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Lending to a person operating a managed investment scheme

22nd Annual BFSLA Conference, Sofitel Reef Casino, Cairns

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1. Categorising the managed investment scheme 4
1.1 Market perspective 4
1.2 Legal perspective 5

2. Is it a scheme, should it be registered and should the operator be licensed? 6
2.1 Is it a 'managed investment scheme'? 6
2.2 Should it be registered? 7
2.3 Risks of dealing with unregistered schemes 8
2.4 Licensing 9

3. Dealing with the RE - lender risk and protection 10
3.1 Due diligence 10
3.2 Trust and scheme formalities 10
3.3 RE powers 11
3.4 Duties of the RE 12
3.5 Officer's duties and liabilities 15
3.6 Related party transactions 16
3.7 Contingent liabilities 18

4. Lender's recourse to the scheme property held by the RE 19
4.1 RE's right of indemnity out of scheme property 19
4.2 Secured and unsecured lending 20
4.3 RE limitation of liability clauses 22
4.4 Claims of former trustees and REs 24
4.5 RE liability for agents and service providers 24
4.6 The value of warranties 25

5. Change in RE 25
5.1 Statutory novation 25
5.2 Matters excluded from novation 27
5.3 Updating affected registers 27

6. External custodians 28
6.1 Need for an external custodian 28
6.2 Custody agreement 29
6.3 Custodian's principal duties 29
6.4 Warranties, undertakings and default events 30
6.5 Taking security from a custodian 30

6.6	Subcustodians	31
6.7	Custodian liability limit clause	31
7.	**Insolvency and winding up**	**32**
7.1	Insolvency of the RE	32
7.2	Administration risk	33
7.3	Winding up the scheme	33
8.	**Stapled security issues**	**34**
8.1	Nature	34
8.2	Conflicts and related party issues	35
9.	**IFRS Impact**	**36**
9.1	Background	36
9.2	Scheme impacts	36
10.	**Ending comment**	**36**

Lending to a person operating a managed investment scheme

Conventions

For convenience, this paper refers to managed investment schemes simply as 'schemes', a responsible entity is the 'RE' and all references to sections are those in the Corporations Act unless stated otherwise.

1. Categorising the managed investment scheme

1.1 Market perspective

Before the introduction of Chapter 5C of the Corporations Act in 1998, collective investments typically were made through unit trusts, with the investment assets owned by the trustee and subject to 'prescribed interests' regulation under the *Corporations Law*. Investors relied on a separate fund manager to make investment decisions and look after their interests. The trustee's responsibility generally was limited to owning the trust assets, and so investors did not expect the trustee to interfere with the decisions of the fund manager.

The property prices collapse in the early 1990's resulted in investors in unlisted property trusts incurring substantial losses (funds with borrowings being worst hit). When investors could not recover from fund managers, they successfully sued trustees on the basis that they had not performed their fiduciary duties. Uncertainty as to the respective responsibilities of trustees and fund managers existed.

Chapter 5C of the Corporations Act resolved this uncertainty by making the operator of certain schemes the 'single responsible entity' and trustee. The Australian Securities and Investments Commission (**ASIC**) has broad powers to supervise REs. The March 2002 Financial Services Reform amendments to the Corporations Act brought the licensing and disclosure regime applying to REs under Chapter 7, with the regulation of interests in schemes as a 'financial product'.

Schemes represent a variety of collective investment arrangements, may be listed or unlisted and may be offered to wholesale and retail investors. An RE may have been formed to promote and operate a particular scheme or may operate several schemes. The RE may be part of a corporate group. The particular RE company for a scheme may change over time.

ASIC's website lists popular schemes as including cash management trusts, property trusts, Australian and international equity trusts, agricultural schemes (eg horticulture, aquaculture, commercial horse breeding), some film schemes, timeshare schemes, some mortgage schemes and actively managed strata title schemes.[1] Specialist funds (eg investing in private equity transactions, airports, toll roads or other infrastructure projects) and general 'cash box' funds with broad investment mandates have been readily taken up by institutional and retail investors.

Schemes also may be established and managed so as not to be a public trading trust for tax purposes to make available flow through benefits to investors[2].

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[1] http://www.asic.gov.au/asic/asic_polprac.nsf/byheadline/Managed+investment+schemes?openDocument.

[2] This requires the scheme not to be carrying on a 'trading business' and not directly or indirectly controlling the affairs or operations of another person carrying on such a business. If investors are entitled to all scheme net income each financial year, the RE should not be subject to income tax where treated as a 'flow through' entity, with income,

The investment proposal may involve each issued interest in the scheme being stapled to an issued interest in a company (that may manage the scheme) or to another scheme operated by the same RE. Particular issues arise when lending to a scheme within a stapled security structure.

Schemes obtain debt facilities for a range of purposes, including asset acquisition or investment finance and takeover finance (such as when taking over another scheme). Schemes also may need bridging finance, such as to fill the capital gap where raising equity by instalments from investors. In that case, the lender will look to the subscription proceeds of the later instalments to takeout the debt, and may request arrangements with the scheme registry and the bank holding the subscription proceeds account to obtain direct access to the proceeds. A risk for such a lender arises if it later turns out that the RE failed to meet the disclosure requirements of Division 2 of Part 7.9 when offering interests in the scheme. In that case, instalment obligations may become voidable at the option of scheme members under section 601MB.

There are a number of methods by which a scheme can be taken over. Since March 2000, listed schemes can be subject to the company takeover provisions in Chapter 6. Recently, the Takeovers Panel has issued Guidance Note 15: *Listed Trust And Managed Investment Scheme Mergers* confirming that an acquisition of a listed scheme pursuant to an amendment of the scheme constitution (following votes of members in the target scheme) is an acceptable alternative to a Chapter 6 takeover bid.

1.2 Legal perspective

Two general classes of scheme are those which require registration with ASIC and those which do not. Those which do not require registration are essentially unregulated, and so can be structured using a range of legal structures such as trusts, partnerships or joint ventures.

A scheme which requires registration must involve creation of a trust[3]. The RE is made a trustee owning the scheme property, with responsibility for holding it for investors (scheme members) and for operating the scheme subject to the scheme constitution (a regulated trust deed with prescribed minimum content), a compliance plan and, in the case of retail clients, a product disclosure statement containing the investment offer.

A scheme therefore is not a legal entity, but rather is a regulated relationship, with obligations and duties between the parties and investors who participate in it. Anyone dealing with the scheme can only do so through the RE as trustee, and scheme creditors are creditors of the RE personally who rely on being subrogated to the trustee's rights of indemnity and proprietary lien.

The RE must be a registered Australian public company holding an Australian Financial Services Licence authorising the RE to operate the scheme[4], will be regulated under Chapter 5C of the Corporations Act, the applicable Trustee Acts of the States and Territories (to the extent not inconsistent with the Corporations Act) and will assume a trustee's general law duties to investors. If things go wrong, it is the RE that investors will sue.

REs have specific duties and responsibilities in relation to scheme property, including to clearly identify that property as being scheme property and to hold it separately from the RE's property

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gains and tax liability flowing through to investors in proportion to their interests in the scheme. Any calculated net income loss for a year can be carried forward by the scheme to be offset against future taxable income (provided certain trust loss carry forward requirements are met).

[3] Section 601FC(2).

[4] Section 601FA. The AFSL may authorise the RE to operate either a specific scheme named on the licence or a scheme or schemes in particular categories according to the type of asset: ASIC Policy Statement 130.21.

and property of any other scheme[5]. As a result, often scheme property is held by a separately contracted custodian, who does so as bare trustee and agent for the RE. However, the RE is liable for anything that a custodian or other agent or appointed person does or fails to do, even if acting fraudulently or outside the scope of their authority.

The variety and complexity of some structures concerning schemes and the nature of the respective interests of the RE, an external custodian, scheme members and lenders mean that a lender must give careful consideration to due diligence and structuring the finance and security arrangements. Particular issues arise if a lender is seeking a guarantee from the RE.

2. Is it a scheme, should it be registered and should the operator be licensed?

2.1 Is it a 'managed investment scheme'?

Schemes arise in a variety of industries and asset classes, using a variety of structures. A lender to an investment arrangement will be concerned to identify whether it is a 'managed investment scheme' and whether it must be registered.

The term 'scheme' itself is not defined in the Corporations Act. It was interpreted (under the former prescribed interests regime in the Corporations Law) to refer to some "programme, or plan of action"[6].

The fundamental elements of a 'managed investment scheme' from the definition in section 9 are[7]:

(a) investors contribute money or money's worth to acquire rights to benefits produced by the scheme;

(b) the pooling or use of investors' contributions in a common enterprise to produce financial or property interest/rights benefits to scheme members; and

(c) investors having no day to day control over the operation of the scheme.

The definition of a 'managed investment scheme' needs to be carefully considered and provides for various exclusions[8].

Some exclusions turn on the nature of the investment interest being issued, and the type of investment interest itself can be determinative as to whether a scheme is a 'managed investment scheme'. For example, whilst the issue of debentures or convertible notes by a body corporate is

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[5] Required under section 601FC(1)(i) and see ASIC Policy Statement 133 *Managed investments: Scheme property arrangements*.

[6] *Australian Softwood Forest Pty Ltd v A-G (NSW)* (1981) 148 CLR 121 at 129-130. A detailed review of the concept can be found in chapter 3 of *A Practical Guide to Managed Investments*, Nessen P & Robertson S, Lawbook Co, 2002.

