DOMINIQUE HOGAN-DORAN RITP
Senior Counsel,
5 Wentworth Chambers

legal update

A MATTER OF TRUST

Insolvency of regulated superannuation trusts and their licensed trustees.

The potential insolvency of regulated superannuation trusts and their licensed trustees has now been examined in a series of superior court decisions. Commencing with *Re QSuper Board* [2021] QSC 276[1] and recently with *AUSCOAL Superannuation Pty Ltd atf the Mine Superannuation Fund; Application for Judicial Advice* [2024] NSWSC 32, the decisions highlight the complex interplay of statutory and general law precepts, as well as the important role of the industry's prudential regulator, APRA.

REGULATORY CONTEXT

It is well understood that a trust comprises two distinct *economic* entities – the trustee and the trust itself – but insolvency law recognises only one of them, the *legal* entity that is the trustee.[2] The general law currently does not address a situation where the trustee is solvent while the trust is *not*.[3] There is no dedicated statutory regime that protects stakeholders' rights or informs the allocation of assets when trusts become insolvent.

ARITA's position is that, for the purposes of insolvency law, trusts should be treated as economic entities (but *not* legal entities) separate from their trustee, and legislation should enliven the existing insolvency regimes so they can be applied to insolvent *trusts* as if they were standalone entities.[4]

Conceptually, this reflects the approach to insolvency issues for regulated superannuation trusts, the *Superannuation Industry (Supervision) Act 1993* (Cth) (SIS Act) and regulations[5] recognising a registrable superannuation entity (RSE) as a separate entity.[6] The Commonwealth Parliament has chosen to regulate such trusts and their trustees in a close and detailed way.[7] Even so, RSEs and their licensed trustees remain affected by the entire body of trusts law and the State/Territory trustee legislation.[8]

As the principal regulator of the Australian superannuation industry, APRA self-describes its role as including it being a '*resolution authority*'. In this sense, APRA seeks to ensure that any failures that do occur will be *orderly* failures. An orderly failure is one "where the entitlements of protected beneficiaries and the stability of the financial system remain intact".[9] APRA's role is thus conceptually similar to the role of an insolvency practitioner "but with a different objective" – an insolvency practitioner manages a failed entity in the interests of its creditors, while APRA manages a failed or failing entity in the interests of its protected beneficiaries and the financial system.

The systemic significance of instability and disorder in the Australian superannuation industry is clear; total superannuation assets amount to some $3.56 trillion.[10]

1 The *QSuper Board* case was the first of 14 so-called '*Section 56 Cases*', triggered by amendments to the trustee indemnity provision in s 56 of the *Superannuation Industry (Supervision) Act 1993* (Cth) (SIS Act) pursuant to the *Financial Sector Reform (Hayne Royal Commission Response) Act 2020* (Cth). **2** Under the general law, a trust is not a juristic person with a legal personality distinct from that of the trustee and beneficiary. It is an equitable obligation binding a person to deal with property that is owned and controlled as a discrete fund, segregated from the personal estate of the trustee, to carry out particular purposes, or for the benefit of particular persons (beneficiaries), who may enforce the obligation. See further J. D Heydon & M Leeming, *Jacob's Law of Trusts in Australia* (Lexis Nexis, 8th edn, 2016) (*Jacobs*), 1 [1-01]. **3** If a trust does not have an external creditor, that is someone other than the trustee or a beneficiary, then it cannot be insolvent. **4** See *ARITA Submission to the Parliamentary Joint Committee on Corporations and Financial Services Corporate Insolvency in Australia Inquiry*, 30 November 2022. The Committee subsequently recommended that the government amend the Corporations Act "*to expressly clarify the treatment of trusts with corporate trustees during insolvency*". **5** *Superannuation Industry (Supervision) Regulations 1994 (Cth)* (SIS Regulations). **6** SIS Act, s 10 (a 'registrable superannuation entity' means (a) a regulated superannuation fund, (b) an approved deposit fund or (c) a pooled superannuation trust, but does not include a self-managed superannuation fund). A "regulated superannuation fund" is a superannuation fund in respect of which there has been compliance with s 19(1) of the SIS Act, i.e. the fund must have a trustee (ss (2)), the trustee is a constitutional corporation pursuant to a requirement contained in the governing rules, or the governing rules provide that the sole or primary purpose of the fund is the provision of old-age pensions (ss (3)), and the trustee has given to the Commissioner of Taxation a signed written notice in the approved form (irrevocably) electing that the SIS Act is to apply in relation to the fund (ss (4)). **7** *Jacobs*, 641 [29-41]. **8** *Trustee Act 1925* (ACT); *Trustee Act 1925* (NSW); *Trustee Act 1893* (NT); *Trusts Act 1973* (Qld); *Trustee Act 1936* (SA); *Trustee Act 1898* (Tas); *Trustee Act 1958* (Vic); *Trustees Act 1962* (WA). **9** APRA Executive Director Policy and Advice Division Renée Roberts – Speech to Risk Management Institute of Australasia Annual Conference, 2022. **10** APRA Quarterly Superannuation Statistics for September 2023 (21 November 2023).

