.

The most important sources are:

Examples involving the application of monies directly from the fund

a. Paying the money out of trust assets generally, pursuant to a power of indemnification expressly granted by the trust deed of the fund;

b. Paying the money out of trust assets generally, pursuant to the residual right to indemnification provided in the general law of trusts (including relevant State trustee legislation);

c. Paying the money out of a fund reserve established for a specific purpose, such as the RSE licensee's Operational Risk Financial Reserve (**ORFR**);

d. Paying the money out of a 'general' reserve of the fund;

Examples involving the application of money from sources external to the fund

a. Paying the money out of the proceeds of a claim on the RSE licensee's Trustee indemnity insurance;

b. Payment by a third party, such as a parent company or other related party, pursuant to a legally-enforceable guarantee[2];

c. Paying the money out of the RSE licensee's own money.

We note that in some circumstances the shareholders of the RSE licensee, or even its directors, may be prepared to meet liabilities of the types identified on page 1 in i) to iii) even in the absence of a legally-enforceable arrangement with the RSE licensee, for instance to enable the RSE licensee to continue in business. These informal arrangements are not considered in this advice because their availability is not something on which a RSE licensee can rely with legal certainty.

2 Are there differences between the different mechanisms?

There are important legal, tax and practical differences between the mechanisms. There are also likely to be qualifications and nuances arising from the precise arrangements pertaining to each RSE licensee. For instance, the availability of funds from these sources will depend on the terms of any powers granted to the RSE licensee by the trust instrument to establish and administer any fund reserves and the existence and wording of any insurance contracts or deeds of guarantee.

At the most general level, it can be said that there are fewer constraints involved when the RSE licensee is using its own money (including where it receives funds from making a claim on an insurance policy or guarantee) rather than fund assets (whether or not sourced from a fund reserve of any kind).[3] (The relevance of the covenant in section 52A(2)(c) of the SIS Act, the 'Best Financial Interests Duty' or 'BFID', to this question is considered in detail in our response to question 5 below.)

Even where the RSE licensee is using its own money, there may be limitations in a specific case arising from the RSE licensee's own constitution, from governance policies it has adopted or from the terms of the insurance or the guarantee, but these are all external to the fund and therefore not regulated by trust law, the trust deed nor the SIS Act.

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[2] A parent entity is not ordinarily required to meet liabilities of the subsidiary however in some circumstances a parent may provide a written guarantee covering specified liabilities of the subsidiary. This is the kind of funding arrangement contemplated by (f).

[3] *Re HEST Australia Ltd* [2021] VSC 809, [81].

In contrast, there are significant barriers to the RSE licensee applying assets of the trust to meet liabilities that are properly recognised as personal[4] liabilities of the entity serving as RSE licensee. Some of these barriers were identified and discussed in our advice to [redacted] in May of last year specifically in relation to the use of reserves. (These are reprised in our answer to question 3 below). In relation to the use of other (ie non-reserve) assets of the fund, it is our view that unless there are express authorisations in the trust instrument permitting application of trust assets to specific types of liability incurred by the RSE licensee in its personal capacity, the right to indemnity the RSE licensee enjoys under the general law (and the relevant state Trustee Act) in respect of expenses properly incurred is not available in respect of personal liabilities. Similarly, the general law and Trustee Acts will not permit indemnification of the RSE licensee in respect of liabilities it has incurred as a consequence of a breach of its trust[5] or from acting beyond its powers or with an improper purpose.[6] Moreover, where there are specific authorisations in the trust instrument, including an express right of indemnity, their validity will be subject to section 56(2) of the SIS Act.

It is worth focussing attention on section 56(2) here, before we proceed with answering the other questions. Section 56(2) voids any provision in the governing rules of the fund that would have the effect of indemnifying the RSE licensee for liability for breach of trust involving conduct that was not honest or intentionally or recklessly careless or lacking in diligence, or purports to indemnify the RSE licensee for certain nominated types of regulatory sanction. Much can be said about the peculiar structure, content and practical application of section 56(2) of the SIS Act. For present purposes it is worth noting:

- Paragraph (a) effectively disallows indemnification for liability arising from dishonest conduct, or an intentional or reckless lack of care or diligence. This statutory disallowance regime is more favourable broadly speaking to RSE licensees than the corresponding regime embodied in trust law, which would potentially disallow indemnification for breaches of trust that do not involve reckless or intentional conduct. As such, it operates to reinforce some, but not all, of the section 52 covenants[7] and also has a complex interaction with the rules around which liabilities, from a public policy perspective, are capable of being insured, as noted in our May advice.
- The list of regulatory sanctions in paragraph (b) for which indemnity is not available was recently extended to include criminal and administrative penalties in relation to a law of the Commonwealth. On its face, the recent extension of the list of penalties may appear to be a major extension of the disallowance regime however, depending on the circumstances, indemnification in relation to some of the penalties would have been disallowed at general law prior to the amendment[8]. The express reference to them in (b) removes any doubt on this score. We do however note in passing that criminal and administrative sanctions imposed as a result of contravention of a law of some other jurisdiction, for

