David Maclean Plenary Session:

Trustee Liability in a Post-Royal Commission World

13 March 2020

This session will discuss:

- *trustee and director liability and the right of indemnity out of the fund;*
- *issues trustees and directors will face in funding payment of civil penalties;*
- *the effects of Commissioner Hayne's recommendation not to run a separate business and impact on ability to pay civil penalties;*
- *the use of operational risk reserves;*
- *the use of judicial advice as a risk mitigant; and*
- *issues trustees and directors will face in accessing PI and D&O insurance.*

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Trustee Liability in a Post-Royal Commission World

Introduction

I am grateful for the invitation to present the David Maclean Plenary Session.[1]

The purpose of this paper is to examine a number of implications for the liability of superannuation trustees and their directors that flow from the following developments in 2019:

- On 1 February 2019, the Final Report of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (the **Financial Services Royal Commission**) was presented to the Governor-General;
- On 5 April 2019, the *Treasury Laws Amendment (Improving Accountability and Member Outcomes in Superannuation Measures No. 1) Act 2019* (Cth) (the **Improving Accountability Act**) was enacted; and
- On 20 September 2019, the Federal Court of Australia handed down its decision in *Australian Prudential Regulation Authority v Kelaher* [2019] FCA 1521 (the **IOOF Case**).

The last of these developments, the IOOF Case, casts considerable doubt on the ability of a superannuation trustee, or its directors, to be indemnified from the superannuation trust fund where they negligently engage in conduct that contravenes one of the covenants in section 52 of the *Superannuation Industry (Supervision Act) 1993* (Cth) (the **SIS Act**). This is a central focus of my paper. In addition, the paper will consider some of the problems that will confront superannuation trustees if the view expressed in the IOOF Case is correct.

Trustee's Rights of Indemnity under the General Law

In equity, a trustee has the right to be indemnified from the trust fund for costs and liabilities properly incurred in carrying out the trust. To give effect to this indemnity, the trustee has a proprietary interest in the assets of the trust fund commensurate with its right of indemnity, as well as a right to hold beneficiaries personally responsible for the indemnity in certain circumstances.[2] But, in the absence of special provisions in the trust deed, a trustee does not have a right to be indemnified for liabilities that arise as a result of its breach of trust.

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1 I am grateful to Paul Annabell (Barrister, Ninian Stephen Chambers), Maged Girgis (Partner, Minter Ellison) and Tom Dearden (Summer Clerk, Minter Ellison) for their assistance in the preparation of this paper.

2 *JW Broomhead (Vic) Pty Ltd v JW Broomhead Pty Ltd* [1985] VR 891 at 936-937.

Under the general law, the trustee's right of indemnity can be altered by a provision in the trust instrument. Such alterations might go either way. On the one hand, the trust instrument could limit or exclude the trustee's general right of indemnity from the assets of the trust or its right to claim indemnity from the beneficiaries personally. Alternatively, the provisions of the trust instrument could "enlarge the rights of indemnity against the trust funds which the trustees would otherwise have in claims by third parties".[3] Trustees also have similar rights of indemnity under state and territory legislation.[4] There are differing decisions in state courts as to whether these provisions only apply to liabilities properly incurred by the trustee, and also whether the right of indemnity can be excluded or limited by particular trust deed provisions.

I have mentioned these matters because they are helpful background to a proper understanding of the meaning and effect of section 56 of the SIS Act. However, it is unnecessary to pursue them in greater detail because general law rights of indemnity, and rights of indemnity under state and territory legislation, have been recognised and enhanced by the SIS Act. Section 56 of the SIS Act invalidates certain governing rules of a superannuation entity. As explained more fully below, the expression "governing rules" is defined widely in the SIS Act so as to include, not just the rules contained in a trust instrument, but also any rules contained in legislation and any unwritten rules of law governing the establishment or operation of the trust fund. As the Hon. JC Campbell QC has pointed out in a very helpful article, the result is that section 56 of the SIS Act operates to modify certain types of express provisions of a trust instrument, or state or territory legislation, about a trustee's indemnity.[5]

Statutory Landscape prior to 2019

This audience will already be familiar with the covenants in Part 6 of the SIS Act. These covenants play a critical role in guiding and regulating the conduct of trustees of superannuation funds.[6] However, it is useful to recount briefly some of the relevant history of Part 6 to provide context for the issues discussed in this paper.

3 JD Heydon and MJ Leeming, *Jacobs' Law of Trusts in Australia* (8th ed, 2016) at [16-17]

4 See, eg: *Trustee Act 1925* (NSW) s 59(4); *Trustee Act 1958* (Vic), s 36(2); and *Trustee Act 1936* (SA) s 35(2).

5 JC Campbell, "Some Aspects of the civil liability arising from breach of duty by a superannuation trustee" (2017) 44 *Australian Bar Review* 24 at 36.

6 Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Final Report* (Volume 1), 225, 261.

The Introduction of the SIS Act

The history of the covenants in section 52 of the SIS Act was examined by Giles JA in *Manglicmot v Commonwealth Bank Officers Superannuation Corporation Pty Ltd* (2011) 282 ALR 167 (***Manglicmot***) at [110]-[118].

As Giles JA noted,[7] the origins of section 52 can be traced to the joint report of the Australian Law Reform Commission and the Companies and Securities Advisory Committee, *Collective Investments: Superannuation* (**ALRC 59**), published in 1992. Amongst other recommendations, the report recommended that the law should specify a number of "basic fiduciary obligations of a responsible entity that cannot be excluded or modified" (Recommendation 9.2).[8]

ALRC 59 also considered the indemnification and insurance of trustees against liability. It noted that, as trustees of superannuation schemes were often not remunerated for their work, trust deeds typically provided that the fund would indemnify the trustee, or the directors of a corporate trustee, for any loss resulting from negligence. Under such an arrangement, the fund was required to pay for any successful claim against the trustee. On the other hand, the report noted that if the scheme purchased third party indemnity insurance and rights of indemnity were excluded, then the insurance company would be responsible for paying any successful claims against the trustee, which would preserve the remaining assets of the scheme.[9] The ALRC ultimately recommended that trustees should be precluded from exercising a right of indemnity against the trust fund:[10]

> **Recommendation 3.1: Indemnification of members of boards**
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> 1. The law should provide that the responsible entity, and the members of the board of management of the responsible entity, for a superannuation fund, an ADF [approved deposit fund] or a PST [pooled superannuation trust] may not be indemnified out of the fund, ADF or PST for any liability incurred by it or them while acting as responsible entity or member. Failure to comply should be an offence as well as a breach of fiduciary obligations.
>
> 2. The law should provide that the responsible entity for a superannuation fund, an ADF or a PST must ensure that the annual report for the scheme include a statement whether the responsible entity or the members of the board of management of the responsible entity are insured in respect of their liability to members of the scheme for loss caused by fraud or negligence and, if they are,

7 *Manglicmot v Commonwealth Bank Officers Superannuation Corporation Pty Ltd* (2011) 282 ALR 167 at [110].
8 ALRC 59 at 111.
9 ALRC 59 at 27-28.
10 ALRC 59 at 29.

the prescribed particulars of that insurance.