[7] It also includes time-sharing schemes, but excludes bodies corporate, franchises, insurance statutory funds, regulated superannuation funds, debentures or convertible notes issued by a body corporate, schemes operated by Australian banks in the ordinary course of their banking business, non-cash barter schemes, retirement village schemes (unless they are time sharing schemes), certain partnerships and other exclusions not listed here.

[8] For example, a scheme in which all the members are bodies corporate that are related to each other and to the body corporate that promotes the scheme; a regulated superannuation fund, an approved deposit fund, a pooled superannuation trust, or a public sector superannuation scheme; the issue of debentures or convertible notes by a body corporate; a retirement village.

expressly excluded in section 9, the definition of 'debenture' in section 9 excludes a promissory note with a face value of at least $50,000.

In a recent case, the issue of such promissory notes (as opposed to debentures or convertible notes) enabled a finding that raising debt from investors for the purposes of on-lending the funds against property development projects meant that a 'managed investment scheme' was being operated[9]. In that case, the court then went on to hold that 'The promissory notes were an interest in a managed investment scheme. This was because:

(a) there was a scheme, in the sense that there was some program, or plan or action;

(b) there were contributions of money as consideration to acquire rights to benefits produced by the scheme, because investors were asked to contribute money so as to make possible the finance arrangements for the particular projects described in the information memoranda, and the investors would in return gain the sorts of benefits made possible by participation in those arrangements;

(c) these contributions were pooled or used in a common enterprise to produce financial benefits, because the information memoranda asked investors to contribute money to produce funds for on-lending; and

(d) because the first three elements were met, counsel agreed the members of the scheme did not have day-to-day control over the operation of the scheme.'

2.2 Should it be registered?

A scheme within the definition of 'managed investment scheme' must be registered by the operator at ASIC if[10]:

(a) it has more than 20 members;

(b) it has 20 or less members, but the scheme is promoted by a person (or an associate of a person) who at that time was in the business of promoting managed investment schemes; or

(c) it has 20 or less members, but ASIC has determined that a number of schemes, having collectively more than 20 members, are closely related.

Notwithstanding the above, a scheme is not required to be registered by the operator if only investment offers are made where a product disclosure statement is not required under Division 2 of Part 7.9[11]. This would limit offers to 'wholesale clients'[12], which includes a person who:

(a) acquires interests in the scheme for a value of $500,000 or more; or

(b) is a business that has more than 20 employees (or more than 100 if a manufacturer); or

(c) is a sophisticated investor (having net assets of $2.5 million or more, or having gross income of at least $250,000 for each of the last two financial years, as certified by a qualified accountant); or

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[9] *Australian Securities And Investments Commission v Emu Brewery Mezzanine Ltd* and *Bayshore Mezzanine Pty Ltd v Australian Securities And Investments Commission* [2004] WASC 241.

[10] Section 601ED(1).

[11] Section 601ED(2).

[12] See section 761G and associated regulations and class orders (beyond the scope of this paper).

(d) is a professional investor (such as a financial services licensee, a superannuation fund with $10 million or more of assets or a corporation registered with the Australian Prudential Regulation Authority under the *Financial Sector (Collection of Data) Act 2001* (Cth)).

ASIC also may grant relief from registration, and has issued various class orders and specific relief for that purpose. An examination of the range of class orders shows the range of investment structures that can become registrable.

2.3 Risks of dealing with unregistered schemes

Regulatory consequences of a operating a scheme that is a 'managed investment scheme' are that the operator must register the scheme with ASIC and comply with Chapter 5C (meet constitution content requirements, be operated in accordance with a compliance plan which is audited annually, be subject to monitoring by a compliance committee and be subject to related party transaction restrictions), must hold an Australian Financial Services Licence from ASIC and, where investors may be 'retail clients', lodge a product disclosure statement under Chapter 7[13]. In addition, members obtain enhanced rights over investors in an unregistered scheme and the RE, its officers and employees become subject to statutory duties in respect of the scheme.

By contrast, an operator of an unregistered scheme need not hold an Australian Financial Services Licence, register the scheme or comply with Chapter 5C.

A lender to an unregistered scheme will wish to be sure that the scheme is not required to be registered. Consequences of a registrable scheme not being registered include the following.

(a) A person 'operating' the scheme will have committed an offence, exposing them to penalties[14]. 'Operating' a scheme has been to held to mean the acts which constitute the management of or carrying out of the scheme activities[15].

Although lending should not of itself constitute 'operating' a scheme, a lender should consider whether it could be exposed to assisting or participating in the commission of an offence by having had a role in creating or promoting the scheme or in exercising significant control over the scheme operator.

(b) ASIC, the scheme operator or a scheme member can apply to court to have the scheme wound up[16]. ASIC has on several occasions successfully applied to have unregistered schemes wound up on this basis[17] and has obtained court orders restraining persons from operating the schemes.

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[13] Chapter 7 is particularly complex legislation when taking together with the regulations, class orders and ASIC's information releases. In short, there are a range of licensing exemptions and reliefs available for particular enterprises, well beyond the scope of this paper.

[14] Section 601ED(5), with an exposure to 200 penalty points and 5 years in prison.

[15] *Australian Securities and Investments Commission v Pegasus Leveraged Options Group Pty Limited* [2002] NSWSC 310.

[16] Section 601EE.

[17] Recent examples include a number of property syndicates (*Brighton Joint Venture Partner No 2 Scheme, Re; Australian Securities and Investment Commission v Primelife Corp Ltd* [2005] FCA 704), other property developments (*Australian Securities and Investments Commission v Tasman Investment Management Ltd* (2004) 183 FLR 294), a car club (*Australian Securities and Investments Commission v Edwards* [2004] QSC 344; (2004) 22 ACLC 1469) and general solicitation of capital contributions for a variety of investments (*Australian Securities and Investments Commission v Drury Management Pty Ltd* [2004] QSC 068).

(c) ASIC or a person whose interests are affected may seek injunctions restraining persons from engaging in conduct to contravene the Corporations Act or to assist or be in any way concerned in or a party to the contravention[18].

(d) The court can make orders against any person engaged in, or 'involved' in, the contravention to compensate any party to proceedings (or to compensate other persons on the application of those other persons or of ASIC on their behalf) for loss or damage suffered due to the person's engaging in the contravention[19]. Further, the court can make a broad range of orders, including that a contract or arrangement is made void or is varied[20].

In this regard, being 'involved' includes aiding, abetting, counselling or procuring the contravention, or being in any way, directly or indirectly, knowing concerned in, or party to, the contravention[21]. A lender would not wish to be so involved.

(e) Investors who accepted an offer or invitation to subscribe for an interest in the scheme may elect to treat their contract as void, by giving notice to the person who offered the investment to them[22]. The contract becomes void 21 days after the notice is given, subject to the rights of the person making the offer or invitation to apply to court for a declaration that the notice has no effect (if the court is satisfied it is just and equitable to do so).

Where the investors' subscription was made void, the subscription money would have to be refunded out of the scheme property. That obligation may have priority over the rights of the lender to seek repayment from the operator.

(f) Investors have a similar right where their interests were offered, or they were invited to apply for them, in contravention of the disclosure provisions of Division 2 of Part 7.9, such as failure to issue a product disclosure statement to provide adequate disclosure[23].

A lender therefore will need to undertake due diligence, and may include a condition precedent to funding that satisfactory evidence is provided establishing why the scheme is not required to be registered. Supporting representations and warranties from the operator also should be obtained.

2.4 Licensing

As noted above, a person who carries on a business of operating a registered scheme will require an Australian Financial Services Licence[24].

A lender may take some comfort in dealing with a licensed RE due to the requirement that the RE demonstrate satisfaction of certain criteria to obtain an Australian Financial Services licence, including:

(a) suitable qualifications and experience of staff and directors;

(b) a certain level of systems for accounting, computing, compliance and operation;

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[18] Section 1324(1).

[19] Section 1325(1).

[20] Section 1325(5).

[21] Section 79.

[22] Section 601MB(1)(a).

[23] Section 601MB(1)(b).

[24] Section 766A(1)(d). There is no exemption under s 911A(2) from the requirement for the operator of a registered scheme to obtain a licence to operate a registered scheme: s 911A(4).

(c) sufficient financial resources to meet foreseeable cash requirements, professional indemnity insurance and insurance against fraud of officers and agents; and

(d) capital adequacy by maintaining net tangible assets of $5,000,000, or where the value of scheme property is less than $10,000,000 the amount of capital to be maintained can be reduced to 0.5% of the assets shown in the latest accounts of the scheme with a minimum of $50,000.

3. Dealing with the RE - lender risk and protection

3.1 Due diligence

As with any other trust, the rights, duties, relationships and property comprising a scheme are not a separate legal entity that can be dealt with. A lender or other third party needs to deal with a legal entity, and in the case of a scheme, this is the RE and any custodian holding scheme property.

The RE has strict duties in its capacity as responsible entity, breach of which may result in a lender's recourse being limited to the RE's personal assets.

As the RE is a company, a lender may obtain protection under Part 2B.2 by making the assumptions specified in section 129 (unless known or suspected to be incorrect) of compliance with the company's constitution, appointment and authority of officers, proper performance of company duties and due execution of documents. No equivalent to Part 2B.2 exists to protect a lender when dealing with a person in a trust or RE capacity and so no protective assumptions can be made that the RE is acting within its scheme powers or complying with its scheme duties.