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4 Although, strictly, all liabilities of the RSE licensee are personal (*Vacuum Oil Company v Wiltshire* (1945) 72 CLR 319), the description 'personal' is employed here to distinguish liabilities incurred by the RSE licensee in its capacity as trustee from those 'personal' liabilities incurred in other non-trustee capacities. Examples of personal liabilities in this sense would include directors' fees, licensing fees, staff remuneration, premiums for directors' and officers' indemnity insurance.

5 *Gatsios Holdings v Nick Kritharas Holdings* [2002] NSWCA 29. See generally J D Heydon and M J Leeming, *Jacobs Law of Trusts in Australia* (8th edn, LexisNexis Butterworths, 2016), [21.06] – [21.07]. As a matter of principle, this prohibition would not seem to extend to liabilities arising from conduct that would have been a breach but for an exoneration clause in the trust instrument or beneficiary consent.

6 *Nolan v Collie* [2003] VSCA 39.

7 See obiter dicta in *APRA v Kelaher* [2019] FCA 1521.

8 The interaction between the general law regime and the terms of a fund's trust deed is a complex matter, particularly given the possibility that some or all of a trust deed provision may be rendered void by section 56 of the SIS Act.

instance a foreign government or a State are not addressed by the expanded statutory disallowance regime in section 56 (but may nonetheless fall within the general law disallowance regime).

There are also some changes in the broader regulatory context relevant to this discussion. Of particular note:

- The introduction of section 54B of the SIS Act in 2019 means that contravention of one of the covenants in section 52 by the RSE licensee is now also a contravention of a civil penalty provision, and as such by virtue of paragraph (b) not indemnifiable.
- A recent amendment to the definition of 'financial service' in section 766 of the Corporations Act to encompass the provision of a superannuation trustee service extends the list of Corporations Act requirements contravention of which may attract civil or administrative penalties.
- ASIC and to a lesser extent APRA have taken a more active enforcement stance against RSE licensees over the past three years, influenced to some extent by the recommendations of the Hayne Royal Commission. This increases the likelihood of regulatory sanction.
- Recent amendments to the Corporations Act have increased the maximum size of penalties that can be awarded.

Although there is some complexity around the extent to which the amendment to section 56 (and also, the introduction of section 54B) have expanded the range of liabilities for which indemnification from fund assets is disallowed, the changes have directed public attention to what had hitherto often been regarded as a somewhat dry and technical area of the law, highlighting its pivotal role from a practical perspective in the regulatory scheme.

Finally, we also note that there are important differences between the different mechanisms from a tax perspective. Consideration of the tax issues is beyond the scope of this advice.

3 Are there limits on how fund reserves can be applied?

The SIS Act expressly provides that RSE licensees can maintain reserves for a specific purpose, unless such a reserve is prohibited under the governing rules of the fund.[9] However as a matter of general law, RSE licensees can only apply assets within those reserves for the purpose for which the reserves were created. Payments outside those purposes (unless authorised under another provision of the trust deed) would be void as a matter of law, and the debiting of amounts against the reserve would be a breach of trust because of the trustee's failure to comply with the rules regulating operation of the reserve. The trustee would then be required to replenish the fund from its own assets in respect of the unauthorised payments.

Consistent with this, assets held in an Operational Risk Financial Reserve (**ORFR**), for instance, can only be applied to address the financial impact of losses arising from an 'operational risk event'.[10] Importantly, application of the assets of an ORFR in this way does not relieve the obligation on the RSE licensee to consider whether it ought, as a means of replenishing the ORFR, to take action against the party whose conduct caused

[9] Section 115, SIS Act. Note, a specific reserve may be expressly provided for in the governing rules of the fund or may be established by the RSE licensee pursuant to a power to create reserves provided in the governing rules. A trustee would not ordinarily (ie in the absence of a court order) have authority to create a reserve without such authority however section 115 gives the trustee a power to create a reserve but only where the reserve is created for a particular purpose.