3. Nothing should prevent the payment out of the fund of the costs associated with obtaining insurance for the responsible entity for the fund, ADF or PST or for a member of the board of management of the responsible entity against fraud or negligence.

However, this recommendation was not accepted by the Federal Government. Instead, the Government took the view that trustees should have the right to be indemnified by the fund against any liability incurred by them while acting in relation to affairs of the fund, provided that the indemnity did not extend to fraud, wilful negligence or default, or penalties imposed by legislation. These protections were embodied in sections 56 and 57 of the SIS Act.

The rationale for this position was set out in a statement by then Treasurer John Dawkins on 21 October 1992:[11]

> **Insurance**
>
> Funds will be encouraged to obtain insurance against loss due to negligence and will be required to disclose to their members whether or not funds have such insurance. It is proposed that the [Insurance and Superannuation Commission], in consultation with the industry, devise a standard form for such insurance cover.
>
> In order to encourage individuals (particularly member representatives) to accept the position of trustee, it is appropriate that they be given some protection against personal financial loss. The governing documents of a superannuation fund, ADF or PST may provide for trustees to be indemnified by the fund against any liability incurred by them while acting in relation to the relevant fund, ADF or PST. Such an indemnity would not extend to any of the following:
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> - fraud;
> - wilful negligence or default; or
> - penalties imposed under the OSS legislation.

The SIS Act

In 1993, the SIS Act was enacted. Section 52(2) of the Act set out a list of eight covenants that were deemed to be included in the governing rules of a "superannuation entity".[12] Although the

11 John Dawkins, *Strengthening Super Security: New Prudential Arrangements for Superannuation: Statement by the Honourable John Dawkins MP, Treasurer of the Commonwealth of Australia* (Australian Government Publishing, 1992).

12 The term "superannuation entity" was defined in s 10 of the SIS Act as meaning a regulated superannuation fund, an approved deposit fund or a pooled superannuation trust.

terms of section 52 differed in several respects from recommendation 9.2 of ALRC 59, "the heredity [was] clear enough",[13] as Giles JA observed in *Manglicmot*.

Section 55 of the SIS Act created a statutory cause of action against persons who had engaged in, or had been involved in, a breach of a covenant:

> **55. Consequences of contravention of covenant**
>
> (1) A person must not contravene a covenant contained, or taken to be contained, in the governing rules of a superannuation entity.
>
> (2) A contravention of subsection (1) is not an offence and a contravention of that subsection does not result in the invalidity of a transaction.
>
> (3) A person who suffers loss or damage as a result of conduct of another person that was engaged in in contravention of subsection (1) may recover the amount of the loss or damage by action against that other person or against any person involved in the contravention.
>
> (4) An action under subsection (3) may be begun at any time within 6 years after the day on which the cause of action arose.
>
> (5) It is a defence to an action for loss or damage suffered by a person as a result of the making of an investment by or on behalf of the trustee of a superannuation entity if the defendant establishes that the investment was made in accordance with an investment strategy formulated under a covenant referred to in paragraph 52(2)(f).
>
> (6) It is a defence to an action for loss or damage suffered by a person as a result of the management of any reserves by the trustee of a superannuation entity if the defendant establishes that the management of the reserves was in accordance with a covenant referred to in paragraph 52(2)(g).
>
> (7) Subsections (5) and (6) apply to an action for loss or damage, whether brought under subsection (3) or otherwise.

Sections 56 and 57 of the SIS Act addressed the right to indemnity of trustees and their directors from the trust assets:

> **56. Indemnification of trustee from assets of entity**
>
> (1) A provision in the governing rules of a superannuation entity is void if:

[13] *Manglicmot v Commonwealth Bank Officers Superannuation Corporation Pty Ltd* (2011) 282 ALR 167 at [116].

(a) it purports to preclude the trustee from being indemnified out of the assets of the entity in respect of any liability incurred while acting as trustee of the entity; or

(b) subject to subsection (2), it limits the amount of such an indemnity.

(2) A provision in the governing rules of a superannuation entity is void in so far as it would have the effect of exempting the trustee from, or indemnifying the trustee against:

(a) liability for breach of trust if the trustee:

(i) fails to act honestly in a matter concerning the entity; or

(ii) intentionally or recklessly fails to exercise, in relation to a matter affecting the entity, the degree of care and diligence that the trustee was required to exercise; or

(b) liability for a monetary penalty under a civil penalty order.

(3) Nothing in the governing rules of a superannuation entity prohibits the trustee of the entity from seeking advice from any person in respect of any matter relating to performance of the duties or the exercise of the powers of the trustee. A provision in the governing rules that purports to preclude the trustee from being indemnified out of assets of the entity in respect of the cost of obtaining such advice, or to limit the amount of such an indemnity, is void.

57. Indemnification of directors of trustee from assets of entity

(1) Subject to subsection (2), the governing rules of a superannuation entity may provide for a director of the trustee to be indemnified out of the assets of the entity in respect of a liability incurred while acting as a director of the trustee.

(2) A provision of the governing rules of a superannuation entity is void in so far as it would have the effect of indemnifying a director of the trustee against:

(a) a liability that arises because the director:

(i) fails to act honestly in a matter concerning the entity; or

(ii) intentionally or recklessly fails to exercise, in relation to a matter affecting the entity, the degree of care and diligence that the director is required to exercise; or

(b) liability for a monetary penalty under a civil penalty order.

(3) A director of the trustee of a superannuation entity may be indemnified out of the assets of the entity in accordance with provisions of the entity's governing rules

that comply with this section.

(4) This section has effect despite section 241 of the Corporations Law of a State or internal Territory.

The meaning and effect of section 56 is addressed in greater detail later in this paper. For present purposes, it is sufficient to note that section 56 was generally understood as imposing a requirement that trustees of superannuation funds should have a right of indemnity for all liabilities they incur while acting as trustee, even if those liabilities were incurred in breach of trust, so long as they were not liabilities attributable to dishonest, intentional or reckless conduct, or a liability with respect to a statutory penalty as more precisely identified in section 56(2).[14] It achieves this result by effectively invalidating or reading down any provision of the general law, or any provision of state or territory legislation, or of the terms of a trust deed, that would prevent the trustee having a right of indemnity for liabilities incurred while acting as a trustee, save in the circumstances specified in section 56(2).

The Trustee Obligations Act

Part 6 of the SIS Act was amended by the *Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Act 2012* (Cth) (the **Trustee Obligations Act**), which came into effect on 1 July 2013. This Act was enacted following the Final Report of the Superannuation System Review on 30 June 2010 (commonly referred to as the "Cooper Review").

The Trustee Obligations Act implemented a number of changes that are relevant for present purposes. Section 52 of the SIS Act was repealed and replaced in its entirety. The revised section 52 applied to "registrable superannuation entities", excluding self-managed superannuation funds.[15] The covenants included in the new section 52(2) were, in general, more onerous in nature. They included new duties relating to conflicts of interest, giving priority to beneficiaries and acting fairly. The standard of care, skill and diligence required of trustees was also increased. These changes were intended to "hold trustees to a higher standard".[16]

14 See JC Campbell, "Some Aspects of the civil liability arising from breach of duty by a superannuation trustee" (2017) 44 *Australian Bar Review* 24 at 40 and 42.