Accordingly, when dealing with the RE the lender must undertake due diligence on the usual trust law issues and public company issues, in each case as modified by Chapter 5C. These modifications are to protect the particular interests of scheme members, such as in relation to RE directors' duties and related party transactions (discussed below).

3.2 Trust and scheme formalities

As with any trust, a lender must satisfy itself that the trust element of the scheme is properly constituted, otherwise a resulting trust may be implied for the benefit of the beneficiaries and that resulting trust automatically may be treated as having been breached. This requires reviewing the trust deed as to certainty of intention to create the trust, certainty of trust property and certainty of objects of the trust, and satisfaction of the rule against perpetuities.

For a scheme, the RE is to be constituted a trustee by performance of its duty to hold the scheme property on trust for the benefit of scheme members as described in section 601FC(2). The trust should be declared in the scheme constitution. Of course, in the case of a new scheme, arguably no trust, trust property or beneficiaries are in existence until the scheme has been registered by ASIC, an offer document issued and the initial applications for investments accepted.

The RE has a duty to ensure that the constitution is contained in a document legally enforceable as between the members and the RE[25].

The RE's duty also is to ensure that the constitution:

(a) makes adequate provision for the consideration to be paid to acquire an interest in the scheme, the RE's powers to invest or otherwise deal in scheme property, a member complaints handling method and winding up the scheme: section 601GA(1);

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[25] Sections 601FC(1)(f) and 601GB.

(b) specifies any right of the RE to be paid fees out of scheme property or to be indemnified out of scheme property for its liabilities or expenses (but only for proper performance of its duties): section 601GA(2);

(c) specifies any powers of the RE to borrow or raise money for scheme purposes: section 601GA(3);

(d) specifies any member rights to withdraw from the scheme (including adequate procedures for withdrawal while the scheme is liquid or illiquid, the latter which must meet the requirements of Part 5C.6): section 601GA(4).

A lender's due diligence will include being satisfied that the scheme constitution contains these matters.

3.3 RE powers

Given the position of trust of the RE and its power to give third parties interests in relation to scheme property having priority over scheme members, its powers are limited to those expressly given in the scheme constitution, and will be construed strictly as against any proposed transaction and the lender's financing of that transaction.

Section 601FB(2) also confers on the RE a statutory power to appoint agents and other persons to do anything which the RE is authorised to do in respect of the scheme.

The RE has a duty to ensure that the scheme constitution makes adequate provision for the RE's powers in relation to making investments of, or otherwise dealing with, scheme property[26]. If the RE does not have the requisite power and acts in breach of duty then the lender may not be able to have recourse to scheme property to satisfy the debt, leaving the lender with an unsecured claim against the RE personally (which may not have substantive assets). If the RE has no power to borrow under the scheme constitution, it will have no right of indemnity against the scheme property, which will therefore not be available to repay the loan.

The safe assumption is that the RE has no power to enter into the transaction proposed unless the scheme constitution gives power expressly to enter into transactions of that kind. Often a scheme constitution will confer on the RE all the powers of a natural person or corporation, and so the extent of investigation required may be reduced significantly.

However, powers of the RE to borrow or raise money for scheme purposes must be specified in the scheme constitution. Any other agreement or arrangement purporting to confer those powers have no effect[27]. The scheme constitution may set out borrowing or other restrictions (such as an investment policy or gearing covenants).

The power to mortgage should also be clear an unambiguous and not limited to mortgaging in relation to another power (eg conducting a business or to secure borrowed money). The powers to both guarantee and indemnify ideally should be express. Whilst most guarantees include an indemnity, there is a risk in simply relying on a power to guarantee as extending to the provision of an indemnity, where a presumption arises that only the guarantee power has been given. It would also be prudent for the power to guarantee to be a power to guarantee with or without security.

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[26] Section 601FC(1)(f) and section 601GA(1)(b).

[27] Section 601GA(3).

PDS/Offer documents

In addition to the constitution, the product disclosure statement or offer documents represent part of the legal relationship between the RE and members. Issues for the lender to consider are whether these confine the scope of the RE's power or make representations about restrictions on borrowing or granting security. In the case of the RE giving a guarantee and indemnity, would investors expect this based on what was represented in the product disclosure statement or other offer document?

Essentially, the RE may have bound itself in the product disclosure statement or elsewhere, not to borrow, or to borrow for restricted purposes or within specified limits. Even though these are outside the formal constitution lodged with ASIC, they form an integral part of the legal relationship between the RE and scheme members. A breach of binding undertakings or representations as to the exercise of powers conferred by the scheme constitution may result in the accrual of liabilities on the part of the RE to scheme members and breach of duties.

Two analyses of the nature of the legal relationship between the RE and scheme members in the offer document are as follows:

(a) as the RE issues interests under the offer document in its capacity as responsible entity, the obligations of the RE arising under that document are trustee obligations, relating to the subject trust in accordance with the scheme constitution; or

(b) any promises and representations in the offer document are contractual to the RE in its personal capacity, in consideration for fees that it earns personally (rather than for the benefit of the scheme).

In addition, the RE is subject to market and other prohibited misconduct provisions of Part 7.10.

Compliance plan

A duty imposed on the RE is to ensure that the compliance plan meets the requirements of Chapter 5C, and to comply with the compliance plan[28].

An issue for a lender is whether the compliance plan imposes any checking requirements before the RE can borrow or guarantee or indemnify. Although the compliance plan concerns internal matters, failure to comply with it will mean a breach by the RE of its duties.

A lender will be concerned as to the extent to which these may impact on the validity of the exercise of the RE's borrowing or other powers conferred by the scheme constitution. Where a lender may be regarded as being on notice of requirements in the compliance plan, an issue arises as to whether the lender's interests are subject to those requirements being complied with.

3.4 Duties of the RE

Sources of duty

The RE is entitled to be indemnified for liabilities incurred in relation to the proper performance of its duties. The RE of a scheme has a number of sources of duty and obligation:

(a) general law fiduciary duties (to act honestly, not to place itself in a position of conflict with the interests of the beneficiaries and to exercise diligence of an ordinary prudent person carrying on the affairs of the scheme);

(b) the duty to operate the scheme and perform the functions conferred on the RE by the scheme's constitution and the Corporations Act: section 601FB(1);

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[28] Section 601FC(1)(g) and (h).

(c) regulatory duties arising under the Corporations Act – a number of duties are imposed on the RE, including those concerning related party transactions, use of confidential information and acting in the best interests of investors;

(d) duties as a holder of an Australian financial services licence (including to have adequate arrangements in place for the management of conflicts of interest that may arise wholly, or partially, in relation to activities undertaken by the licensee or a representative of a licensee in the provision of financial services)[29];

(e) duties specified in the scheme constitution;

(f) duties specified in section 601FC(1), which include to:

  (i) act honestly, exercise its powers and duties with a level of care and diligence that a reasonable person would exercise if they were in the RE's position, to act in the best interests of the members, and if there is a conflict between the members' interests and its own interests, give priority to the members interests;

  (ii) treat members who hold interests of the same class equally and members who hold interests of different classes fairly;

  (iii) not use information acquired through being the RE in order to gain an improper advantage for itself or another person or to cause detriment to scheme members;

  (iv) ensure that the constitution and compliance plan meet the requirements of Chapter 5C, and to comply with the compliance plan and the constitution;

  (v) ensure that scheme property is identified as such and held separately from the RE's or another scheme's property, and is valued at regular intervals appropriate to the nature of the property;

  (vi) ensure that all payments out of the scheme property are made in accordance with the scheme's constitution and the *Corporations Act 2001*(Cth);

  (vii) report any breaches of the *Corporations Act 2001* (Cth) to ASIC; and

(g) the duty specified in section 601FC(2) to hold scheme property on trust for scheme members.

Conflicts of interest

The duty of the RE to act in the best interests of the members and to give priority to the members' interests over conflicting interests of the RE will override, for example, any interests that the RE may have in relation to the RE as a company or as a member of a corporate group[30].

This will affect the RE's ability to give a guarantee or third party security to a lender, such as in respect of group facilities or on account of another company within the RE's corporate group.

There are real benefit issues when the RE is asked to guarantee a third party's debts. The relevant test is whether the scheme members benefit. Unless the proceeds of the guaranteed debt are to be used for the purposes of the scheme (being the common enterprise for which investors' money was pooled or used), there will be a significant risk that there is no sufficient benefit in giving the guarantee or any security to secure that guarantee.

[29] See ASIC Policy Statement 181 for guidance as to minimum requirements to meet the conflicts management duties.

[30] Section 601FC(3) states that the RE's duties in section 601FC(1) and (2) expressly override any conflicting duty of the RE's officers or employees under Part 2D.1 to act in the best interests of the RE as a company.

In the absence of sufficient benefit, it is likely that the RE is acting outside its powers and would be incurring any liability only in its personal capacity. Any security given by the RE in these circumstances would be given only to the extent of its personal interest and would fail to secure the beneficial value of the scheme property secured.

Consequences of breach of duty

Breach of a duty contained in section 601FC will result in a contravention by the RE and also by any other person involved in the breach of a civil penalty provision[31] (subject to a civil standard of proof, and which may result in a court order to pay a penalty amount referable to the seriousness of the contravention, a disqualification order or a compensation order).

A court also may impose liability on any person who was engaged in, or involved in, a contravention of Chapter 5C to compensate any party to proceedings (or to compensate other persons on the application of those other persons or of ASIC on their behalf) for loss or damage suffered due to the person having engaged in the contravention[32].

