The IOOF Case: The Federal Court bursts the Royal Commission's "best interests" balloon

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The case in a nutshell

In the well-publicised decision in the IOOF case,[1] APRA sought to establish that two superannuation trustees and some of their directors and other officers engaged in conduct that contravened the statutory covenants in the *Superannuation Industry (Supervision) Act 1993* (**SIS**). APRA was aiming to obtain disqualification orders against the individuals concerned on the basis that the alleged contraventions meant that they should not be allowed to hold the positions they held.

The alleged contraventions involved decisions that were made by the trustees in various specific scenarios. The scenarios are briefly summarised below but a common theme of APRA's case was that the trustee entities had reasonably arguable claims against third parties (including parties related to IOOF) and should have sued those parties instead of applying general or operational risk reserves within the fund to compensate members for losses caused by administrative errors. One incident involved the trustee indicating an unwillingness to proceed with a requested successor fund transfer (**SFT**) to a competitor fund. APRA argued that this decision was motivated by commercial considerations rather than acting in members' best interests. The Court found that this did not take account of the fact that the trustee had identified various issues (including a potential tax liability) which it felt had to be resolved before it could agree to the transfer.

The Court dismissed APRA's application because the evidence did not support any findings that the covenants had been contravened in the circumstances. Pleasingly, the case supports the principle that directors can rely on management and expert advice. It will also be a relief to trustees who are under pressure to report possible breaches of the law promptly that breach reports cannot be used as an admission in such cases.

The Royal Commission's examination of a handful of carefully selected case studies suggested that misconduct involving a failure to act in the best interests of members was rife in the financial services industry. The Royal Commission Final Report concluded that the regulators were slow to act in taking superannuation trustees to task for such failures. Trustees are well aware of the need to act in members' best interests and routinely apply this test in relation to all aspects of the fund's operations, for example when selecting investments or insurance policies. To take a specific example, how does the trustee decide whether a more expensive insurance policy that offers higher benefits or a cheaper insurance policy that offers lower benefits is in the best interests of the members as a whole? Many of these judgment calls involve weighing up competing considerations and reasonable minds may differ in their approach to such an exercise.

The IOOF case is a stark reminder that general standards of duty such as those reflected in the statutory covenants are not well suited for use by regulators to admonish those engaged in conduct which the regulator considers to be improper. The case perhaps also suggests that regulators are not always well-placed to assess the inner workings and commercial decisions made by a trustee board from a distance.

Particular challenges highlighted in the case were the complexity of the environments in which trustees typically operate and the finely balanced judgments they are often required to make. The case is a reminder of the significant barriers faced by regulators when prosecuting a trustee for a breach of a general duty, where it will be necessary to bring evidence to inform the Court of all circumstances relevant to the exercise of a discretion and clearly spell out how the trustee fell short, rather than simply relying on documents created by the trustee.

This case may cause APRA to alter its approach either by focussing on breaches of more prescriptive provisions of the law (rather than general duties based on the exercise of judgment) or using other enforcement tools such as imposing licence conditions or issuing directions to trustees.

Analysis

What does the decision say about the statutory covenants in SIS?

The covenants are set out in sections 52 and 52A of SIS and impose obligations on superannuation trustees and their directors, respectively. Unlike ordinary statutory provisions, the covenants are taken to be included in the trust deeds of all superannuation funds. This approach was adopted so as to standardise and enhance, in legislative form, obligations of a similar kind to those imposed under trust law. While trust law is highly flexible it is, in each case, subservient to the trust deed. It is possible to draft trust deeds to limit the scope of a trustee's role and duty.

This is where the SIS covenants (and other SIS provisions) come in. They attempt to standardise certain aspects of the trust deed to ensure that trustees cannot "contract out" of important duties such as the duty to act in the best interests of their members.

Section 55 of SIS gives a member a statutory basis to recover loss or damage suffered where a covenant is breached by the trustee.

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1. APRA v Kelaher [2019] FCA 1521.

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Due care and skill covenant

In a number of places in the judgment, Justice Jagot distinguishes the standard of care required of a superannuation trustee from being "an insurer against all loss", which was the effect of APRA's submissions. The mere fact that there is a flaw in a system which causes a financial product to operate otherwise than as promised does not, of itself, mean that the standard of care has been breached.