Growing geopolitical risk, rising interest rates and high inflation, the growing threat of cyber-attacks, and increased frequency of natural disasters has prompted APRA to prioritise activities that address these key challenges, including building the resilience of superannuation funds and their trustees as part of a stronger, more stable financial system.[11]

INSOLVENCY OF RSE LICENSED TRUSTEE

The SIS regime provides for the comprehensive regulation and supervision of RSEs, their trustees, directors and officers.[12] These include a responsibility on the RSE licensed trustee board for maintaining the solvency of the trustee, and ensuring that the trustee's business operations have adequate resources to undertake the activities for which it holds its RSE licence.[13]

A rationale for such close regulation can be explained by the fact that superannuation trusts are different in nature from traditional trusts,[14] including because the beneficiaries are not volunteers, there is an underlying contract of employment to all superannuation schemes, the size of the trust fund is variable over time, the employers' continuing financial interest, and the prevalence of a power to amend the rules governing the scheme.[15]

The legislative overlay is not static, and has been subject to ongoing change. Since the *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry* there have been significant increases in the regulatory requirements imposed on RSE licensed trustees and sanctions for their non-compliance.[16] These changes have meant that RSE licensed trustees are exposed to an ever widening range of potential liabilities, in a broader range of circumstances (including where they have not engaged in criminal conduct nor acted dishonestly). In particular, improper exercise of an RSE licensed trustee's powers or discretions could result not only in claims by members for compensation,[17] or under the general law,[18] but expose the RSE licensed trustee to a pecuniary fine or penalty.[19] Importantly, changes to s 56(2) and 57(2) of the SIS Act, with effect from 1 January 2022, expressly preclude

> "The general law currently does not address a situation where the trustee is solvent while the trust is not.

indemnification out of RSE assets for a liability for an amount of a criminal, civil or administrative penalty, incurred by the trustee in relation to a contravention of a Commonwealth law,[20] or payment of any amount payable under a Commonwealth infringement notice.[21]

Consequently, commencing in late 2021, numerous RSE licensed trustees approached their applicable state Supreme Courts for their advice, opinion or direction as to whether they would be justified in amending their trust deeds to authorise the charging of fees, with the view to building a financial contingency reserve on the trustee balance sheet to protect against insolvency risk. Whilst some RSE licensed trustees already enjoyed a fee-charging power (particularly those in the retail sector), this was not the case for those in the industry (or "profit to member") funds sector.

In reasoning consistent across the various judgments, the courts recognised that, without the ability to build and maintain a contingency reserve, an otherwise well run and well performing RSE licensed trustee could be rendered insolvent by even a minor operational administrative error

11 The cross-industry Prudential Standards *CPS 190 – Recovery and Exit Planning* and *CPS 900 – Resolution Planning* came into effect on 1 January 2024 for banks and insurers and will take effect from 1 January 2025 for RSE licensees. CPS 190 requires APRA-regulated institutions to contemplate the sort of severe financial stress scenarios that may threaten their viability, and then to put in place a financial contingency plan in order to successfully navigate these scenarios. Like CPS 190, CPS 900 is concerned with successfully navigating a crisis, but unlike CPS 190, CPS 900 focuses on what happens post-failure. **12** See especially the covenants implied by SIS Act ss 52(2) and 52A(2). **13** APRA Prudential Standard *SPS 220 - Risk Management* (in force 1 January 2020). **14** See *Commonwealth Bank Officers Superannuation Corporation Pty Ltd v Beck* [2016] NSWCA 218; (2016) 334 ALR 692 at [89]-[91] (Bathurst CJ, Macfarlan and Gleeson JJA agreeing). **15** Lord Browne-Wilkinson, 'Equity and its Relevance to Superannuation Schemes Today' in M. Scott Donald & Lisa Butler Beatty (eds), *The Evolving Role of Trust in Superannuation* (The Federation Press, 2017), 58, esp 60-62. **16** These substantive changes in the "regulatory landscape" are summarised by Kelly J in *Re QSuper Board* [2021] QSC 276 at [19]-[30]. **17** Pursuant to SIS Act, s 55(3). **18** See further Professor the Hon. J Campbell, 'Some aspects of the civil liability arising from breach of duty by a superannuation trustee' (2017) 44 *Australian Bar Review* 24. **19** SIS Act, ss 54B(3) and 202(1). **20** SIS Act, s 56(2)(b). **21** SIS Act, s 56(2)(c).

punishable by a fine or penalty. The trustee indemnity changes themselves created a risk to the financial resilience of the applicant RSE licensees, introducing instability in their role as a superannuation trustee. The disorderly failure of an otherwise sound and sustainable RSE licensed trustee is likely to be severely detrimental to members, as it would likely impose material costs and create significant operational risks.