15 SIS Act, s 10. Covenants relating to self-managed superannuation funds were set out in ss 52B and 52C. Self-managed superannuation funds are outside the scope of this paper.

16 Explanatory Memorandum, Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Bill 2012 at [1.46].

A new section 52A was added, imposing parallel covenants on directors of corporate trustees. Again, the intention of this section was to "hold those individuals who are directors of corporate trustees…to a higher standard".[17]

Section 52(8) included a new covenant requiring trustees to maintain and manage, in accordance with the prudential standards, financial resources to cover the "operational risk" relating to the entity. The Explanatory Memorandum to the Trustee Obligations Act defined operational risk as including inadequate or failed internal processes or failures by people and systems. It gave specific examples, including a miscalculation of member benefits, computer or software failure, fraud, negligence or misconduct.[18]

A new subsection 56(2A) was included as follows:

> A provision in the governing rules of a registrable superannuation entity is void in so far as it would have the effect of allowing a trustee of the entity:
>
> (a) to indemnify itself out of the assets of the entity for any amount expended out of capital of the trustee managed and maintained by the trustee to cover the operational risk of the entity; or
>
> (b) to indemnify itself out of any assets of the entity that do not form part of a reserve maintained for the purpose of covering the operational risk relating to the entity, any amount that relates to that risk, without first exhausting the reserve and any other financial resources managed and maintained by the trustee to cover the risk.

The requirement to maintain and manage an 'operational risk reserve' was intended to provide members with enhanced protection for operational risks. It was envisaged that an operational risk reserve would be built up over time, and therefore members who happened to be members of a fund at the time an operational risk loss was identified would not bear an unfair proportion of the loss.[19]

As noted in the Explanatory Memorandum to the Trustee Obligations Act, section 56(2A) aimed to ensure that, where an operational risk loss was paid from the operational risk reserve, a trustee could not immediately rely on its right of indemnity to recoup those expenses from trust funds. This would defeat the purpose of an operational risk reserve, which was to protect members of the fund from bearing the full cost of an operational risk loss. However, section 56(2A) was not

17 Explanatory Memorandum, Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Bill 2012 at [1.139].

18 Explanatory Memorandum, Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Bill 2012 at [1.99]

19 Explanatory Memorandum, Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Bill 2012 at [1.102]-[1.104].

intended to prohibit licensees from replenishing their capital through the imposition of fees charged to fund members over time.[20] Nor did section 56(2A) entirely forbid any recourse to the trustee's right of indemnity. Rather, it required that the trustee must first exhaust the reserve and any other financial resources managed and maintained by the trustee to cover the risk, before the trustee could have any recourse to its right of indemnity. If the trustee first claims against the fund's operational risk reserve and that is not sufficient to discharge the trustee's liability, and the trustee has no other assets or reserve that it has set aside to cover the risk, then it would seem that the trustee could exercise its right of indemnity against the trust fund to discharge the balance of its liability. I note that this view differs slightly from the view Mr Campbell QC expressed in his article, where he said that "[it] is only to the extent that the trustee has already exhausted the operational risk reserve in the fund, any operational risk reserve in its own assets, and any other assets on which it can draw to meet an operational risk, that it is possible for the trustee to draw on assets of the fund outside the operational risk reserve to satisfy its right of indemnity."[21] The difference between us is that the section does not go so far as to require the trustee to meet the liability from "any other assets from which it can draw".

The Australian Prudential Regulation Authority (**APRA**) has issued *Prudential Standard SPS 114*, which governs the management of operational risk reserves.[22] The standard defines an operational risk in much the same way as the Explanatory Memorandum did, ie as a risk resulting from inadequate or failed internal processes, people and systems, or from external events. Operational risk includes legal risk but excludes strategic and reputational risk.[23] Amongst other requirements, the standard requires RSE Licensees to have an operational risk strategy, approved by the board. That strategy must address, amongst other things, meeting the target amount for the operational risk reserve and the process for determining when and how the financial resources held to meet that amount can be called upon.[24] If the amount falls below the

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20 Explanatory Memorandum, Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Bill 2012 at [1.113]-[1.114].

21 JC Campbell, "Some Aspects of the civil liability arising from breach of duty by a superannuation trustee" (2017) 44 *Australian Bar Review* 24 at 48.

22 *Superannuation (prudential standard) determination No.1 of 2012: Prudential Standard SPS 114 Operational Risk Financial Requirement*. This standard imposes obligations on trustees in at least two ways. First, the terms of the covenant in s 52(8) of the SIS Act require the trustee to maintain and manage the operational risk reserve "in accordance with the prudential standards". Secondly, s 29E(1)(a) of the SIS Act imposes a condition on all RSE licensees that they must comply with RSE licensee law, including prudential standards (SIS Act, s 10).

23 *Superannuation (prudential standard) determination No.1 of 2012: Prudential Standard SPS 114 Operational Risk Financial Requirement*, [6]-[7].

24 *Superannuation (prudential standard) determination No.1 of 2012: Prudential Standard SPS 114 Operational Risk Financial Requirement*, [18]-[19].

determined tolerance limit, the RSE Licensee must implement a replenishment plan to replenish the reserve.[25]

The Financial Services Royal Commission

On 1 February 2019, the Final Report of the Financial Services Royal Commission was presented to the Governor-General. The Final Report included a significant focus on trustee duties and the role of regulators in the superannuation industry. Two findings are of particular significance for present purposes.

Dual-regulated entities

The Final Report noted that trustees holding dual roles presented a particular risk of conflicts of interest, as their duties as trustees of superannuation funds might, for example, conflict with duties owed as the responsible entity of a managed investment scheme. The proposed solution was a prohibition on trustees from assuming obligations that did not arise out of the holding of the office of trustee:[26]

> **Recommendation 3.1 – No other role or office**
>
> The trustee of an RSE should be prohibited from assuming any obligations other than those arising from or in the course of its performance of the duties of a trustee of a superannuation fund.

This recommendation was not intended to prevent RSE Licensees from acting as the trustee of more than one superannuation fund. Rather, its intention was to prevent trustees from assuming obligations of any other kind.[27]

In February 2020, an exposure draft of legislation was released that would give effect to Recommendation 3.1 of the Final Report.[28] The draft legislation would impose a new licence condition on RSE Licensees as follows:[29]

> [The] RSE licensee must not have a duty to act in the interests of another person, other

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25 *Superannuation (prudential standard) determination No.1 of 2012: Prudential Standard SPS 114 Operational Risk Financial Requirement*, [20].

26 Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Final Report* (Volume 1), 229.

27 Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Final Report* (Volume 1), 229.

28 Financial Sector Reform (Hayne Royal Commission Response — Protecting Consumers (2020 Measures)) Bill 2020: RSE licence condition — no other duty (FSRC rec 3.1) (Cth).

29 Financial Sector Reform (Hayne Royal Commission Response — Protecting Consumers (2020 Measures)) Bill 2020: RSE licence condition — no other duty (FSRC rec 3.1) (Cth), schedule 3.1.

than a duty that arises in the course of:

(a) performing the RSE licensee's duties, or exercising the RSE licensee's powers, as a trustee of a registrable superannuation entity; or

(b) providing personal advice.