The Court observed 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" (at [39], see also [702] and [789]).

In considering the relevance of context, beyond circumstances, the nature of the trustee and organisation itself are relevant – the due care and skill covenant "necessarily must also take account of the scale of the superannuation trusts and the relevantly immaterial amounts at issue, and the other tasks to which [trustees] and their directors had to attend in managing the superannuation trusts" (at [44]).

Best interests covenant

Justice Jagot observed (at [64]):

> In my view, a decision which is not reasonably justifiable as in the best interests of the beneficiaries, assessed objectively by reference to the circumstances as they in fact existed at the time, will be in breach of the covenant. Equally, subject to the exception I have noted, a decision which is reasonably justifiable as in the best interests of the beneficiaries, assessed objectively by reference to the circumstances as they in fact existed at the time, will not be in breach of the covenant.

The exception referred to is where the trustee's subjective purpose or object in acting was contrary to the best interests of the beneficiaries.

The test as to whether one course of action was in the best interests of the client "is **objective** and is **to be applied prospectively**, that is, from the position of the trustee at the time of the decision, without impermissible hindsight" (at [55]).

A decision does not lose its character of having been in the best interests of beneficiaries at the time it was made just because at that time, more information could have been obtained (at [53] and [58]).

The day-to-day decisions that a trustee of a large fund makes in the administration of the trust are not subject to the same kind of requirements relevant to a trustee's consideration of a beneficiary's entitlement to a payment out of the trust. In rejecting APRA's submission seeking to elevate such onerous requirements to the trustee's daily administration, the Court recognised the "myriad of decisions taken every day by trustees of large superannuation funds which potentially affect the fund both materially and immaterially" (at [52]).

Conflicts covenant

Justice Jagot accepted that the conflicts covenant applies only to actual conflicts and not to mere possible future conflicts, and that it is not equivalent to the fiduciary obligation not to act when in a position of conflict.

As APRA did not explain why a conflict existed between the interests of super and non-super investors, this conflict was "left at the level of mere theory" and APRA's alleged breach of the conflicts covenant was unproven in respect of each such supposed conflict.

Compliance or non-compliance with an entity's internal policy (such as a conflicts policy) does not of itself establish any contravention of the conflicts covenant (at [70]).

What does the decision say about the position of trustee directors?

APRA submitted that trustee directors can no longer rely upon officers without verification, however Justice Jagot rejected this, noting that there are many circumstances in which a director is entitled to rely on management, provided there are not circumstances from which the director knew or ought reasonably to have known that such reliance was misplaced.

In particular, Justice Jagot rejected APRA's assertion that "compensation plans" are matters "uniquely within the sphere of responsibility of the directors" (at [42]).

What does the decision say about a trustee's right to be indemnified from fund assets or excused from liability?

Traditionally, SIS was understood to give superannuation trustees a wide scope to be excused from liability for breaches of general duties like acting in the best interests of beneficiaries. This was predicated on the idea that trustees may be drawn from the workplace and that making a judgment call on what is in members' best interests is more of an art than a science. The breadth of this potential indemnity may seem overly generous however the philosophy at the time SIS was introduced was that while such trustees would need to understand and discharge the important duties traditionally attaching to a trustee role, they should not be expected to be legal, finance or investment experts.

The standard of care that was originally set for superannuation trustees under SIS was of an "ordinary prudent person". Subsequently, there was a recognition that notwithstanding retention of the equal representation rules, those individuals wanting to serve as superannuation trustee directors should meet higher standards, and the test for superannuation directors was upgraded to that of a "prudent superannuation director".

When SIS was introduced, it was considered appropriate that trustees should not bear personal or criminal liability other than in the most serious cases, for example, involving dishonesty or recklessness. Hence, section 56

of SIS implies that an indemnity will only be unavailable if the trustee has been dishonest, reckless or has intentionally failed to comply with its duties.