The judgments reflected a practical realism about the application of insolvency regimes to RSE licensed trustees. Part 17 of the SIS Act provides for arrangements in the event of actual or threatened insolvency of an RSE licensed trustee. In the case of insolvency, APRA would be required to appoint an acting trustee to prevent adverse impacts on members and ensure stability of the governance of the fund until a new long-term trustee could be identified and be ready to take over. However, the route to acting trustee is complex, certain triggers need to be satisfied, and it requires a specific licence.[22] Distinct from an acting trustee, to install a long-term future trustee to run the fund as a viable going concern would take considerable time. Given legal requirements, including ensuring its existing members are not disadvantaged, such a trustee would need to engage in due diligence. It would also need to be ready to harmonise operations, technology and platforms used for administration. As is now widely acknowledged, it is not a quick or easy fix.

RSE licensed trustees have long been obliged to hold a risk reserve *within* the fund to meet operational risk events.[23] The Section 56 Cases authorised many RSE licensed trustees to establish separate trustee capital reserves quarantined from the assets of the fund. In supporting this trustee capital reserving, the Section 56 Cases made careful distinctions between trust assets and trustee assets. If not addressed in the trust deed, a future question to resolve is what will happen to these different reserves on any wind up. Industry members have argued that holding separate reserves to meet different liability risks is an inefficient use of members' funds, prompting calls for a *single* risk reserve with flexible allowable use to meet a range of contingency scenarios.[24]

INSOLVENCY OF RSE

In practice, the disorderly insolvency of an RSE should be a rare, and avoidable, event. The SIS regime seeks to manage potential insolvency threatened by employer underfunding or industry collapse, by providing for periodic valuations and funding plans to restore the fund (or sub-fund) to a 'satisfactory financial position'.[25] If a fund is ever adjudged as 'technically insolvent'[26] the trustee must either implement a program to restore solvency within five years, or initiate winding-up of the fund.[27]

There is a dearth of authority on the winding-up of an insolvent trust.[28] That is unsurprising, because a trust does not have creditors or debtors: the trustee is personally liable to creditors and entitled as against debtors, but has a right of indemnity against trust property to satisfy its liabilities to creditors (and a duty to account to beneficiaries in respect of recoveries from debtors).

Under the various State and Territory trustee legislation, there is no statutory right or power to wind up or terminate a trust, and generally speaking it is unconventional to speak of "winding up" a trust.[29] Moreover, even the notion of a trust being "terminated" is somewhat misleading, as the absence of trust property does not necessarily relieve a trustee of responsibility in respect of antecedent breaches.[30] The "winding up" of a trust involves no more and no less than the transfer of the trust property to those beneficially entitled under and in accordance with the trust instrument, which has the consequence that, there being no longer any trust property in the hands of the trustee, the trusts are extinguished.[31]

The SIS regime deals with the insolvency of superannuation trusts in a manner that may require the winding up of a fund, or other action, in circumstances that may arise independently of a decision made by the trustee of the fund to terminate it. Part 9, Div 9.4 of the SIS Regulations deals with the winding up of defined benefit funds, and Div 9.7 the winding up of accumulation funds. The different treatment is required because of the essential differences between defined benefit and accumulation interests. In an accumulation