[10] "Operational risk events' are defined in Australian Prudential Regulation Authority, *Prudential Standard SPS114 - Operational Risk Financial Requirement* (1 July 2013), [6] - [7].

the financial loss.[11] As per our May 2021 advice, an RSE licensee who does not consider such action, or who exercises its discretion not to take such action on inappropriate grounds (such as the presence of a conflict of interests or a lack of diligence) may find itself liable for that failure in addition to any liability arising from misapplication of the assets of the ORFR. Nor, importantly, does the application of the assets of the ORFR to remediate members' accounts extinguish the liability of the RSE licensee to remediate the trust if it was the RSE licensee's own conduct which caused the operational risk event.

Some RSE licensees are empowered by the relevant trust instrument to maintain a general reserve. However, despite the lack of an articulated purpose for such a reserve, the RSE licensee cannot circumvent the limits on indemnification for the RSE's personal expenses (as described in 2 above) by simply drawing money from that reserve because assets held in a reserve are nonetheless fund assets and section 56 applies to all fund assets. In addition, drawing money in that way may expose the RSE licensee to civil (and quite possibly criminal) liability. It would therefore be improper for a RSE licensee to use the assets in a general reserve to meet liabilities the RSE licensee has incurred as a consequence of maladministration of the fund for which the RSE licensee is not otherwise entitled to indemnification. It would similarly be improper for a RSE licensee to use assets held in a general reserve to pay for indemnity insurance for the RSE licensee, which as noted in our May advice, is a personal expense of the RSE licensee to the extent it provides funding for personal liabilities. It would also be improper for the RSE licensee to distribute assets from a general reserve to itself to use as capital.

Finally, we note, as per our May advice, that the RSE licensee's decisions with respect to all reserves will be subject to the familiar requirements of honesty, care, skill, diligence, best financial interests, fair dealing etc that attend all conduct by the RSE licensee under the covenants in section 52 of the SIS Act and the general law.

4 How might a trustee build up its capital?

There are a number of regulatory regimes that apply to the issuance of share capital by a company generally and also to a company with Australian Financial Service (**AFS**) and RSE licenses. This advice does not purport to address the requirements arising from those regimes. This advice focuses narrowly on the issues related to the application of trust assets by the RSE licensee to meet, directly or in anticipation of, liabilities arising from its maladministration of the fund.

We can identify three ways in which a RSE licensee may legitimately be able to build up its capital:

- By issuing shares to third parties, which process will be subject to the capital raising and authorisation regimes alluded to above.
- Organically, by collecting a fee as remuneration for performing the role of trustee. Entitlement to that fee will require express provision in the trust instrument. We note that where the trust instrument authorises the payment of remuneration, this creates a personal right in favour of the trustee. As such, the various statutory and trust law duties that apply to the trustee in relation to the exercise of its powers in the course of administering the fund such as the BFID have no application when a trustee pays remuneration to itself consistently with the authorisation. If no such entitlement is present in the trust instrument, an RSE licensee would require court approval to amend the trust instrument given the inherent conflict of interests involved. This is true even if the RSE licensee has been granted a wide amendment power in the trust instrument. We note that a number of RSE licensees have gone down this route in recent months.

[11] *APRA v Kelaher* [2019] FCA 1521. Note, however, the obligation is to consider whether pursuing legal action is desirable. It is not an obligation to initiate pursuit in all circumstances.

- It may be possible to approach the court to permit a once-off transfer of trust assets to the RSE licensee, under the court's 'expediency' jurisdiction.

In our view, and building on the principles articulated above, it would not be proper for a RSE licensee, absent court authorisation, to:

- Pay itself money from a general reserve to build up the RSE licensee's capital, as this would represent unauthorised remuneration and the payment of remuneration other than pursuant to a clause authorising the payment of remuneration would be an intentional breach of duty, meaning that indemnification would be disallowed by section 56.
- Pay itself money from an already-existing reserve established for a specific purpose to build up the RSE licensee's capital for the same reasons as above unless the reserve contained a clause clearly authorising the payment of remuneration to the trustee. In addition, the assets in a reserve are only available for application by the RSE licensee if the nominated triggering conditions are met (for instance an operational risk event). It would not, in our view, therefore be permissible for the RSE licensee to appropriate assets from the reserve for itself as a contingency against the risk of incurring such liabilities in the future.
- Establish a reserve whose purpose is identified as being to provide money to the RSE licensee to build up its capital or to discharge the personal liabilities of the trustee. In our view this course of action would not be permitted, because a decision to do so involves a clear conflict between the interests of the RSE licensee and fund members and it is hard to see how establishing such a reserve would satisfy the RSE licensee's obligation to prioritise members' interests.