Although a lender will obtain warranties that there is no contravention by the RE (to ensure that the RE gives due consideration in the context of the finance), a lender will always be concerned not to be found to be a person 'involved' in a contravention. This effectively means being satisfied that there is no contravention to be involved with (or at least satisfied that the circumstances do not give rise to unanswered suspicion of contravention).

Obtaining warranties will not protect a lender from a civil or criminal penalty where the lender has been 'involved'. As noted earlier, being 'involved' includes aiding, abetting, counselling or procuring the contravention, or being in any way, directly or indirectly, knowing concerned in, or party to, the contravention[33]. Sometimes a lender will insist on an additional certification from one or more directors that there is no contravention.

Section 1325(5) also provides a wide range of orders that a court can make, including to declare void or to vary any contract or other arrangement.

In addition to any other rights a scheme member may have at law, section 601MA(1) provides that a scheme member may take action against the RE to recover any loss or damage suffered due to the RE's breach of a provision of Chapter 5C[34]. The scheme member may do this whether or not the RE has been convicted of an offence or has had a civil penalty order made against the RE in respect of the breach. However, this remedy is available against the RE only, not other persons involved in the breach.

The RE's right of indemnity for a liability incurred to the lender will not arise if the RE acted outside of its powers or breached its duties when incurring that liability[35]. Where the RE's right of indemnity for recoupment out of scheme property is lost or reduced, so is the lender's rights to be subrogated to that indemnity.

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[31] Sections 601FC(5) and 1317.

[32] Section 1325.

[33] Section 79.

[34] A scheme member must begin an action against the RE within 6 years after the cause of action arises: section 601MA(2).

[35] *Holli Managed Investments Pty Ltd v Australian Securities Commission* (1998) 30 ACSR 113.

Following trust law[36], if scheme property has been applied to satisfy the RE's liability and right of indemnity (exoneration) in breach of duty:

(a) the RE would be liable to compensate the scheme members;

(b) the scheme members could then trace the scheme property; and

(c) those who knowingly received scheme property in breach of trust or who knowingly assist in breach of trust, may become liable as constructive trustee.

A lender taking proceeds of enforcement of security or recovering other amounts from the RE with the knowledge of breach of the RE's trust duties therefore would be found to hold those proceeds and amounts on constructive trust for the scheme members.

Another possible consequence of breach of duty is that the members may wish to remove the RE from office, which they can do by ordinary resolution (for a listed scheme) or extraordinary resolution (for an unlisted scheme) by following the procedures in section 601FM. In that case, the statutory novation procedures under Division 2 of Part 5C.2 can be used (discussed below).

Default events

A lender normally also will specify default events in the finance documents that include:

(a) a material provision of the scheme constitution is illegal, void, voidable or unenforceable;

(b) a person becomes entitled to terminate, rescind or avoid any material provision of the scheme constitution, or it is varied or terminated without the lender's consent;

(c) the execution, delivery or performance of the scheme constitution results in a contravention of any law;

(d) appointment of (or steps taken to appoint) a liquidator, receiver, administrator or other controller to the RE or the scheme property, or the RE ceases to carry on business;

(e) insolvency or deregistration of the custodian, or the making of an application or order, or passing a resolution, to wind up the RE;

(f) without the lender's consent, the RE ceases to be the single responsible entity of the scheme or a new RE is appointed, or an application is sought or order made in any court to remove the RE as responsible entity;

(g) the loss or restriction on the RE's right of indemnity from the scheme property for obligations and liabilities incurred by it under the finance documents;

(g) breach by the RE of the scheme constitution or of its other obligations and duties as responsible entity and trustee;

(i) the RE's Australian financial services licence is suspended, revoked or cancelled.

3.5 Officer's duties and liabilities

Similar duties as those imposed on REs apply to each of the officers of the RE[37]. Officers are exposed to civil and other penalties for breach of their duties as officers of the RE. These duties include:

(a) act honestly, exercise its powers and duties with a level of care and diligence that a reasonable person would exercise if they were in the RE's position, to act in the best

[36] *Barnes v Addy* [1874] 9 Ch App 244.

[37] Section 601FD(1)(b) and (c).

interests of the members, and if there is a conflict between the members' interests and its own interests, give priority to the members interests;

(b) not use information acquired through being an officer of the RE in order to gain an improper advantage for itself or another person or to cause detriment to scheme members;

(c) not use make improper use of their position as an officer to gain, directly or indirectly, an advantage for itself or another person or to cause detriment to scheme members; and

(d) take all steps that a reasonable person in the officer's position would take to ensure that the RE complies with the Corporations Act, any licence conditions, the scheme constitution and the scheme compliance plan.

Similar to the position in relation to the RE, the duties of the officers of the RE in section 601FD will override any conflicting duty of the officers under Part 2D.1 in their capacity as officers of the RE as a company[38].

Given the significance of the Full Court of South Australian Supreme Court decision in *Hanel v O'Neill* [2003] SASC 409 for the liability position of directors of trustee companies (including REs) and subsequent market reaction, mention must be made of the placing on to the Parliamentary agenda of the *Corporations Amendment Bill (No 1)* 2005 (Cth) on 2 June 2005. A good summary of the issues and proposed amendments to section 197(1) is found in the Explanatory Memorandum to the Bill in the House of Representatives.

The unfortunate *Hanel v O'Neill* decision essentially re-interpreted section 197(1) so that directors of corporate trustees (including REs) could be personally liable in any case where there are insufficient assets to discharge the liabilities of the trust. Directors effectively become guarantors, with the potential cost of premiums for corporate trustee directors' and officers' insurances.

If enacted, the Bill will rewrite subsection 197(1) to only impose personal liability on directors where the corporation's right of indemnity as trustee is reduced or lost in specified circumstances. The proposed circumstances in which a corporate trustee will not be entitled to be fully indemnified against the liability out of trust assets (and for which a director may become personally liable) are:

(e) where a trustee corporation has acted in breach of trust and the conduct relates to the incurring of the liability by the corporation;

(f) where the corporation has acted outside the scope of its powers as trustee; and/or

(g) where there is a term in the trust deed denying, or limiting, the corporation's right as trustee to be indemnified against the liability.

Accordingly, where the trustee maintains a right to be indemnified for a liability, the directors will not be personally liable even if there are insufficient trust assets to discharge the liability.

3.6 Related party transactions

Part 5C.7 operates by applying the public company related party provisions of Chapter 2E to schemes with certain modifications. Part 5C.7's stated purpose is to protect the interests of the scheme's members as a whole, by requiring member approval for giving financial benefits to the responsible entity or its related parties that come out of scheme property or that could endanger those interests.

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[38] Section 601FD(2).

Scope of transactions concerned

As with Chapter 2E, the concept of giving 'financial benefits' to a related party is determined in a broad way under section 229 without regard to whether is any consideration for the benefit. The economic and commercial substance of the conduct is considered over the legal form, and may be traced indirectly through interposed entities. The examples of giving a financial benefit in section 229(3) include providing finance or property to the related party, taking up or releasing an obligation of the related party, the sale/purchase or lease of an asset or provision/receipt of services.

As modified, section 208 concerns financial benefits which are given:

(a) by the RE, an entity it controls or any agent or person engaged by the RE (such as a custodian);

(b) 'out of' scheme property or which 'could endanger' scheme property; and

(c) to any of the RE, an entity it controls or any agent or person engaged by the RE (such as a custodian) or a related party of any of them.

'Related party' of a company (RE, custodian etc) in this context means its controlling entity, a director or persons making up a non-body corporate that is its controlling entity, and any of their spouses and de facto spouses, parents and children[39]. As usual, this extends to persons who currently are related parties, or who have been in the previous 6 months or who have reasonable belief that they will be in future.

Whilst the potential scope is very broad, in a lending context, the usual concern will be financial benefits given by the RE or a custodian to themselves or their controlling entities or to entities controlled by the RE or custodian, in circumstances that benefit is out of scheme property or which otherwise places the scheme property at risk. This clearly would include a guarantee or grant of security by the RE or a custodian over scheme property.

When financial benefits permitted

Like Chapter 2E, the giving of a financial benefit is permitted only with member approval or if one of the specified applying exceptions is available[40]. To avoid member approval, the principal exception relied on is where it can be established that the terms of giving the financial benefit would be reasonable in the circumstances if the giver of the benefit and the related party were dealing at arm's length (or on terms which are less favourable to the related party)[41].

Establishing arm's length terms can be particularly problematic where the RE is being asked to provide a financial benefit by way of a guarantee to a lender on account of a related party. On what terms would the RE give the guarantee if the related party wasn't actually related? A guarantee that was secured by a charge over scheme property certainly may 'endanger' the scheme property in the sense of the interests of the scheme's members as a whole.

Unlike Chapter 2E, there is no equivalent or modified exception for benefits given between closely-held subsidiaries (or for small amounts given to directors and their spouses)[42].

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[39] Section 228.

[40] In Division 2 of Part 2E.1.

[41] Section 210.

[42] Section 601LD omits sections 213 and 214 from applying under Part 5C.7.

Consequences of giving a financial benefit which is not permitted

Consistent with the position in Chapter 2E, giving a financial benefit in breach of section 208 (as applied by Part 5C.7) does not affect the validity of any contract or transaction connected with the giving of the benefit, nor does it make the RE guilty of an offence[43]. However, a person involved in the RE's breach will contravene section 209(2) which is a civil penalty provision (subject to a civil standard of proof, and which may result in a court order to pay a penalty amount, a disqualification order or a compensation order), but also will commit an offence if their involvement is dishonest[44] (which may result in a criminal penalty fine and/or imprisonment).