Enforcement of trustees' covenants

The Final Report also noted that, at the time, breach of a covenant in the SIS Act did not attract any penal consequences (civil or criminal). Given the central importance of the covenants to the conduct of trustees, the enforcement measures were less direct than they should be.[30] The Final Report recommended that breach of the trustee's covenants should be enforceable by way of an action for civil penalty:[31]

> **Recommendation 3.7 – Civil penalties for breach of covenants and like obligations**
>
> Breach of the trustee's covenants set out in section 52 or obligations set out in section 29VN, or the director's covenants set out in section 52A or obligations set out in section 29VO of the SIS Act should be enforceable by action for civil penalty.

The Final Report noted that legislation had been introduced into Parliament which would make a breach of section 52A a civil penalty provision, but at that time the Bill had not yet been passed.[32]

The Improving Accountability Act

On 5 April 2019, the Improving Accountability Act was enacted. Amongst other amendments to the SIS Act, the Act removed sections 55(1) and (2) and incorporated those provisions in a new section 54B. New sections 54B and 54C provided:

> **54B Civil and criminal consequences for contravening sections 52 and 52A covenants**
>
> *Section 52 covenants*
>
> (1) A person must not contravene a covenant that:
>
> (a) is to the effect of a covenant set out in section 52; and
>
> (b) is contained, or taken to be contained, in the governing rules of a superannuation entity.

30 Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Final Report* (Volume 1), 260-262.

31 Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Final Report* (Volume 1), 262.

32 Treasury Laws Amendment (Improving Accountability and Member Outcomes in Superannuation Measures No 1) Bill 2017 (Cth); Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Final Report* (Volume 1), 261.

Section 52A covenants

(2) A person must not contravene a covenant that:

(a) is to the effect of a covenant set out in section 52A; and

(b) is contained, or taken to be contained, in the governing rules of a superannuation entity.

Contravention has civil and criminal consequences

(3) Subsections (1) and (2) are civil penalty provisions as defined by section 193, and Part 21 therefore provides for civil and criminal consequences of contravening, or being involved in a contravention of, those subsections.

(4) A contravention of subsection (1) or (2) does not result in the invalidity of a transaction.

(5) This section does not limit the operation of section 55.

Note: A contravention of subsection (1) or (2) may result in an action to recover loss or damage under section 55.

54C Other covenants must not be contravened

(1) A person must not contravene any other covenant contained, or taken to be contained, in the governing rules of a superannuation entity.

(2) A contravention of subsection (1) is not an offence.

(3) A contravention of subsection (1) does not result in the invalidity of a transaction.

(4) This section does not limit the operation of section 55.

Note: A contravention of subsection (1) may result in an action to recover loss or damage under section 55.

As amended by the Improving Accountability Act, section 55(3) now provides:

> Subject to subsection (4A), a person who suffers loss or damage as a result of conduct of another person that was engaged in in contravention of subsection 54B(1), 54B(2) or 54C(1) may recover the amount of the loss or damage by action against that other person or against any person involved in the contravention.

The Final Report of the Financial Services Royal Commission notes that the effect of these amendments was to create civil penalty provisions for breach of the covenants in sections 52 and 52A of the SIS Act. Pursuant to section 56 (2) of the SIS Act, trustees and directors may not be indemnified from liability under a civil penalty order, and that kind of liability cannot be excluded.[33] Further, criminal liability may be imposed in respect of a breach of covenant if certain conditions are met.[34]

[33] SIS Act, ss 56(2)(b) and 57(2)(b).
[34] SIS Act, s 202.

The IOOF Case

The IOOF Case was commenced by APRA in December 2018 following the taking of evidence in the Financial Services Royal Commission.[35]

In summary, APRA alleged that two trustee companies within the IOOF Group ('IIML' and 'Questor'), and two of their directors, had contravened covenants in sections 52 and 52A of the SIS Act. The alleged contraventions related to five incidents (described in the decision as 'CMT', 'Pursuit', 'Sweep', 'Bendigo' and 'Optus') affecting the funds. A recurring theme was the use of operational risk reserves to compensate members, rather than seeking compensation from other parties. In particular, APRA alleged that the relevant respondents had failed to: exercise the requisite degree of care, skill and diligence;[36] act in the best interests of beneficiaries;[37] and give priority to the interests of the beneficiaries in the event of a conflict of interest.[38]

Although no contravention was found on the evidence, a preliminary point considered by Jagot J was whether IIML and Questor were exempted from liability for contraventions of the section 52 covenants or alternatively could indemnify themselves from the assets of the trusts in respect of liability for such contraventions. The governing rules of each of the relevant trusts included provisions exempting the trustee (or the trustee and its directors) from liability, and in addition providing for indemnification from the assets of the fund.[39]

In her judgment, Jagot J noted that section 55(1) and (2) had been repealed by the Improving Accountability Act and replaced by section 54B(1) and (2) which were to the same material effect. While the case before her predated these amendments, Jagot J's conclusions about section 55 are equally applicable to section 54B.

In argument before Jagot J, APRA contended that IIML and Questor could not be exempted or indemnified from liability for contraventions of the covenants.[40] On APRA's construction of the provisions, the limitations in sections 56 and 57 were not exhaustive of the limitations on provisions in the trust instrument. Further, liability under section 55 of the SIS Act could not be modified or excluded by the trust instrument, otherwise the SIS Act would not apply according to its terms. APRA relied on section 7 of the Act, which provided as follows:

35 Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Final Report* (Volume 1), 234.
36 SIS Act, ss 52(2)(b) and 52A(2)(b).
37 SIS Act, ss 52(2)(c) and 52A(2)(c).
38 SIS Act, ss 52(2)(d) and 52A(2)(d).
39 *Australian Prudential Regulation Authority v Kelaher* [2019] FCA 1521 at [16]-[17].
40 *Australian Prudential Regulation Authority v Kelaher* [2019] FCA 1521 at [8], [18].

> This Act applies to a superannuation entity despite any provision in the governing rules of the entity, including any provision that purports to substitute, or has the effect of substituting, the provisions of the law of a State or Territory or of a foreign country for all or any of the provisions of this Act.

The respondents contended that the governing rules of the trusts excluded liability for contraventions of the covenants.[41] On their construction, the SIS Act permitted trustees to exclude liability for breaches of the covenants in section 52, subject only to the restrictions in section 56(2) and (2A) of the Act. Further, the cause of action in section 55(3) was not limited to the covenants in section 52 of the SIS Act and included any covenant in the governing rules of a superannuation entity. The respondents also pointed out that if a trustee could not be indemnified for liability under section 55(3), it would follow that a trustee or a director could not be indemnified for liability in respect of *any* breach of covenant in the trust deed, not just the section 52 covenants.