A preliminary question considered by Justice Jagot was the effect of section 56 when read together with section 55, and whether a trust deed may exclude personal liability or give the trustee a right to be entitled to indemnification out of the trust assets for breach of a statutory covenant. The governing rules of the relevant funds purported to do this, consistently with section 56. If those rules were effective, APRA's case would necessarily fail as it did not allege dishonesty or intentional or reckless failure to exercise the required care and diligence.

Somewhat controversially, Justice Jagot held that this important protection for trustees does not extend to cases where the trustee has breached one of the statutory covenants. This overturns much conventional thinking on the application of section 56 and is likely to be of concern to trustees and perhaps also to the providers of trustee indemnity insurance.

In discussing this issue and analysing the interplay between different parts of SIS, Justice Jagot concedes that she did not find reaching a resolution "straightforward" and confines her comments to SIS and the governing rules of the fund. She did not discuss whether, and if so, how, the SIS provisions would affect the general law indemnification rights of a trustee which, according to the Honourable Kevin Lindgren QC[2], are not displaced by section 56.

Justice Jagot considered the causes of action provided for in section 55 of SIS for a breach of covenant to be a "code" and as such, that the protections contained in section 56 do not apply where a statutory covenant is breached. In effect, she seems to be saying that if section 56 was available to limit a trustee's liability for breach of a statutory covenant, this would potentially undermine the operation of the covenants. This leads one to ask – what is the purpose of the covenants?

A key reason, not examined in the IOOF judgment, for including the statutory covenants in SIS was to make them readily accessible to those who were willing to take on a trustee role. There was a concern that the trust law principles from which many of the covenants were drawn are not widely known and understood in the community. Making these prominent by stating them in the legislation was designed as a signpost as to the standard of conduct required. After all, not every trustee will have a Jacobs' Law of Trusts text book by his or her bedside table!

Justice Jagot's conclusion that liabilities arising from a breach of a statutory covenant fall outside the protections conferred by section 55 of SIS is problematic looking at the overall scheme of SIS. Section 55 provides specific "safe harbour" defences for breaches involving the investment strategy covenant and the management of reserves covenant. The fact that there are no safe harbours in SIS for breaches of the other covenants can be explained by the expectation that exoneration would be available under the governing rules in terms consistent with section 56. This rationale does not sit well with Justice Jagot's interpretation.

Under general trust law, trustees can apply to the Court for relief from liability for a breach of trust if the trustee acted honestly and reasonably and ought fairly to be excused. A version of this defence is found in section 221 of SIS, but this defence is only available for a breach of a civil penalty provision. Until recently, a breach of a covenant was not a civil penalty provision. It seems anomalous that this defence is available in proceedings for a civil penalty order but not if a claim is made under section 55 for compensation for a breach of covenant. Again, a possible explanation for this approach is that trustees were expected to have the benefit of an exoneration clause in the governing rules.

What does the decision say about the operational risk reserve?

Importantly, the decision confirms that a trustee is not required to exhaust all other means of risk management (including the pursuit of weak claims against third parties to recover loss) before resorting to use of the reserves (see [124] and [795]).

Superannuation trustees are required to maintain and manage resources to cover their operational risks under the section 52(8) covenant. Section 115 allows them to maintain reserves for this or other purposes and provides that the fund's governing rules must not prohibit them from maintaining an operational risk reserve.

IOOF's Reserves Policy provided that the operational risk reserve was to be used to fund losses resulting from operational risk events, meaning that current or former members could be compensated for losses or restored to the position they would occupy had the event not occurred.

APRA's arguments included that an operational risk reserve cannot be used "where there are other sources of compensation available, outside of the trust fund, that are not being considered and pursued".

In answer to APRA's 'last resort' argument, Justice Jagot states (at [122]):

> SPS 114 contemplates that the ORFR [Operational Risk Financial Requirement] is available for all operational risk events and not just those where there was no insurance or third party liability. This concept of the ORFR being a last resort only is a construct of APRA's.

The decision also acknowledges that the operational risk reserve has been established for a specific purpose. It does not form part of a member's account (which is typically how the member's benefit entitlement is

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

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measured). As such, application of the reserve for those purposes is not a misappropriation of member benefits. Referring to the funds credited to the reserve in simplistic terms as "members' money" does not tell the full story.