Usually, the finance documents will contain an undertaking that the RE will not transact with related parties otherwise than on an arm's length basis. Further, a breach of section 208 will usually be specified as a default event.

Of course, a lender will always be concerned not to be found to be a person 'involved' in a contravention, such as where the finance documents themselves may result in, or enable, the giving of a financial benefit. Being 'involved' includes aiding, abetting, counselling or procuring the contravention, or being in any way, directly or indirectly, knowing concerned in, or party to, the contravention[45].

As noted elsewhere in this paper, simply obtaining warranties from the RE that there is no contravention will not protect a lender from a civil or criminal penalty where the lender has been involved in a contravention. Instead, the lender needs to be satisfied that there is no contravention to be involved, or otherwise member approval may be required).

3.7 Contingent liabilities

Already it will have been seen that a number of hurdles exist for a lender seeking a guarantee from the RE of a scheme. These concern whether the express power exists for the RE to grant a guarantee and an indemnity under the scheme constitution, whether this is inconsistent with any undertaking or representation by the RE in a product disclosure document or other offer document, whether the guarantee is in the best interests of the scheme members and whether the RE and its directors can satisfy their duties to prioritise the interests of scheme members above the RE's own interests when committing the scheme property to support a liability of someone other than scheme members.

As noted earlier, it is a condition of the RE's licence that it maintain net tangible assets of at least $5,000,000 (or where the value of scheme property is less than $10,000,000, at least equal to 0.5% of the assets shown in the latest accounts of the scheme with a minimum of $50,000). Net tangible assets are calculated on the basis of assets and liabilities valued and recognised as they would appear if a statement of financial position were made up for lodgement as part of a financial report under Chapter 2M at the time of calculation on the basis that the RE's a reporting entity[46].

Where the RE incurs a guarantee liability without a corresponding asset benefit, this will affect the calculation of the RE's net tangible assets. This would need to be considered in light of any

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[43] Section 209(1).

[44] Section 209(2).

[45] Section 79.

[46] Adopting the financial requirements for Managed Investments and Custody Services in ASIC's Pro Forma 209 Australian financial services licence conditions (as reissued 14 January 2005) and ASIC Policy Statement 131 - Managed Investments: Financial requirements

limit on liability to the scheme property, as the giving of the guarantee may affect the RE's ability to meet the financial conditions of its Australian financial services licence.

Further consideration is needed as to the impact of a contingent liability for RE's following implementation of the International Financial Reporting Standards from the commencement of the first financial year after 1 January 2005. In particular, RE's will need to consider how guarantee liabilities will it be treated and any consequential impact on unit pricing, management fees, financial reporting, and calculation of net tangible assets for licensing purposes.

4. Lender's recourse to the scheme property held by the RE

4.1 RE's right of indemnity out of scheme property

As with any trustee, the RE is personally liable for scheme contracts and debts that are incurred in the administration of the scheme[47]. However, the interests of scheme members are postponed to the right of the RE to use scheme property to discharge the liability where incurred in proper performance of the RE's duties[48].

As the lender is looking to the credit of the scheme property (rather than the RE personally), the ability of a lender to recover amounts owing to it depends on the RE having and maintaining a right of indemnity out of the scheme property. In an insolvency of the RE, unsecured scheme creditors would have only a personal right against the RE and no direct recourse to the scheme property. It is the RE's right of indemnity that would become available for distribution (not scheme property).

There probably are three sources of the right of indemnity available to the RE:

(a) the general law right of indemnity attributed to the RE due to its position of trust (discussed below);

(b) the statutory right afforded to the RE under State and Territory trustee legislation, due to its position of trust[49]; and

(c) the form of indemnity drafted in the scheme constitution, as required under section 601GA(2).

The general law right of indemnity arises out of the entitlement of the RE (as a trustee) either to reimburse itself out of the scheme property for amounts it has paid out of its own funds (recoupment), or to apply scheme property directly to pay or discharge liabilities it incurs (exoneration), provided in all cases the liabilities are incurred in the proper administration of the scheme and without breach of trust.

A right of indemnity accrues each time such a liability is incurred, and is supported by a proprietary interest in the scheme property (a lien) for satisfaction of the liability. This represents the RE's beneficial interest in the scheme property, which exists in priority to the interests of

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[47] Following the principle in *Royal British Bank v Turquand* (1855) 119 ER 478.

[48] Section 601GA(2)(b).

[49] Section 59(4) of *Trustee Act* 1925 (NSW) (which also applies in ACT); section 36(2) of *Trustee Act* 1958 (Vic); section 72 of *Trusts Act* 1973 (Qld); section 71 of *Trustee Act* 1962 (WA); section 35(2) of *Trustee Act* 1936 (SA); section 26 of *Trustee Act* 1893 (NT); section 27(2) of *Trustee Act* 1898 (Tas).

scheme members to the extent that the balance of amounts owing as between the RE and scheme members is in favour of the RE[50].

Where a lender's claim against a trustee would be unsatisfied, the lender has an equitable right of subrogation to be put in the place of the trustee so as to enforce the trustee's right of indemnity and proprietary rights. By being subrogated to the trustee's rights, a lender therefore obtains priority in the trust assets over the interests of beneficiaries. However, if the trustee's right of indemnity is denied or reduced, a lender's right of subrogation is equally reduced[51].

The risk of the RE's right of indemnity being denied or reduced therefore is passed to a lender. There are few controls around this risk that a lender can employ, and particularly for an unsecured lender, once the right is gone, so has the lender's claim to any asset of significant value.

Chapter 5C also deals with the right of indemnity, and must be considered as to when that indemnity may be available, restricted or denied. In the case of a scheme, the RE will have no right to be indemnified out of scheme property for liabilities or expenses incurred in relation to its performance of its duties unless it is for the 'proper' performance of those duties and unless those rights of indemnity are specified in the scheme constitution[52]. Section 601GA(2) goes further to state that any other 'agreement or arrangement' to confer a right of indemnity has no effect. It is not clear whether this overrides trustee legislation rights of indemnity afforded to the RE as trustee.

A lender therefore must ensure that the right of indemnity is contained in the scheme constitution and is expressed sufficiently widely to capture liability, expenses and obligations incurred in respect of any proposed transaction and the lender's financing of that transaction. The qualification that the indemnity is only available in relation to the 'proper performance' of the RE's duties means that no reliance should be placed on the indemnity to the extent that it is expressed to be broader than that. Of note also is that the RE must exercise a degree of care and diligence of a 'reasonable person' in the RE's position. If this test also is not met, a question still may arise as to the availability of the RE's indemnity.

A lender also would be concerned to see whether the right of indemnity may be restricted in the scheme constitution in any way, such as being restricted to certain assets only.

The RE's right of indemnity is statutorily preserved in the case of a liquidation, administration or deed of company arrangement despite any provision in the scheme constitution to the contrary, but the right of indemnity then may only be exercised by the liquidator or the administrator[53].

4.2 Secured and unsecured lending

Secured lending

A secured lender will have direct access to particular scheme property the subject of a valid security (granted by the RE and custodian if there is one) as it has a direct security interest in the property. It then falls to determine whether this interest has priority over the interests of scheme members.

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[50] A trustee would be reimbursed before distribution of trust assets to beneficiaries, and a court may authorise sale of trust assets to satisfy a trustee's right of reimbursement or exoneration: *Chief Commissioner of Stamp Duties v Buckle* (1998) 151 ALR 1.

[51] *Octavo Investments Pty Ltd v Knight* (1979) 144 CLR 360 at 367, 370-1.

[52] Section 601GA(2).

[53] Section 601FH.

A lender taking a legal security over scheme property, such as a mortgage by assignment of legal title, will have priority over claims of scheme members to the extent of that secured property if the security is taken by the lender in good faith, for value and without notice of the breach. This will be the case even if the security was granted by the RE in breach of duty, because a legal interest will prevail over the competing equitable interest of the scheme members in these circumstances. This applies for example where a lender takes a legal security in good faith without notice that the secured property is trust property.

An equitable security (such as a charge) created in accordance with an express power and otherwise without breach of trust also will prevail over the interests of scheme members to the extent of the secured property. However, a lender taking an equitable security granted by the RE outside of its powers or in breach of duty would lose priority in the scheme property to the scheme members (even if the security was taken in good faith, for value and without notice of the breach).

A lender relying on an equitable security always must (and a lender relying on a legal security who may not have taken the security in good faith, for value and without notice of breach of trust, must) satisfy itself that the proposed dealings with the RE are within power and not in breach of duty, and will obtain warranties to that effect. However, the value of the security is not affected by unrelated prior breaches of trust.

Unsecured lending or taking an unsecured guarantee

An unsecured lender has no security interest in any particular scheme property and relies on being subrogated to the RE's indemnity and associated proprietary rights against the scheme property generally[54].

An unsecured lender has no better interest in the scheme property than that of the RE, and risks a reduction or loss of the RE's right of indemnity (with a corresponding reduction in the lender's right of subrogation). The RE's right of indemnity for a liability incurred to the lender will not arise if the RE acted outside of its powers or breached its duties when incurring that liability[55].

Accordingly, an unsecured lender (as with a secured lender) will perform due diligence in respect of the proposed dealings with the RE to satisfy itself that the dealings are within power and not in breach of duty, and will obtain warranties to that effect.