Justice Jagot adopted APRA's construction, concluding that a trustee's liability with respect to a section 55(3) action could not be excluded or made the subject of a right of indemnity, notwithstanding the provisions in section 56(1) and (2). Her Honour's detailed reasoning was as follows:

> 20 I do not find resolution of this aspect of the dispute straightforward. There are what appear to be anomalies on both approaches to construction. On balance, however, I consider that APRA's approach better reflects the provisions construed in the context of the SIS Act as a whole. This is because I consider s 7 of the SIS Act to be of fundamental importance to the resolution of this aspect of the dispute. By s 7 the SIS Act applies despite any provisions in the governing rules. Section 55(3) provided for a statutory cause of action, with its own limitation period and its own defences, which included compliance with all of the covenants in ss 52 to 53 (amongst others). If, by governing rules, a trustee may exclude liability under s 55(3) then it cannot be said that the SIS Act is being applied despite anything in the governing rules. Similarly, if, by governing rules, a trustee may indemnify itself out of the trust assets then it cannot be said that the SIS Act, specifically the statutory cause of action and limited defences, are being applied.
>
> 21 It may be accepted that s 56(1) uses the words "any liability", but the section is to be read in harmony with ss 7 and 55. Section 56(1) is also about provisions in the governing rules which are void because they purport to preclude or limit the trustee's right of indemnity in respect of any liability from the assets of the entity. The liability with which s 55 is concerned is that provided for in s 55(3). Section 56(1) is not purporting to operate on s 55(3). As such, it is not trespassing on the code which s 55 has created. Section 56(2), in contrast, is not a code of any kind.

[41] *Australian Prudential Regulation Authority v Kelaher* [2019] FCA 1521 at [8], [19].

> It is identifying some kinds of provisions of governing rules which will be void. The fact that liability under s 55(3) does not appear in the list of void provisions is immaterial. Section 55 operates according to its terms and, by s 7, despite any provision in the governing rules of a trust.
>
> 22 For these reasons, to the extent that the respondents' defences depended on the proposition that IIML and Questor could never have been liable under s 55(3) and would have had a right of indemnity under the trust instruments for any such liability, I do not accept those defences. If my conclusion is incorrect then, as the respondents submitted, APRA's case must fail. There is no allegation of dishonesty or an intentional or reckless failure to exercise the required degree of care, skill and diligence.

Her Honour's findings on this issue appear to represent a significant departure from the previous consensus amongst superannuation practitioners. As noted above, it had generally been assumed that trustees and their directors could limit their liability, or could claim to be indemnified in respect of breaches of the covenants in sections 52 and 52A, subject only to the exclusions in section 56 and section 57 of the SIS Act (including a failure to act honestly, and an intentional or reckless failure to exercise the requisite degree of care and skill).[42]

Justice Jagot noted at [20] of her judgment that she did not find the resolution of this issue to be straightforward. One possible reason for that is that the exercise of statutory interpretation needs to take into account the interrelationship between Part 6 of the SIS Act and trustee duties under the general law.[43] There are also a number of drafting anomalies within Part 6, which have been noted by several commentators.[44]

Having carefully considered Jagot J's reasons, and the history, context and language of the relevant provisions, I consider that her Honour probably erred, and that the better view is that a trustee or trust director may be exempted or indemnified in respect of a liability under section 55(3) of the SIS Act for a breach of covenant. My reasons follow.

An appropriate starting point for the analysis is the language and structure of sections 55, 56 and 57. In that respect, it seems to me that neither the arguments presented by APRA,[45] nor Jagot

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42 M Vrisakis and R Stringer (Herbert Smith Freehills), "The IOOF Case: The Federal Court Bursts the Royal Commission's 'Best Interests' Balloon" <https://www.herbertsmithfreehills.com/latest-thinking/the-ioof-case-the-federal-court-bursts-the-royal-commissions-best-interests>.

43 See, generally, K Lindgren, "A superannuation fund trustee's right of indemnity" (2010) *4 Journal of Equity* 85.

44 See JC Campbell, "Some Aspects of the civil liability arising from breach of duty by a superannuation trustee" (2017) 44 *Australian Bar Review* 24 at 73 and K Lindgren, "A superannuation fund trustee's right of indemnity" (2010) 4 *Journal of Equity* 85 at 87.

45 At least as summarised by Jagot J: [18].

J's reasons, come to grips with the different spheres of operation of section 55 on the one hand, and sections 56 and 57 on the other. I propose to refer to section 55 as Jagot J did, even though the same substantive provisions are now found in sections 55(3) and 54B.

Section 55 gives a person who suffers loss or damage as a result of conduct of another person that contravened the statutory covenants a right to recover the amount of the loss or damage against the person who contravened the covenants or against any other person involved in the contravention. That cause of action is subject to a 6-year limitation period and can only be instituted by leave of the court where the allegation is that directors of a trustee have contravened their covenants. The section does not mention, and does not appear to be aimed at, the trustee's right of indemnity which is specifically preserved by section 56. Nor does section 55 provide that the provisions of a trust instrument cannot exclude a trustee's liability for breach of trust generally, or more specifically for breach of covenants of the kind that are found in section 52.

In my view, the function and operative effect of section 55 is not altered by section 7 of the SIS Act. Section 7 is directed at provisions of the governing rules which purport to exclude the application of the SIS Act to a superannuation entity.[46] However, an exclusion of liability or indemnity does not prevent the application of section 55(3) to the superannuation entity. Even where a trustee has the benefit of an exclusion of liability, section 55(3) could still have application. For example, a trustee would still be liable under section 55(3) for a failure to act honestly.[47] In addition, a member could recover loss from a person "involved in the contravention" who does not have the benefit of a limitation of liability.[48] In my view, the heavy reliance that Jagot J placed on section 7 was misplaced. In particular, section 7 has equal application to sections 55 and 56 as provisions of the Act that apply despite any provision of the governing rules. It is therefore wrong to treat section 7 as if it bolstered section 55 in some way that directs that section 55 must be used to read down section 56.

Compared to section 55, section 56 performs an entirely different function. In terms, it invalidates the governing rules of a superannuation entity where they have one or other of a number of specified effects. Subject to the exclusions and requirements in subsections (2) and 2(A), section 56(1) invalidates any provision of the governing rules of a superannuation entity that purports to preclude a trustee from being indemnified out of the assets of the entity in respect of "any liability" incurred while acting as trustee of the entity. Likewise, it invalidates any provision that attempts to limit the amount of the trustee's indemnity. The provision is clearly intended to have a wide and general operation. As mentioned above, the expression "governing rules" is broadly defined in

46 See, eg, *Coshott v Prentice* [2014] FCAFC 88 at [25].
47 SIS Act, s 56(2)(a)(i).
48 SIS Act, s 53(3).

section 10 of the SIS Act, so that the effect of section 56(1) is to invalidate any provision of the general law, or any provision of state or territory legislation, or any provision within the terms of a trust instrument, that would prevent or limit the trustee having a right of indemnity for *all liabilities* incurred while acting as a trustee. This would include any liability incurred while purporting to act as a trustee, that is to say acting as a trustee but doing so in breach of trust or in breach of statutory covenants.