That said, the decision nonetheless also clearly acknowledges that the reserve is an asset of the fund. As such, the trustee's duties apply in relation to decisions the trustee makes about its application, and about seeking recourse from third parties either as an alternative to using the reserve or in order to replenish it.

Were there reasonable causes of action against IOOF's related party service provider as APRA had asserted?

IOOF Service Co provided various personnel and services to the trustees under a number of services deeds during the relevant period. These deeds required reciprocal and overlapping obligations of both IOOF Service Co and the recipients, relating to the performance of the services.

For instance, under one deed the trustee was required to give proper lawful instructions or directions to IOOF Service Co employees and subcontractors, ensure that those personnel complied with all legislative requirements, and keep adequate systems, procedures and processes to ensure those personnel and IOOF Service Co could carry out their duties. This deed also provided that no party would be liable to the other for "indirect or consequential loss".

Justice Jagot accepted that the range of reciprocal obligations made it inherently difficult to assign responsibility as between the parties to the contract. This, as well as the limitation of liability for indirect or consequential loss, meant that proving that IOOF Service Co was potentially liable to the trustee for a breach of contract would have been far from straightforward.

For instance, a claim against IOOF Service Co would have to explain why a failure by IOOF Service Co to adequately supervise personnel was not, rather, a failure by the trustee to provide the personnel with proper lawful instructions or directions.

This commentary raises interesting questions about outsourcing practices in the superannuation industry, especially where trustees engage related parties. If the relevant contracts do not enable responsibilities to be appropriately allocated and liabilities for operational failures to be clearly delineated, this may raise questions about whether the trustee has fulfilled its duties when establishing and documenting its outsourcing arrangements.

What does the decision say about employer–requested bulk transfers of member benefits without member consent?

SIS and the regulations made under SIS do not give an employer any right to require a superannuation trustee to transfer its employees' default superannuation balances to an alternative fund under an SFT. Rather, employers usually rely on specific terms of their arrangement with the trustee to do so. These are often captured in a "participation agreement", however in this case, there was no such agreement.

The Optus SFT alleged breach (discussed below) is a reminder that while it is easy enough for an employer to arrange a new default fund for future contributions for its employees, the trustee cannot then simply agree to implement a bulk transfer of those employees' existing accounts at the request of the employer, without the consent of the members. In this case, neither the trust deed nor the relevant employer plan rules allowed a bulk transfer at the request of the employer but required instead that the trustee seek the consent of the employees to the transfer.

SIS and its relevant regulations impose stringent obligations on trustees, including to ensure an 'equivalency' of rights in respect of benefits under the current and proposed new fund, before implementing an SFT. The decision recognises that the equivalency of rights analysis is a statutorily mandated process which must be fulfilled before a trustee can agree to a requested SFT. Only once the statutory process is complete does the question of whether the SFT would or would not be in the best interests of members arise. The strict process is necessary, given that members are transferred to another fund without their consent, and the trustee of the original default fund must itself be the assessor and protector of the employees' interests.

Systemic weaknesses in APRA's case

Justice Jagot noted that a systemic weakness in APRA's case was that APRA ran a purely documentary case, however the documents relied on, which included breach reports, assumed that the reader knew the otherwise unproven details of IOOF's systems, policies and procedures, were often expressed at a high level and were created by unknown authors with the benefit of hindsight.

> Reports and documents brought into existence for the purposes of internal investigations and self-reporting after-the fact are of limited probative value.

This was found to be particularly so where such documents:

- are expressed at a high level of generality;
- are brought into existence for specific purposes;
- are by authors whose qualifications, experience, and/or motive are unknown;
- use the benefit of hindsight; and/or
- assume otherwise unproven knowledge (in this case, of IOOF's systems, policies and procedures)

The Court's criticism of APRA's reliance on such reports, and in particular those reports produced in hindsight, was widespread throughout the judgment (see for example [4], [134]-[136], [216]-[220], and [712]). Given the prevalence of such documents amongst large organisations, the judgment provides some comfort around the value these documents may have to proving wrongdoing.

Use of IOOF documents as admissions

An organisation's own admissions of wrongdoing in internal documents are of limited evidentiary value.