22 There is a separate RSE licence class for acting trustees who may act as trustee during the period of suspension or vacancy of a trustee of a RSE: see SIS Act, s 29B(4) and SIS Regulations, reg. 3A.03A **23** See APRA Prudential Standard *SPS 114 - Operational Risk Financial Requirement* (in force 1 July 2013). APRA is currently consulting on proposed amendments to SPS 114 and its associated guidance. **24** See submission by the Australian Institute of Superannuation Trustees dated 17 February 2023 to the APRA consultation on financial resources for risk events in superannuation. **25** See SIS Regulations, Division 9.3 (Funding and solvency of defined benefit funds) and APRA Prudential *Standard SPS 160 - Defined Benefit Matters* (in force 28 June 2013). An overview of the regulations is set out in *Ansett Australia Ground Staff Superannuation Plan Ltd v Ansett Australia Limited* [2002] VSC 576; (2002) 174 FLR 1, at [43]-[44] (Warren J). **26** SIS Regulations, reg 9.16. **27** SIS Regulations, reg 9.17. **28** Other than in the context of managed investment schemes, in respect of which corporate analogies are provided by statute. Section 601EE of the *Corporations Act 2001* (Cth) makes specific provision for the court to make such orders as "*it considers appropriate*" for the winding up of an unregistered scheme. **29** See *Park & Muller (liquidators of LM Investment Management Ltd) v Whyte (receiver of the LM First Mortgage Investment Fund)* [2015] QSC 283 at [19]; *Fordyce v Ryan* [2016] QSC 307 at [50]. **30** *Austec Wagga Wagga Pty Limited (in liq)* [2018] NSWSC 1476 (*Austec*), [13] (Brereton JA). **31** *Austec*, [14].

fund, a member's entitlement depends solely on contributions made by or on behalf of that member, the performance of the fund and the fees charged: thus it is the member who bears the risk of market fluctuations. As a result, a member's account balance in an accumulation fund is calculated and fluctuates daily depending on fund performance and on the rules of the fund for calculating and allocating surpluses and deficits between members. In a defined benefits fund a member is entitled to a calculated amount irrespective of the value of the fund at any given time: thus a member is 'insulated' from market movements. In this way, under a defined benefits plan, a member's entitlements are 'effectively' guaranteed by their respective employers.[32]

Whilst external creditors of an RSE (including the RSE licensed trustee itself) can expect to receive priority over the beneficiaries of the RSE, a question arises as to whether there will be any priority given as *between* beneficiaries on the winding up of an RSE. Where the RSE is a 'hybrid' fund consisting of different cohorts with defined benefits and with defined contribution (accumulation) interests, will all members be treated as a single class of beneficiary, despite holding very different beneficial interests?

In *AUSCOAL Superannuation Pty Ltd atf the Mine Superannuation Fund; Application for Judicial Advice* [2024] NSWSC 32 (*Mine Super*), Robb J addressed the difficulties arising from the application of Pt 9 of the SIS Regulations to a potential deficit scenario of a '*hybrid*' superannuation fund – one that provides both accumulation and defined benefit interests. Difficulties arose in relation to (a) how the SIS Regulations categorise individual funds as being defined benefit or accumulation funds; and (b) how the SIS Regulations distinguish between funds and sub-funds.[33]

The advice of Robb J indicates that for other RSE trustees with defined benefit members, whether Divs 9.4 and 9.7 can be applied separately to their membership cohorts will depend upon:

a) the proper construction of the SIS Regulations, in particular the meaning to be given to "defined benefit fund" in the context of those Divisions, having regard to the ordinary principles of statutory construction
b) the existence of any exemption or modification of the SIS Regulations made by APRA in exercise of its powers under s 328 or 332 of the SIS Act, respectively, and
c) the application of that construction, exemption or modification to the trust deed for the 'hybrid' superannuation fund' in question.

> "The disorderly failure of an otherwise sound and sustainable RSE licensed trustee is likely to be severely detrimental to members.

Without expressing a definitive view on the proper construction of the SIS Regulations, his Honour concluded that, if a hybrid fund is required to be treated as a single fund for the purposes of the application of Pt 9 of the SIS Regulations, it will be a *defined benefit* fund, notwithstanding that the *majority* of its members by number and beneficial entitlement are members with accumulation interests. His Honour considered that there was thus a risk of disadvantage to accumulation members by the application of the SIS Regulations as, if distributions are made to all members in the winding up of a hybrid fund in insolvency, the distributions will be based upon the individual members' entitlements. In a fund subject to a trust deed with a "single trust" clause (as was the case for Mine Super), there will be a risk of defined benefit members receiving part of their distributions out of assets that had been attributed to accumulation members.[34] The consequence of this would be that, unless APRA otherwise intervened (as it had indicated it would consider doing in the case of Mine Super), the *unmodified* regulation 9.23 would require the RSE licensed trustee to initiate winding up proceedings of the *whole* fund,[35] not just the insolvent defined benefit sub-fund. That is, without intervention, assets otherwise attributed only to accumulation members would be available to help satisfy defined benefit entitlements – an outcome contrary to the expectations of those members.

32 *Re Legal Super Pty Ltd* [2023] VSC 545, [25]. **33** *Mine Super*, [207]. **34** *Mine Super*, [246]. **35** *Mine Super*, [239].