I agree with the construction that was placed upon section 56(1) by Mr Campbell QC in his illuminating article in the Australian Bar Review: [49]

> The way in which s 56(1) operates is by reading down any provision of the general law, of the state or territory legislation, or of the terms of the trust instrument, that would prevent the trustee having a right of indemnity for all liabilities incurred while acting as trustee. In particular it takes the general law rule that a trustee has a right of indemnity from the trust assets for liabilities properly incurred, and reads out any requirement that the liability be incurred 'properly', because that provision in the rule is inconsistent with the trustee having the full right of indemnity described in s 56(1). It also removes any express or implied provision in the trustee legislation of the States and Territories that prevents the trustee from having the full right of indemnity described in s 56(1). In this way s 56(1) has the effect of *requiring* there to be a right of indemnity for all liabilities incurred by the trustee while acting as trustee, but not actually conferring its own statutory right to indemnity.
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> (footnotes omitted)

Section 56(2) qualifies the general right of indemnity enshrined in subsection (1) by excluding certain categories of conduct from the scope of the indemnity, including dishonest, or intentional or reckless breaches of covenant, and liability under a civil penalty order.

Section 56(2A) then further qualifies the general right of indemnity in two ways. First, the trustee is precluded from indemnifying itself out of the fund's assets in respect of any amount expended out of capital. Secondly, the trustee is required to maintain and indemnify itself out of a reserve that must be maintained within the superannuation fund for the purpose of covering operational risks, or out of any other fund that the trustee manages and maintains to cover operational risk, before the trustee can have recourse to its right of indemnity against other fund assets.

Sections 56 and 57 utilise language that clearly appears to contemplate that a trustee or trustee director may be indemnified (or, in the case of section 56, also exempted) in respect of conduct which would constitute a breach of statutory covenant. For example, section 56(2)(a)(i) makes void any provision in the governing rules of a superannuation entity which would exempt or

[49] JC Campbell, "Some Aspects of the civil liability arising from breach of duty by a superannuation trustee" (2017) 44 *Australian Bar Review* 24 at 50.

indemnify a trustee against liability for breach of trust if the trustee fails to act honestly in a matter concerning the entity. This mirrors the content of the covenant in section 52(2)(a) (covenant to act honestly in all matters concerning the entity).[50] Similarly, section 56(2)(a)(ii) refers to a liability for breach of trust if the trustee intentionally or recklessly fails to exercise the degree of care and diligence that the trustee was required to exercise.[51] This appears to be directed at a subset of the content covered by the covenant in section 52(2)(b) (covenant to exercise the same degree of care, skill and diligence as a prudent superannuation trustee would exercise in relation to an entity).

Turning to Jagot J's reasons, her Honour observed that section 56 does not proport to create a code in relation to the exclusion of liability and indemnification, but simply identifies certain kinds of provisions of governing rules which will be void. In contrast, Jagot J seemed to consider that section 55 established a code upon which section 56(1) did not trespass. I do not think that the characterisation of each provision as a code, or not a code, is helpful. It is more helpful to identify the precise sphere of operation of each particular provision, as I have attempted to do. Furthermore, it seems to me that Jagot J gave inadequate weight to the way in which section 56(1) is directed to "any liability" of the trustee. Section 56(1) may not mention section 55(3), but it clearly intends that the trustee should have a right to be indemnified out of the assets of the superannuation fund in respect of any liability incurred while it is acting as trustee of the entity. In this way, section 56(1) harnesses the right of indemnity that is available under the general law but frees it from any restrictions other than those imposed by section 56(2) and (2A).

Another weakness in her Honour's reasoning is that she does not appear to distinguish between an exclusion of liability and an indemnity in respect of that liability. The question of whether a trustee is liable under section 55(3) is separate from the question whether the trustee enjoys a right of indemnity in respect of that liability.[52] In the latter case, the trustee has a liability under section 55(3), but is able to call on an indemnity. By way of example, if a small group of members suffer a loss as a result of a negligent unit pricing error and claims against the trustee under section 55(3), the trustee would be liable, but could obtain an indemnity from the assets of the fund. The net result of the liability under section 55(3) and the indemnity would, in effect, distribute the impact of the loss amongst all members. In the case of an indemnity, therefore, the reasoning at [20]-[21] of the decision that section 55 of the Act is not being applied is difficult to sustain.

50 See also s 57(2)(a)(i) and 52A(2)(a) in respect of the position of directors.

51 See also s 57(2)(a)(ii) and 52A(2)(b) in respect of the position of directors.

52 K Lindgren, "A superannuation fund trustee's right of indemnity" (2010) *4 Journal of Equity* 85 at 93.

There is, of course, a fundamental difference between the concepts of indemnity from liability and exemption from liability. A trustee has a right of indemnity under the general law which can be enlarged or narrowed by the provisions of a particular trust instrument. Section 56(1) operates upon that general law right of indemnity and effectively enhances it, but subject always to the qualifications and exclusions in section 56(2) and (2A). In contrast, whether or not a trustee is exempted from liability depends on the terms of the particular trust instrument. There is no equivalent general law right. Section 56(1) does not address, and does not have any impact upon, the provisions of a trust deed that may exempt a trustee from liability in certain specified respects. Section 56(2) addresses both indemnification and exemption from liability, but that is to ensure that the governing rules can never exempt a trustee or indemnify a trustee in respect of liabilities of the kind specified in subsection (2). The remaining provisions of section 56, namely subsections (2A) and (3), are directed towards the question of indemnity.

In the circumstances described in the preceding paragraph, the part of Jagot J's conclusion that is directed towards exemptions from liability is perhaps more understandable. In short, there might be an argument that the absolute requirement that the governing rules must be taken to contain the covenants listed in section 52 and 52A, coupled with the conferral of a specific cause of action for breach of covenants in the governing rules, is inconsistent with the inclusion of an exemption from liability for breach of such covenants (section 56). The riposte, though, might be that if the power of exemption was intended to be limited in this way, it would have been expressly stated in section 56(2). But instead of doing that, the premise that underlies section 56(2) is that governing rules may exempt a trustee from liability in any respect, save and except for dishonest breaches of covenant and the other categories of liability listed in section 56(2).

Her Honour's process of reasoning also has far-reaching and perhaps unintended consequences. The statutory cause of action in section 55(3) is not limited to contraventions of the statutory covenants in sections 52 and 52A. It extends to contraventions of section 54C(1), which contains a prohibition on contravention of "any other covenant contained, or taken to be contained, in the governing rules of a superannuation entity". Given the wide definition of "governing rules" in section 10 of the SIS Act, and following her Honour's reasoning at [20]-[21], it would appear that it is not possible for a trustee or director to exclude liability or to obtain an indemnity for a section 55(3) liability in respect of a contravention of *any* covenant in the trust deed or other documents governing the operation of the trust.

Some unresolved issues

It appears to me that the reasoning in the IOOF Case leaves a number of unresolved questions.

First, the status of this aspect of Jagot J's judgment as a matter of precedent is unclear. On the one hand, her Honour appeared to treat the resolution of this issue as a "necessary step in reaching [her] conclusion".[53] She treated the matter as a preliminary issue that she resolved in her judgment.[54] On the other hand, Jagot J's factual findings meant that the result of the issue did not determine the outcome of the case. Had Jagot J reached a different conclusion on the issue, APRA's case would still have failed.[55] Accordingly, it might be arguable that her Honour's observations are *obiter dicta*. A statement of principle, which, if decided differently, would not alter the outcome of the case, is generally considered to be *obiter dicta*.[56] But I doubt that these technical arguments will make much difference in practice, because her Honour's conclusion on the issue will be treated with great respect. At the very least, her Honour's interpretation will be regarded as highly persuasive. It is likely to be followed by a single judge unless that judge can be persuaded that her Honour's conclusion was clearly wrong. Moreover, Jagot J's judgment appears to represent the only judicial consideration of the issue to date. APRA has announced that it does not intend to appeal the decision in the IOOF Case.[57]

Secondly, it is difficult to determine how far the reasoning in the IOOF Case extends. As discussed above, her Honour's reasoning appears to indicate that a trustee or director cannot be excused or indemnified in respect of a liability under section 55(3). On her Honour's reasoning, it would appear to follow that it is not possible for a trustee or director to exclude liability or to obtain an indemnity for a section 55(3) liability in respect of a contravention of *any* covenant in the trust deed or other documents governing the operation of the trust.