APRA's principal evidence comprised IOOF documents brought into existence for the purpose of internal investigations and self-reporting of breaches, which APRA relied upon as admissions. However, Justice Jagot found that a party's conclusion of law, such as an IOOF employee's opinion that there has been a breach of a statutory covenant, cannot generally constitute an 'admission' of fact – rather, it amounts to inadmissible opinion evidence.

Such admissions are often made with the benefit of hindsight and following an investigation into circumstances that were not previously known, rendering their probative weight "virtually nil". The weight to be given to such conclusions is to be assessed in light of the role and qualifications of the author, and the regulatory context - a prudent entity seeking to understand and in future prevent a breach should not be fearful of creating documents to assist it to that end on the basis that a regulator could subsequently use the documents against the entity.

Justice Jagot also found that whether or not a trustee or director was aware that APRA believed that a contravention had occurred was irrelevant to its case.

In relation to the Pursuit failure (discussed below), Justice Jagot found that "the mere fact that an insurance claim was made on the basis of a genuine belief that [the trustee] would be liable to compensate beneficiaries does not constitute an admission by [the trustee] that it was so liable".

Bare assertions of deficient systems

It is not enough for APRA to argue the fact of an error and resultant loss as establishing a contravention of the due care and skill covenant; what is required is an "evaluative and nuanced analysis" (at [138]).

A bare assertion that regulatory breaches occurred as a result of deficiencies in an organisation's systems, policies and procedures is not enough to prove such deficiencies and relevant breaches.

In dealing with an allegation that IOOF did not have an adequate framework in place to detect, prevent, mitigate or manage bugs in the IT system (relating to the Pursuit failure), Justice Jagot found that while APRA was not required to prove what a compliant framework would have been, it did need to prove that there was a system reasonably available (and known) at the time that would have been capable of detecting the error (at [581]).

Justice Jagot provided some insight into what may be required to inform the foundation of a 'system deficiency' claim, including:

- the details of the actual system in existence;
- the nature of the default or flaw in the system;
- the reasonable foreseeability of that default or flaw;
- the reasonable availability of any alternative that might have avoided the default or flaw; and
- the materiality of the potential consequences of the default or flaw.

The scenarios

First scenario: CMT error

The first scenario involved an investment in a Cash Management Trust (**CMT**), a managed investment scheme (**MIS**) for which one of the superannuation trustees was the responsible entity (**RE**). The custodian of the CMT incorrectly classified a maturing term deposit as 'income' rather than 'capital'. This caused an overpayment to the unitholder in the CMT, including the RE in its capacity as trustee of the superannuation fund. The overpayment was in turn distributed to members of the superannuation fund. The RE of the CMT recovered the overpayment by reducing distributions from the MIS to the unitholder over a three year period, and by settling a dispute with its custodian for a portion of the loss relating to the classification error. This payment provided partial compensation for the superannuation members. The superannuation trustee applied funds from a general reserve to provide the remainder of the compensation to the superannuation fund members.

APRA made a number of allegations about this but a key argument was that there was a failure on the part of the trustee to exercise due care, skill and diligence in the operation of the fund, and that the plan to use the general reserve to compensate members was not in the best interests of members and involved a conflict between the interests of the members (which would be served by seeking compensation from elsewhere) and the interests of the IOOF group (whose interests were best served in utilising the reserve as it avoids the need to consider seeking compensation from IOOF group companies).

Justice Jagot found in relation to this scenario that APRA's evidence was insufficient and relied heavily on documents brought into existence by IOOF years after the event and with the benefit of hindsight. The RE of the MIS was entitled to rely on the custodian and there was no evidence to suggest that by doing so it was negligent. Even if the RE attempted to sue the custodian for loss, any loss arising from the event could and should have been recouped from the overpaid members. There was no proven conflict of interest. It was also held that the use of the general reserve to compensate members was within power and for a proper purpose.