An additional exposure for an unsecured lender is that the value of the RE's right of indemnity can be reduced or even extinguished due to the existence of prior liabilities of the RE incurred to the scheme members, even though unrelated to the lender's dealings, whether or not the lender may be aware of those liabilities.

If the RE previously has applied scheme property to satisfy a liability incurred by the RE in breach of trust, the RE will have accrued liabilities owed to scheme members. Some cases suggest that until the RE has accounted for these liabilities, the RE would be prevented from being indemnified out of scheme property (a postponement of indemnity). However, the position seems to be that the RE would still have a right of indemnity to the extent that liabilities properly incurred by the RE exceed the amount of liabilities due by the RE to the scheme members (a set-off against indemnity)[56]. Accordingly, unaccounted for previous liabilities for breach of trust will

[54] Applying the reasoning in *Octavo Investments Pty Ltd v Knight* (1979) 144 CLR 360 at 370.

[55] *Holli Managed Investments Pty Ltd v Australian Securities Commission* (1998) 30 ACSR 113.

[56] In *RWG Management Ltd v Commissioner of Corporate Affairs* [1985] VR 385 at 397, Brooking J states: "Judges have on occasions said that a trustee who does not have a clear account is not entitled to be indemnified (Re Morris, deceased; Re Frith [1902] 1 Ch 342), but the true position, as I apprehend, is not that a trustee liable to compensate

reduce the value of the RE's right of indemnity, and therefore ultimately can reduce the recourse of the lender to scheme property through the lender's rights of subrogation to that indemnity.

4.3 RE limitation of liability clauses

An RE usually will adopt a 'standard' liability limit clause, which where possible, is to be inserted into every document to which the RE is a party. This is particularly so for finance documents, with a forced exception for documents that are to be registered in certain land titles registers[57]. These documents are usually supplemented by a separate non-registrable deed confirming the intended trust capacity and liability limit.

The form of liability limit clause can vary from RE to RE. However, the structure of the clause usually has the following elements.

(a) **A statement of capacity and contractual restriction on enforcement rights**

The RE only enters into the Relevant Documents in its capacity as responsible entity of the scheme and in no other capacity. The RE will seek to negate any liability accruing to it personally (or in another trustee capacity) outside of what it is covered for as RE of the relevant scheme.

This is supported by a contractual prohibition on other parties to a Relevant Document from:

(i) suing the RE in any capacity other than as responsible entity of the scheme;

(ii) seeking the appointment of a receiver (except in relation to property of the scheme), a liquidator, an administrator or similar person to the RE;

(iii) proving in any liquidation of or affecting the RE (except in relation to scheme property); or

(iv) exercising any right of set-off against the RE (except in its capacity as responsible entity of the scheme or in relation to scheme property).

It is important to note that a lender must ensure that the contractual prohibition on enforcement rights contains appropriate carve-outs (as indicated above) to enable enforcement and other action in relation to the scheme property.

A secured lender may seek to include an additional overriding provision to confirm that nothing in the liability limit clause limits the lender's recourse to any scheme property which is the subject of a security. This simply reflects that a secured lender will have direct access to the scheme property through a valid security.

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the estate must actually bring the money in before he is able to assert a lien, but that a balance is to be struck between what is due by way of compensation and what is due by way of indemnity." And at 398: "The principle of these decisions shows that a balance is to be struck, with the result that the trustee will still have the right of indemnity to the extent to which the liabilities properly incurred exceed the compensation due to the estate".

[57] For example, section 82(1) of *Real Property Act* 1900 (NSW) states: 'The Registrar-General shall not record in the Register any notice of trusts whether express, implied, or constructive'. What is recorded on the register is a registration form and, unless provisions are incorporated from a registered memorandum, the provisions of any annexure to the registration form. The technically correct position therefore is that a mortgage should be rejected by the Registrar-General if the registration form or any annexed provisions refer to a trust.

(b) **The basic limit on liability - to the extent of indemnification out of scheme property**

The basic limit is that any liability of the RE arising under or in connection with a relevant document can be enforced against the RE only to the extent to which the RE can be satisfied out of scheme property out of which the RE is actually indemnified for the liability or by exercise of rights under the relevant documents.

Some liability limit clauses seek to support this with an express waiver and release by the lender from any personal liability of the RE, other than when the limit is agreed not to apply due to disentitling conduct of the RE.

The basic limit is expressed to extend to all liabilities and obligations of the RE in any way connected with any representation, warranty, conduct, omission, agreement or transaction related to a relevant document or the scheme.

In this way, the lender's recourse is to be limited to that subset of scheme property which is available to satisfy the RE's right of indemnity. As was seen earlier in this paper, particularly in the case of unsecured lending, the RE's right of indemnity may not arise for a liability incurred in breach of duty, and its value is exposed to being reduced or extinguished by the amount of unsatisfied liabilities that the RE may accrue to scheme members due to losses caused by the RE in breach of its duties. Accordingly, the exceptions to the limit require careful consideration.

(c) **When the limit will not apply (disentitling conduct)**

While a lender can agree to limit its recourse and enforcement rights to that part of the scheme property available to satisfy the RE's right of indemnity, a lender is not to take risk on fraud and similar actions of the RE that may extinguish or reduce that indemnity.

The usual formulation is that the liability and recourse limit will not apply (and so the RE will incur personal liability) to the extent that a liability is not satisfied because, under the scheme constitution, under any document to which the RE is party, or by operation of law, there is an extinguishment or a reduction in the extent of the RE's indemnification out of the scheme property, due to specified types of disentitling conduct engaged by the RE.

The usual types of disentitling conduct are the RE's fraud, negligence, wilful misconduct and breach of trust, but also may include deceit, breach of duty or failure to properly perform duties within the meaning of section 601GA(2).

An RE may seek to insist that a higher standard of 'gross' negligence is appropriate before the limit ceases to apply, on the basis of protection against the effect of technical breaches. This is sometimes accepted by lenders, although it is not well understood at what point negligence becomes 'gross'. 'Gross negligence' has been analysed by Australian courts in the context of acts of criminal neglect (a conscious act or omission with risk of significant harm that a reasonable person would have exercised a higher standard of care). This is distinguished from a simple lack of care civil wrongs for which monetary compensation is possible[58]. However, rather than seeking to fix a different degree of 'gross' negligence in a civil law context, the courts seek to interpret the intention of the parties in describing conduct as worse than ordinary negligence, such as through thoughtless or unprofessional conduct (regardless of whether the acts or omissions were in deliberate disregard to harmful consequences[59]).

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[58] *R v Stephenson* [1976] VR 376; *Nydam v R* [1977] VR 430.

[59] *McMullin v ICI Australia Operations Pty Ltd* [2000] FCA 404.

The risk in using 'gross' is that it can have an uncertain meaning in a civil context. The issue is then a balance of whether the RE should be personally on risk for all of its negligent actions or whether the lender should have the burden of proving an additional but uncertain 'gross' element. An unsecured lender in particular will ask whether it should risk having no recourse to the RE personally where the RE's negligence causes its right of indemnity to be reduced or extinguished.

Some attempt usually is made to scope out what is 'fraud' or 'negligence' (for the purposes of the liability limit clause) in the context of the RE's varied responsibilities in operating the scheme and its reliance on certain service providers. In particular, any fraud or negligence is disclaimed to the extent it is caused by a service provider to the scheme failing to fulfil its obligations relating to the scheme or by any other act or omission of any person who provides services in respect of the scheme (other than the RE's employees, agents or delagatees).

From the RE's perspective, if it is to become personally liable to a lender, this should not occur simply by virtue of breach of a warranty or undertaking in the finance documents. Rather, it is in those circumstances that the RE will wish to have the lender's recourse remaining limited to the scheme property. As a result, often a liability limit clause will contain an acknowledgment that a breach of a warranty or undertaking by the RE in the finance documents will not be considered a breach of trust by the RE unless the RE has acted with negligence, or without good faith, in relation to the breach.

(d) **Preserving the limit when other persons can bind the RE**

Finally, finance documents usually involve the grant of power or agency to a lender, and under a charge or mortgage, a lender can appoint a receiver who is the agent of the chargor or mortgagor. To seek to contain exposure to personal liability, the RE's liability limit clause also may contain a prohibition or restriction in authority for any attorney, agent or receiver appointed under the finance documents from acting on the RE's behalf in any way which would expose the RE to personal liability.

This may be resisted by a lender on the basis that this creates uncertainty as to the scope of enforcement powers and how a receiver could manage the secured property appropriately in a default scenario.

4.4 Claims of former trustees and REs

A trustee's right of indemnity is not extinguished because it ceases to be trustee, and remains available to a former trustee for liabilities properly incurred while trustee. As a former trustee no longer has ownership or direct access to trust assets vested in the new trustee, a former trustee's claim for indemnity is against the present trustee[60].

Where the RE changes in accordance with Part 5C.2, section 601FS(2)(b) similarly preserves any unsatisfied indemnity rights of the former RE as remaining with the former RE, notwithstanding the statutory novation under that Part.

4.5 RE liability for agents and service providers

Where the RE appoints agents or engages other persons to do anything the RE is authorised to do in relation to the scheme, their acts and omissions, even if fraudulent or outside the scope of engagement, are attributed to the RE for the purpose of determining whether the RE has a liability to scheme members or whether the RE has properly performed its duties for the purposes of

[60] *Dimos v Dikeakos Nominees Pty Ltd* (1996) 149 ALR 113; *Belar Pty Ltd (in liq) v Mahaffey* [2000] 1 Qd R 477.

section 601GA(2)[61]. This extends to sub-agents or other persons engaged downstream, as they also are taken to have been appointed by the RE[62].