Thirdly, it is unclear to what extent her Honour's reasoning would apply to other statutory rights and remedies in the SIS Act. Although her Honour only addressed the cause of action in section 55(3) of the SIS Act, her Honour's reasoning (and in particular, her reliance on section 7 of the SIS Act) could potentially extend to other statutory rights and remedies.

Fourthly, the IOOF Case did not consider the differences between the way in which the trustee's right of indemnity is addressed in section 56, and the way in which a trustee director's rights of indemnity are addressed in section 57. Subject to subsections (2) and (2A), section 56 preserves and enhances the rights of indemnity available to trustees under the general law and state or territory legislation. In contrast, section 57 is merely permissive in relation to the potential right of

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53 See, eg, *New Cap Reinsurance Corporation Ltd (in liq) v AE Grant* (2008) 221 FLR 164 at [82]-[83]. See also P Herzfeld, T Prince and S Tully, *Interpretation and Use of Legal Sources: The Laws of Australia* (Thomson Reuters, 2013) at [25.4.400].

54 *Australian Prudential Regulation Authority v Kelaher* [2019] FCA 1521 at [8], [22].

55 *Australian Prudential Regulation Authority v Kelaher* [2019] FCA 1521 at [22].

56 *Bristol-Myers Squibb Co v FH Faulting & Co Ltd* (2000) 97 FCR 524 at [150].

57 Australian Prudential and Regulatory Authority, Media Release (17 October 2019) <https://www.apra.gov.au/news-and-publications/apra-to-not-appeal-ioof-judgment>.

a trustee director to claim indemnity from the trust fund. Subject to the excluded liabilities in section 57(2) (which match those in section 56(2)), section 57(1) merely states that the governing rules of a superannuation entity may provide for a director of the trustee to be indemnified out of the assets of the entity in respect of a liability incurred while acting as a director of a trustee. Similarly, section 57(3) provides that a director may be indemnified out of the assets of the entity in accordance with provisions of the entity's governing rules that comply with section 57. Because there is no underlying general law right of indemnity relating to trustee directors, section 57 falls well short of requiring that the governing rules make provision for the indemnification of directors. But putting these differences to one side, and subject to any potential conflict with section 197 of the *Corporations Act 2001* (Cth), there is no reason why the governing rules of a superannuation entity could not provide for a director to be indemnified in respect of the director's negligent breaches of covenant, including negligent breaches of the covenants applicable to a director under section 52A.

Incidentally, there is a peculiarity about section 57 that should be noted. The reference to section 241 of the *Corporation Act 2001* (Cth) is no longer apposite. That section of the *Corporations Act* previously dealt with the grant of an indemnity to directors for negligence, but the relevant provision is no longer found in section 241. Rather, it is found section 199B. That provision precludes a company indemnifying a person, including a director, for, inter alia, a liability that is owed to the company itself or a related body corporate, or a liability arising under a pecuniary penalty order or certain compensation orders. In so far as any reliance can be placed upon the outdated reference to section 241 of the *Corporations Act*, it would seem to indicate that section 57 was not excluding the possibility that the governing rules of the superannuation entity could indemnify a director for breach of trust or for breach of the covenants referred to in section 52A of the SIS Act.

Fifthly, it is unclear whether a trustee may insure against a section 55(3) liability in respect of a breach of covenant. On one view of her Honour's reasoning, liability insurance could amount to an indirect indemnity which could have the effect that "it cannot be said that the SIS Act is being applied".[58]

Finally, assuming the correctness of Jagot J's decision on this point, it raises a question as to the treatment of previous uses by trustees and their directors of exclusions of liability and indemnities. If a trustee has previously obtained an indemnity in respect of a liability under section 55(3) of the SIS Act, there may be a potential for members to seek restitution of the amount of the indemnity.

[58] *Australian Prudential Regulation Authority v Kelaher* [2019] FCA 1521 at [20].

Observations on the operation of the covenants

For completeness, it should be noted that there are several aspects of the decision in the IOOF Case which may provide reassurance to trustees and their directors. At several points in her judgment, Jagot J observed that: the role of the trustee is not to act as an insurer to the beneficiaries of the trust; and not every error by the trustee constitutes a breach of covenant.[59] At [39], she stated:

> The respondents referred to the fact, which I accept, that a trustee's duty does not amount to a duty to avoid all loss and that an ordinary prudent person (and for that matter prudent superannuation trustee) can commit errors of judgement without being liable: *In re Chapman* [1896] 2 Ch 763 at 765; *Jacobs' Law of Trusts in Australia* (8th ed, 2016), at [17]-[18].

Practical Issues

The cumulative effect of the three developments discussed in this paper appears to be an increased risk of liability for superannuation trustees and their directors. I intend to focus on three practical issues that may arise from the developments discussed in this paper:

(a) the ability of superannuation fund trustees to attract directors;

(b) the impact on industry superannuation funds (as opposed to retail funds); and

(c) potential avenues to mitigate the risk of liability.

Impact on directors

If the risk of personal liability for directors is substantially increased, trustee companies may face difficulties attracting talented directors. At the time the SIS Act was introduced, it was recognised that individuals may be unwilling to assume the role of trustee unless they received some protection against the risk of personal financial loss.[60] The limited indemnity recognised in sections 56 and 57 of the SIS Act was informed by that policy rationale.

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59 *Australian Prudential Regulation Authority v Kelaher* [2019] FCA 1521 at [6], [38]-[39], [138], [524], [702], [789].

60 John Dawkins, *Strengthening Super Security: New Prudential Arrangements for Superannuation: Statement by the Honourable John Dawkins MP, Treasurer of the Commonwealth of Australia* (Australian Government Publishing, 1992).

Superannuation regulation is already notoriously complex. As noted by the authors of Jacobs' Law of Trusts in Australia: [61]

> It is obvious that the legislature has chosen to regulate superannuation trusts in a close and detailed way. Apart from the general law, it is necessary to consider the effect of the SIS Act, the SIS Regulations made pursuant to various sources of power, the prudential standards made under section 34C, and the operating standards prescribed under section 31(1). Among other aspects of regulation not mentioned above, there are also RSE licensee conditions imposed by section 29E. This structure has, not without cause, been criticised. It is complex. In practice the changing requirements can be inaccessible, generating a risk of inconsistency. It involves the devolution of wide law-making powers to persons other than the legislature.
> (footnotes omitted)

In that context, an increased risk of personal liability has the potential to deter talented directors from assuming positions on the boards of trustee entities.