Second and third scenarios: Pursuit failure and "sweep" breach

The 'Pursuit' platform was used to make investments for members of a superannuation fund in accordance with their directions. The platform was also used by non-super investors through an MIS. For a period of five years, the trustee and another IOOF group company, in administering and operating that platform, failed to give effect to investors' instructions in respect of income distributions and did not detect the problem. An investor identified the problem and brought it to IOOF's attention. The flaw in the system was that distributions received in one reporting period but processed in the following period were overlooked – the problem therefore only affected a small subset of distributions, not all distributions. The income distributions remained in the investors' low-return cash accounts, resulting in a loss across the affected members of approximately $817,000. The trustee determined to compensate non-super investors with its own money and to compensate superannuation members out of the fund's operational risk reserve. APRA alleged that this involved a conflict between the interests of superannuation members and the interests of non-super investors and was not in the best interests of the super members. Again, APRA asserted that a reasonably arguable claim existed against the IOOF related party service provider for the error and that the trustee's failure to pursue this claim involved a breach of the no conflicts and best interests covenants, and that the Pursuit failure itself involved the breach of the due care and skill covenant.

The 'Sweep' breach involved the failure of an IOOF group company to implement the instructions of superannuation fund members and non-super MIS members to transfer their investments from funds which were being closed into another IOOF fund. This caused a total loss to super members and MIS members of approximately $1 million, for which APRA alleged the trustee and the IOOF group company were liable to the members. Although the trustee first intended to use the superannuation fund's operational risk reserve, the loss to superannuation members was eventually compensated by the trustee from its own monies. Despite this, APRA alleged that the original plan to compensate super members from the operational risk reserve and to compensate MIS members from the trustee's own funds involved a conflict between the interests of the super members and the interests of the MIS investors, and was not in the best interests of the super members.

In relation to the Pursuit failure, Justice Jagot found that the fact that the system failure occurred and was not detected does not mean that there must have been a breach of the due care, skill and diligence covenant. In its evidence, APRA failed to explain the system or how the flaw could or reasonably should have been detected. Justice Jagot also pointed out that APRA had misunderstood the error – they argued that the problem was that the system was "incapable of reinvesting distributions when, in fact, the error was far more confined and related to a circumstance (distributions received in one period but not processed until the next period) that was not reasonably anticipated at the time the system was developed" (at [585]).

It was also held that no conflict existed between the interests of non-super investors and super investors – the non-super investors had no interest in the superannuation assets or the operational risk reserve and were entirely unaffected by the trustee's decision as to whether the compensation paid to superannuation beneficiaries was sourced from the funds of the reserve, the trustee or the related party service provider.

In relation to the Sweep breach, APRA's reasoning that the fact that members' instructions were not followed **necessarily** meant that the required standard of care was not exercised was rejected. It was irrelevant that the trustee was considering paying compensation from the operational risk reserve as an unimplemented decision cannot involve any contravention of the statutory covenants.

In both cases, the evidence did not establish that the trustee had a reasonably arguable claim against the related service provider.

Fourth scenario: Bendigo breach

The 'Bendigo' breach involved a defined benefit employee sub-plan of Bendigo and Adelaide Bank. A human error resulted in an investment of the sub-plan being sold by mistake. Although this was reversed two weeks later, it caused approximately $114,000 loss. The trustee used the reserves of the Bendigo Plan to compensate for this loss. APRA alleged that when determining to use the reserves to fund the compensation, the interests of IOOF were in conflict with the interests of the members of the sub-plan because an IOOF entity was potentially liable to compensate for the loss.

Justice Jagot found that APRA's case appeared to assume that the fact of an error and loss necessarily involved a breach of the due care covenant. The evidence did not establish a reasonably arguable claim against the IOOF entity – in fact, the relevant loss was indirect and consequential, categories of loss which were excluded under the service contract.

Fifth scenario: Optus SFT alleged breach

This alleged breach concerned a decision to reject a request made by Optus for an SFT of Optus' employee default superannuation arrangements to an AMP superannuation fund without giving genuine consideration to whether the proposal may have been in the best interests of beneficiaries. APRA did not allege that the decision should not have been made, rather that the process through which the decision was made breached the statutory covenants, including the best interests and no conflicts covenants.

Justice Jagot found that the trustee was legally prohibited from complying with Optus' request. For instance, the trust deed required members to be given a choice to remain in the fund. There was therefore no power to complete the SFT as requested by Optus and it therefore could not have been a breach of the statutory covenants to decline the request.

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