5 Are there limits on how capital held by the trustee can be applied?

The directors of a corporation must ordinarily apply the assets of the corporation in what they believe are the best interests of the corporation.[12] As a matter of general principle, the assets of the corporation are not subject to the obligations that arise in relation to its role as trustee which are focussed on the assets it holds on trust. In the superannuation context, however, it is important to consider the implications of the covenants in section 52A(2)(c) and (d) of the SIS Act.

Those covenants are:

(c) to perform the director's duties and exercise the director's powers as director of the corporate trustee in the best financial interests of members; and

(d) where there is a conflict between the duties of the director to the beneficiaries, or the interests of the beneficiaries, and the duties of the director to any other person or the interests of the director, the RSE licensee or an associate of the director of the RSE licensee:

(i) to give priority to the duties to an interests of the beneficiaries over the duties to and interests of other persons; and

(ii) to ensure that the duties to the beneficiaries are met despite the conflict; and

(iii) to ensure that the interests of the beneficiaries are not adversely affected by the conflict; and

(iv) to comply with the prudential standards in relation to conflict.

On one reading, it might be possible to argue that the directors of a company that serves as the RSE licensee are constrained by the covenant in section 52A(2)(c) (as reinforced by the covenant in section 52A(2)(d) to give priority to members) always to make

[12] Section 182, *Corporations Act*.

decisions in the best financial interests of the members even when the RSE licensee is dealing with the RSE licensee's own personal assets.

We do not believe that is the appropriate way to interpret section 52A(2)(c). In our view, the inclusion of the words 'as director of the corporate trustee' makes it clear that the requirement on the director to exercise his/her powers in the best financial interests of members arises only when the company is acting as trustee. If the legislature had intended that the covenant was to apply to all acts of the director, those qualifying words would not have been included.

This position is not simply a matter of semantics. Section s15AA of the Acts Interpretation Act 1901 (Cth) provides that the interpretation that would best achieve the purpose of the legislation be preferred to other interpretations. An interpretation of section 52A(2)(c) that would require directors of a trustee company to subordinate the interests of the company, or of creditors unrelated to the trust, to the interests of members at all times seems contrary to the policy settings that have prevailed since the start of the compulsory superannuation system in 1993, namely the accommodation of commercial interests within the system.[13] We therefore conclude that any suggestion that the directors of a company serving as an RSE licensee cannot declare dividends, remunerate staff, purchase indemnity insurance, determine the price at which their product is sold or otherwise determine the management of the company of which they are directors is unsustainable at law and contrary to almost thirty years of bi-partisan public policy. It is only when the directors are making decisions relating to the RSE licensee's administration of the trust (or trusts) that the covenants in section 52A(2)(c) and (d) are engaged.

This is so even where the trustee has obtained funds by (legitimately) charging a fee and paying the fee to itself from fund assets. Once the fee is paid to the trustee, it ceases to be part of the trust and the trustee can use that money however it chooses.

That said, although as a general principle, trust law and the SIS Act do not regulate how an RSE licensee applies its 'own' money, which does not mean that there are no constraints at all. There may be provisions in the constitution of the RSE licensee itself that constrain how the money may be used. There are also rules that uniquely apply to trustee capital that is held to satisfy the operational risk financial requirements as outlined in *SPS114 Operational Risk Financial Requirement*.

Regard will also have to be had for provisions in the Corporations Act, such as sections 199A and 199B and the provisions in Chapter 2J that regulate the conduct of the company.

6 Is some level of capital necessary, or can all types of liability be met from a combination of reserves, trustee indemnity insurance or the trustee's inherent right of indemnity from trust assets?

Unlike some other AFSL holders, there is at present no legal requirement for RSE licensees to have any particular level of capital.[14]

This question does however have a practical dimension that ought not to be under-estimated. In our view it would be possible for the trust instrument to be crafted in such a way that a combination of reserves and indemnity insurance would cover much of the potential liability faced by an RSE licensee for its administration of the trust. However, it

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13 The Hon. Paul Keating, reported in Nick Coates and Sasha Vidler, 'Superannuation Policy. Commentary on an Interview with Paul Keating, former Prime Minister' (2004) 53 *Journal of Political Economy* 9, 12.