The prospect of civil penalties for breaches of statutory covenants,[62] or liability for breaches of covenant which cannot be indemnified,[63] may raise significant concerns for directors. The covenants in section 52A of the SIS Act encompass a broad spectrum of obligations. Section 52A(b) and (f) impose obligations of care, skill and diligence on directors. There is also significant uncertainty regarding the scope of some of the covenants. For example, the difficulties surrounding the application of the "best interests" covenant have been considered by a number of authors.[64] Submissions made to the Financial Services Royal Commission indicated that in some fact situations some trustees had difficulty understanding when and how the covenant applied.[65] It should be noted that the SIS Act contains a number of relevant defences and limitations,[66] however, these are unlikely to provide significant comfort for directors.

If in due course the courts reject Jagot J's construction of section 55 and section 56, perhaps by preferring the kind of analysis I have advanced, then trustees and trustee company directors would find themselves in a slightly more protected position. To my mind, that is the balance that

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61 See, eg, JD Heydon and MJ Leeming, *Jacobs' Law of Trusts in Australia* (8th ed, 2016) at [29-41].

62 SIS Act, s 54B(3).

63 SIS Act, s 55(3).

64 See, eg, The Hon Justice MK Moshinsky, "The Continuing Evolution of the 'Best Interests' Duty for Superannuation Trustees from *Cowan v Scargill* to the Current Regulatory Framework" (Speech given at the 2018 Superannuation Conference: Order in the House, 9 March 2018) and David Pollard, "The Short-form 'Best Interests Duty' – Mad, Bad and Dangerous to Known: Part 2 – The Problems and a Suggested Better Formulation" (2018) 32 *TLI* 176.

65 Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Final Report* (Volume 1), 225.

66 See, eg, SIS Act, ss 55(4)(A), 55(4)(B), 55(6), s 221, 310 and 323.

the legislation has sought to achieve through the provisions of section 56 and section 57, and the exclusions and restrictions contained in section 56(2) and (2A) and section 57(2). There are sound policy reasons for allowing a trustee or trustee company director to exercise a right of indemnity in limited and appropriate cases even, where the liability concerns a breach of trust or a breach of statutory covenant. It affords protection to those who take on such onerous roles in the interest of members, and where the risk of negligent breaches of covenant must be a constant concern. It also ensures that creditors dealing with the trustee can have the security of knowing there can be some recourse to the trust fund through the trustee's rights of indemnity. On the other hand, any overreach, and any risk of incentivising poor business practices, is addressed by the exceptions and restrictions on the right of indemnity that are found in the subsections of section 56 and section 57.

Impact on industry funds

The increased focus on trustee and director liability may have a disproportionate impact on industry superannuation funds. Industry superannuation funds are generally operated on a non-profit basis. Typically, industry funds recoup operating costs through either: (i) drawing on the assets of the fund using a right of indemnity; and/or (ii) charging a fee (deducted from the assets of the fund).

This structure may render trustees of industry superannuation funds particularly vulnerable to liability risks that cannot be excluded or indemnified. In contrast to retail funds, where the trustee entity is often a subsidiary of a large financial services group and can draw on the group's financial resources in the event of an operational error by the trustee,[67] industry funds rarely retain significant capital which could cover such a liability. The issue may be compounded by the draft legislation giving effect to Recommendation 3.1 of the Final Report of the Financial Services Royal Commission,[68] which may further limit the ability of superannuation trustees to draw capital from other sources.

It appears to me that trustees may need to consider increasing fees drawn from members in order to meet liability risks. Otherwise, the potential for such liabilities may place trustees at greater risk of insolvency.

67 JC Campbell, "Some Aspects of the civil liability arising from breach of duty by a superannuation trustee" (2017) 44 *Australian Bar Review* 24 at 50.

68 Financial Sector Reform (Hayne Royal Commission Response — Protecting Consumers (2020 Measures)) Bill 2020: RSE licence condition — no other duty (FSRC rec 3.1) (Cth), schedule 3.1.

Risk mitigation

Finally, I make some observations about potential measures available to trustees to mitigate the impact of the developments discussed in this paper.

Liability insurance may provide a partial solution to reduce the risks to trustees and directors. However, following the Financial Services Royal Commission, there appears to be an industry trend towards higher premiums and reduced coverage in the financial services sector. According to a December 2019 publication by insurance broker Marsh:[69]

> In this environment of heightened scrutiny and more onerous legal exposure, the [Directors' and Officers' Insurance] market finds itself in the midst of a perfect storm: greater risk, higher premiums, lesser coverage, increased retentions and lower limits.

Trustees may also seek to take greater advantage of judicial advice. Each state and territory permits trustees to seek judicial advice.[70] Although the approaches vary between States and Territories, there is unlikely to be any difference in practice.[71] The purpose of such advice is both to provide protection for the interests of the trust and to provide personal protection to the trustee; it follows that the advice is private advice.[72]

In practice, judicial advice may be of utility to trustees in determining significant, discrete questions affecting the fund. Examples of decisions where judicial advice may be useful include: whether to commence or defend proceedings; whether an asset should be sold; or the interpretation of the terms of the trust.[73] The advice will generally state whether a trustee is justified in taking or abstaining from action. However, it is not the function of the court to tell the trustee what to do.[74] Accordingly, it is not feasible for trustees to obtain advice from the Court on day-to-day issues affecting the fund.

Trustees should also be aware they may seek advice from other sources. Section 56(3) of the SIS Act recognises that trustees may seek advice from any person in respect of any matter

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69 See, eg, Marsh JLT Specialty, *The D&O Insurance Wave: Staying Above Water* (December 2019).

70 See, eg, *Supreme Court (General Civil Procedure) Rules 2015 (Vic)*, r 54.02; *Trustee Act 1925* (NSW), s 63.

71 The Hon Chief Justice S Kiefel AC, "Judicial Advice to Trustees: Its Origins, Purposes and Nature" (2019) 42 *Melbourne University Law Review* 993.

72 *Macedonian Orthodox Community Church St Petka Inc v His Eminence Petar The Diocesan Bishop of The Macedonian Orthodox Diocese of Australia and New Zealand* (2008) 237 CLR 66 at [64], [195].

73 The Hon Chief Justice S Kiefel AC, "Judicial Advice to Trustees: Its Origins, Purposes and Nature" (2019) 42 *Melbourne University Law Review* 993.

74 *Re Application of NSW Trustee and Guardian* [2014] NSWSC 423 at [24].

relating to the performance of the duties or the exercise of the powers of the trustee. Similarly, Jagot J recognised in the IOOF Case that it may be appropriate in some circumstances to rely on advice from management.[75]

Conclusion

As I have noted in this paper, Part 6 of the SIS Act performs a central role in the conduct of superannuation trustees and their directors. It is the product of numerous legislative amendments and reflects a complicated balance of competing policy concerns.

In this paper, I have sought to examine a number of discrete issues relating to the operation of Part 6 of the Act. Many of these issues remain unresolved. Until further consideration by the courts or the legislature, it appears that trustees and their directors may remain in an uncertain position in relation to their liability.

[75] *Australian Prudential Regulation Authority v Kelaher* [2019] FCA 1521 at [41].