The RE therefore takes significant risk on negligent and wrongful acts and omissions of others, even where fraudulent or outside the scope of engagement. Where this prevents an accrual of the RE's right of indemnity or creates a liability of the RE in favour of scheme members that reduces the value of the indemnity, the value of a lender's right of subrogation to enforce the RE's indemnity equally is affected.

4.6 The value of warranties

Where the RE's right of indemnity is reduced or extinguished, the lender's rights to be subrogated will have a corresponding reduction or loss, meaning that the lender's recourse will be to the RE personally. Following the chain of risks identified above, as with a trustee, a lender will obtain a range of warranties from the RE, including that:

(a) the finance documents are for the benefit of the scheme;

(b) the RE is not in breach of trust and has the right to be indemnified out of, and a lien over, the scheme property for all liabilities incurred by it under the finance documents, before the claims of scheme members;

(c) the right of indemnity has not been limited in any way, and the RE has no liability which may be set off against that right of indemnity;

(d) the lender is entitled to the benefit of the RE's rights of indemnity against, and lien over, the scheme property, and has recourse to the scheme property to satisfy the RE's liabilities under the finance documents.

However, as seen above, the lender usually will have agreed to limit the RE's personal liability to the extent it actually can be indemnified out of scheme property, except in the case of disentitling conduct such as fraud or negligence. In this regard, also specifying breach of trust as disentitling conduct is necessary as that is when the RE's right of indemnity is affected.

Even where disentitling conduct is found, the RE personally is unlikely to have substantial assets itself, or at least not sufficient assets that would have warranted the lender taking the credit risk in providing the funding. Accordingly, unless the RE still has significant unsatisfied liabilities for which it may be properly indemnified by reimbursement out of scheme property, a lender may be left looking to insurances.

5. Change in RE

5.1 Statutory novation

A change in the RE may arise because the RE wants to retire (section 601FL) or is voted out by scheme members (section 601FM)[63].

Chapter 5C sets out a regime to facilitate a change in the RE, aiming to place the new RE in the former RE's shoes as regards the scheme. Unfortunately, no similar regime applies for a change in custodian, in which case a more cumbersome and less certain approach of assignments and

[61] Section 601FB(2).

[62] Section 601FB(3).

[63] If the RE is voted out and the members fail to choose a new RE or their selected company does not consent to become the new RE, the scheme must be wound up by the existing RE: section 601NE.

formal novations is required, which may require looking at particular contracts and liabilities incurred by the custodian on behalf of the RE. However, having documents and property held by a custodian can work reasonably well with a change in the RE as the RE's beneficial interest in the documents and property and liabilities incurred by the custodian as agent are novated, but leaving the principal title and contracts in the name of the continuing custodian.

It is important to understand the mechanics and statutory effects of the change. The trigger as to when there is a change in the RE is when ASIC updates its record of the entity which is the RE for the scheme[64]. Until then, any purported change in the RE is ineffective[65].

On the change in RE taking effect, section 601FS provides that the former RE's "rights, obligations and liabilities" in relation to the scheme become the rights, obligations and liabilities of the new RE.

Section 601FT aims to obviate the need for novation or assignment of documents from the former RE to the new RE and to preserve the effect of any other documents in existence. It does this by providing that:

(a) all documents to which the former RE was a party or in which a reference is made to the former RE have effect as if the new RE (and not the former RE) was that party or was referred to; and

(b) all documents under which the former RE has acquired or incurred a right, obligation or liability, or might have acquired or incurred a right, obligation or liability if it had remained the RE have effect as if the new RE (and not the former RE) has or might have acquired or incurred the right, obligation or liability under it.

So, to the extent of the jurisdiction of the Corporations Act all rights, obligations and liabilities in relation to the scheme and any documents become novated to the new RE[66]. An additional approach would be required in the case of foreign law contracts, liabilities and property.

It seems clear that a new RE would be bound by contracts made by the former RE, including any finance documents entered into by the former RE.

However, not all scheme assets may be sufficiently captured within the meaning of "rights" or "documents" under those sections. Part 5C.2 does not set out an express statutory vesting of all of the former RE's interests in scheme property or assets. In the absence of a statutory vesting, what happens to the property and assets? This was examined by Barrett J in *Re Investa Properties Limited and Another* (2001) 187 ALR 462 involving the change in two successive REs of a scheme.

Justice Barrett considered that the new RE must have acquired the property and assets due to the operation of section 601FC(2). That section declares that an RE of a registered scheme "holds scheme property on trust for scheme members". If an entity becomes the new RE, it must have begun to hold the property (because section 601FC(2) declares this), and only could have done so by acquiring the property. Whilst the section appears expressed more in terms of a statement of

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[64] Section 601FJ(1).

[65] Section 601FJ(2).

[66] While section 601FS confines its effect to rights, obligations and liabilities "in relation to the scheme", section 601FT is expressed to apply in respect of all documents. Section 601FT, if taken literally, would have the effect of drawing in documents concerning the RE in its personal capacity or in its capacity as responsible entity or trustee of a different scheme or trust. The section would need to be read down to documents "in relation to the scheme" to have the intended application, and this was done in *Re Investa Properties Limited and Another* (2001) 187 ALR 462.

fact rather than a duty, it is described in section 601FC(3) as being a duty of the RE as to holding scheme property.

For NSW law governed schemes, given the position of the RE as a trustee, a deed of retirement and appointment also should be registered in the general register to obtain the benefit of the statutory vesting provisions in the relevant trustees legislation in relation to the trust property[67].

5.2 Matters excluded from novation

Unlike the situation with a change in a trustee, section 601FS(2)(d) expressly excludes from the novation of rights and liabilities any liability for which the former RE could not have been indemnified out of the scheme property if it had remained the scheme's responsible entity. Section 601FT(2) similarly excludes relevant related documents.

Accordingly, the risk of claim for improper liabilities remains as against the former RE and does not transfer to the new RE. This is particularly beneficial to an unsecured lender because the lender's recourse to scheme property through the lender's rights of subrogation to the new RE's right of indemnity is no longer at risk for unaccounted prior liabilities of the former RE for breach of duty reducing the value of the new RE's right of indemnity. The new RE is effectively a clean-skin for such liabilities.

Section 601FS(2)(b) expressly excludes from the novation of rights and liabilities any right of the former RE to be indemnified for expenses it incurred before it ceased to be the responsible entity. Section 601FT(2) similarly excludes relevant related documents. This preserves to the former RE unsatisfied claims for its expenses properly incurred (although properly incurred liabilities will have novated to the RE). As scheme property is held by the new RE, the former RE no longer has direct access to that property, and so must make the necessary claim for its unsatisfied expenses against the new RE.

5.3 Updating affected registers

The statutory treatment of a change in RE will not automatically flow through to relevant registers, such as interests in land or registration of charges. Accordingly, a secured lender will need to deal with the new RE to ensure continuation of the validity of existing registered security granted by the former RE.

For example, where scheme property was subject to an existing registered charge granted by a former RE, a new RE will have acquired the scheme property subject to that charge, requiring lodgment of an ASIC Form 309 against the new RE. The RE must lodge the Form 309 within 45 days of the acquisition (on change of responsible entity)[68] or within 45 days of the chargee becoming aware that the property charged has been acquired[69]. Otherwise it may be necessary to apply for a court order[70].

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[67] See for example section 9 of the Trustee Act 1925 (NSW). Section 9(1) states: "Where a new trustee is appointed, the execution and registration of the deed of appointment shall without any conveyance, except as otherwise provided in this section, vest in the persons who become and are the trustees for performing the trust, as joint tenants and for the purposes of the trust, the trust property for which the new trustee is appointed". Similar provisions exist in other States and Territories. However, it would still be necessary to register transfers (such as a transfer of land) where there is a statutory register for the asset.

[68] Section 264(1).

[69] Section 266(1)(f).

[70] *Re Investa Properties Limited and Another* (2001) 187 ALR 462.

A charge granted by the former RE will be at risk of being void as against a liquidator, administrator or administrator under a deed of company arrangement (as the case may be) in respect of the new RE, unless a Form 309 is lodged within 45 days after the chargee becomes aware of the appointment of the new RE[71], subject to extension of that period under the discretion of the court.

To complete a Form 309 in this context will require specifying that the date the property was acquired was the date the RE changed and that the charge is created by 'other conduct', being a 'statutory novation' pursuant to section 601FS. A copy of the existing charge (as novated from the former RE) would be attached, and lodged together with a Form 350 (as to stamp duty having been paid).

A Form 312 would need to be lodged to remove registration of the charge against the former RE. The transaction of novation involved with a change in RE and the consequential acquisition of property through declaration of trust under section 601FC(2) is not strictly a release of property, however only an ASIC Form 312 can be accepted by ASIC to remove registration of the charge against the former RE. A chargee would wish to ensure that there is no argument that the charge (as continuing as a document novated to the new RE) has in anyway had property released from the charge, either before the new RE acquires the scheme property or in a way that relates to the charge as a registered charge against the new RE. This could be the subject of express assurances from the new RE.

6. External custodians

6.1 Need for an external custodian

REs have specific duties in relation to scheme property, including to clearly identify that property as being scheme property and to hold it separately from the RE's property and property of any other scheme[72].