14 Close analogies would seem to be the requirements on Respons ble Entities serving registered managed investment schemes and on IDPS operators, the requirements for each of which are set out in ASIC RG 166: Licensing Financial Requirements (April 2021). Notably, until repealed in 2012, section 29DA of the SIS Act required RSE licensees to hold (directly, via a guarantee or through a custodian) at least $5m in capital unless all assets of the fund were invested in a prudentially regulated entity (which would itself be subject to a minimum capital requirement).

seems to us that the limits on indemnity provisions brought about by section 56(2) of the SIS Act and on the indemnity cover available (including the likelihood of excess being payable on any claim) and on the use of reserves, together with the familiar impossibility of indemnification for criminal sanctions, means that a gap in cover is inevitable even if each of those mechanisms were to be employed to their maximum permissible extent. As such, it seems inescapable that, from a practical perspective, some level of capital, or a third party guarantee, will be required to cover fully the range and extent of RSE licensee liabilities for maladministration.

7 Does the introduction of the Best Financial Interests Duty change things in respect of the issues raised in 1 - 6?

In terms of the issues raised in this advice, in our view the amendment of section 52(2)(c) to include the word 'financial' has not changed the substance of the covenant materially. The 'financial' gloss has been repeatedly adopted in Australian courts prior to the amendment, following the seminal English case of *Cowan v Scargill*[15] in 1985.[16] This conclusion is unaffected by the reversal of the onus of proof effected by section 117A of the SIS Act.

Furthermore, the right of a trustee to indemnify itself from assets of the trust is a personal right. The Best Financial Interests Duty does not apply to decisions made by a trustee to exercise those rights. As such, this duty is not directly relevant to the substance of the matters that are the subject of this advice.

Similarly, suggestions that the amendment to section 52(2)(c) requires that RSE licensees try to identify and secure external sources of capital sufficient to address the sorts of liabilities identified in our answer to question 1 above before changing (or seeking to introduce) a fee conflate the duties of the entity as an RSE licensee and its management of its own affairs as a corporation. Although the maximum level of a fee may be specified in the trust instrument, decisions about what fee to charge are not a matter for trust law or the SIS Act unless the RSE licensee attempts to charge more than is authorised. Alternatively, where a trustee, including an RSE licensee, seeks to be remunerated for its services (ie charge a fee) and this is not provided for in the trust instrument, the trustee will typically have to approach the court for authority. In that situation, the court is likely to have regard to a wide range of factors, including the interests of members, in deciding whether to grant an amendment of the trust instrument permitting remuneration.

8 What are the consequences of a trustee being unable to meet a liability it has incurred for maladministration?

An RSE licensee that is unable to meet its liabilities as and when they fall due will face insolvency proceedings and is likely to be wound up. If the personal assets of the RSE licensee (including any payouts it has received from trustee indemnity insurance policies) at that time are inadequate to satisfy its various creditors, any remediation of the members for the losses incurred as a result of the maladministration of the trust by the RSE licensee is likely to be incomplete. Put simply, members will lose out because the RSE licensee won't have sufficient assets to cover the losses it has caused.

For completeness, and at the risk of giving them undue prominence, this usual outcome is subject to three main qualifications:

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15 (1985) 1 Ch 270.

16 See for instance *Invensys Australia Superannuation Fund Pty Ltd v Austrac Investments Ltd* (2006) VR 87; *Commonwealth Bank Officers Superannuation Corporation v Beck* (2016) 334 ALR 692; *APRA v Kelaher* [2019] FCA 1521.

1. The fund not offering defined benefits (in which case the allocation of losses will be a much more complex question, dependent on matters such as the governing rules and the state of funding);
2. To the extent that losses to the fund resulted from fraud or theft, the members may be eligible for financial assistance from the Commonwealth pursuant to the mechanism provided in Part 23 of the SIS Act; and
3. Section 197 of the Corporations Act may be enlivened, making the directors of the RSE licensee liable for the undischarged liabilities of the company.

In addition to the possibility that there are losses that are unable to be recouped fully from the insolvency proceedings of the RSE licensee, or from another source, we note that there is also likely to be inconvenience and cost involved in transitioning to a new RSE licensee. Traditionally the law has had a low tolerance for insolvent trustees because of the risk that the trustee may be tempted to use trust assets to relieve its personal position.[17] Courts would therefore typically replace trustees facing bankruptcy or insolvency proceedings. This sensibility is reinforced in the superannuation context by the financial fitness conditions attaching to the AFSL and RSE licences required of most superannuation trustees. As a result, it is highly unlikely that an entity serving as an RSE licensee would be permitted to serve as a RSE licensee if there were grounds to suspect that it was, or was about to become, insolvent. (An RSE Licensee who is in fact an insolvent under administration is deemed by section 120 of the SIS Act to be automatically a disqualified person, and as such is prohibited by section 126K of the SIS Act from acting as a trustee of a registrable superannuation fund.)

Yours sincerely,

[redacted]
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17 *Miller v Cameron* (1936) 54 CLR 572.