ASIC has specified minimum outcomes which must be achieved by the person holding scheme property (whether the RE or a custodian appointed as an agent of the RE):

(a) the custodial organisation structure must be independent from the RE, not involved in investment decisions, trading decisions or other decisions resulting in the movement of scheme property and must report directly to the compliance committee or board of directors of the responsible entity (that is, separate reporting lines and no common staff);

(b) custody staff must have the experience, qualification, knowledge and skills necessary to perform their functions properly;

(c) adequate secure computer systems, record procedures, settlement and clearance systems;

(d) methods of identifying the scheme property;

(e) at least $5 million net tangible assets.

If the RE does not meet these standards, the RE's Australian financial services licence will be issued subject to a condition that another entity which meets the standards acts as custodian of the scheme property. A separately contracted custodian often is appointed to do this, and does so as bare trustee and agent for the RE.

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[71] Sections 266(1)(a) and 266(2)(c).

[72] Required under section 601FC(1)(i) and see ASIC Policy Statement 133 *Managed investments: Scheme property arrangements.*

6.2 Custody agreement

ASIC Policy Statement 133 states that, as a condition of the RE's licence, there must be a written agreement with the custodian (agent), setting out minimum requirements. These include:

(a) assurances that the custodian meets the standards set out in ASIC PS133;

(b) how the RE will give authorised instructions to the agent;

(c) how the scheme will be compensated for loss due to the agent' breach of the agreement and the minimum level of the custodian's professional indemnity insurance;

(d) a prohibition on the custodian from taking a charge, mortgage, lien or other encumbrance over, or in relation to, assets of the scheme (other than for expenses and outlays made within the terms of the agreement, but not including unpaid custodian fees);

(e) the use of sub-custodians and prescribing that a sub-custody agreement must cover, to the extent practicable and relevant, the same issues which should be covered in the custody agreement and the liability of the sub-custodian to the RE and the agent when acts or omissions of the sub-custodian make them liable.

The agency of the custodian is important because acts of the custodian within the scope of agency will bind the RE as principal. In addition, section 601FB(2) also attributes acts or omissions of agents to the RE (including any sub-agents), even if fraudulent or outside the scope of agency.

A lender therefore will wish to see in the custody agreement an indemnity by the custodian in favour of the RE for loss due to the custodian's fraud, negligence, breach of trust and breach of duty. Usually any amount recovered under such an indemnity is recoverable by the RE. However, if the agent's acts or omissions were wrongful or negligent and the RE's loss relates to a consequential failure by the RE to perform its duties, any amount recovered from the agent forms part of the scheme property[73].

6.3 Custodian's principal duties

Given their limited role as bare trustee and agent, custodians will expect to have no responsibility for commercial judgments. The principal appointed duties and responsibilities of the custodian are to:

(a) hold scheme property for the RE;

(b) act as agent of the RE in entering contracts and effecting transactions in relation to the scheme property;

(c) open and maintain bank accounts to holds cash, income and proceeds from the scheme property; and

(d) act on the RE's written directions from time to time.

The custodian is therefore also a trustee, acting to hold the scheme property only for the benefit of (and as directed by) the RE, on notice that the RE in turn is trustee for the scheme members. On this analysis, the RE only holds the equitable title to the scheme property held by the custodian.

A custody agreement will usually provide that the custodian is not to be considered a trustee of the scheme property except to the extent that it holds bare title to the scheme property as agent for the RE. This is to ensure that it is the RE who is the responsible trustee for scheme members. Given that the custodian is on notice of the role of the RE and that scheme members are the ultimate beneficiaries, potential exists for custodian's duties being extended to scheme members.

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[73] Section 601FB(4).

6.4 Warranties, undertakings and default events

Usually, a lender will insist on the benefit of certain warranties and undertakings in the finance documents in respect of the custody agreement and the custodian. Typical provisions include:

(a) a warranty that the RE's entry into the transactions will not contravene the custody agreement;

(b) an undertaking to notify the lender of any default under the custody agreement, and of any intention of the RE to exercise a power or remedy under the custody agreement due to the custodian's default;

(c) an undertaking by the RE to enforce its rights and remedies under the custody agreement;

(d) an undertaking by the RE to comply with its undertakings under the custody agreement;

(e) an undertaking not to vary, terminate or waive material obligations under the custody agreement.

A lender may also clearly place funding risk on the RE by inclusion of default events concerning the custodian. These may include the following:

(a) a material provision of the custody agreement is illegal, void, voidable or unenforceable;

(b) a person becomes entitled to terminate, rescind or avoid any material provision of the custody agreement, or it is varied or terminated without the lender's consent;

(c) the execution, delivery or performance of the custody agreement results in a contravention of any law;

(d) appointment of (or steps taken to appoint) a liquidator, receiver, administrator or other controller to the custodian or the scheme property or the custodian ceases to carry on business;

(e) insolvency or deregistration of the custodian, or the making of an application or order, or passing a resolution, to wind up the custodian;

(f) without the lender's consent, the custodian ceases to be the sole custodian of the scheme property or a new custodian is appointed.

6.5 Taking security from a custodian

A lender seeking security over scheme property will find the title vested in the custodian. When lending on a secured basis, should a lender obtain direct security and undertakings from both the custodian and the RE? As the custodian holds scheme property on bare trust for the RE, taking security over the RE's beneficial interest in scheme property and the RE's rights under the custody agreement will give the lender indirect control of the property through the RE.

However, an effective security over scheme property will require dealing directly with the custodian who holds the title to the assets, particularly to take a legal security or to obtain a registered security interest. That will mean having the custodian execute mortgages or charges or any other security documentation.

Custodians, as bare trustees generally only act on proper instructions from the RE, will not normally wish to give undertakings or warranties of any kind to a lender, and will want all liability excluded to the extent possible. It will be the RE which assumes the principal liability to the lender. Often a custodian will agree to give the minimum undertakings and warranties to create a valid security interest, with the principal undertakings and warranties imposed on the RE who must ensure that the custodian complies with all other undertakings.

A lender still must consider whether the custody agreement gives the custodian express power to give a guarantee, to give an indemnity, to grant security over custody property and to enter into contracts relating to the custody property.

As the custodian is a bare trustee for the RE, a lender also wish to see that the custody agreement contain sufficient rights of indemnity out of the custody property, noting the positions of each of a legal security holder and equity security holder discussed earlier in this paper. The lender will wish to have security over the right of the custodian to be indemnified and the custodian's lien on trust assets.

A lender taking security from a custodian may address the above issues in each security document by having both the RE and the custodian a party, so as to:

(a) expressly authorise and instruct the custodian to enter into and perform all obligations and liabilities it incurs under the finance documents; and

(b) agree, for the lender's benefit, to give all necessary directions and instructions from time to time so that the custodian can continue to observe and perform those obligations and liabilities;

(c) agree not to give the custodian any instruction or direction which, if complied with, would cause the custodian to breach any of its obligations under the custody agreement, any finance document or any law;

(d) ensure that the custodian observes and performs everything that the custodian as a security provider has agreed to do, or not do, under the security;

(e) indemnify the lender and any receiver appointed under the security for loss or damage in connection with the custodian failing to fully perform its covenants, obligations and liabilities as a security provider; and

(f) obtain the express agreement from the custodian and the RE that all instructions and directions given by the RE under the terms of a finance document constitute 'Proper Instructions' received by the custodian for the purposes of the custody agreement for which the custodian does not require clarification from the RE.

6.6 Subcustodians

Having tied down the RE and the custodian, a lender will be concerned to prohibit the custodian itself appointing a subcustodian or agent to hold any secured scheme property. If it were necessary that a subcustodian is used, the lender would need to repeat the due diligence and documentation requirements that it had in respect of the custodian. That is, the subcustodian must provide the security on terms that

6.7 Custodian liability limit clause

As noted above, a custodian has a limited role of bare trustee and agent for the RE in connection with the holding of scheme property. For this reason, a custodian also will have a 'standard' liability limit clause similar to that discussed above for the RE.

Whilst a custodian's liability limit clause is similar in formulation to that of the RE (discussed at paragraph 4.3 of this paper), it also may:

(a) record that the custodian can only act in accordance with the custody agreement under which it is appointed;

(b) seek to be released from any liability or obligation to any party under the Finance Documents on it ceasing to be the custodian of the scheme;

(c) provide for its basic liability limit to be framed in terms of its right of indemnity out of the custodial property plus its right of indemnity against the RE under the custody agreement;

(d) seek to limit the custodian's liability to the extent that the Finance Documents require satisfaction out of the scheme property held under the custodian's control and in its possession to the intent that the scheme property held by the custodian is handed over to the lender in exoneration of the liability;

(e) seek to disclaim any fraud or negligence to the extent caused or contributed to by the RE failing to fulfil its obligations relating to the scheme or by any other act or omission of any person who provides services in respect of the scheme (other than the Custodian's employees, agents or delagatees).

7. Insolvency and winding up

As with trustees, it is important to consider each of the winding up of a scheme and the insolvent administration or winding up of the RE. These can happen separately or together.

Usually the RE will have only contracted on a limited recourse basis, as discussed above, and so will have sought to minimise any exposure to personal insolvency and winding up actions.

7.1 Insolvency of the RE

The RE, as a company, is subject to the same insolvency and external administration regimes applicable to other companies under the Corporations Act.

If a liquidator is appointed to the RE, the liquidator will be obliged to perform (in the name of the RE) the RE's duties in relation to the scheme until a new RE is appointed. In this way, the scheme is able to continue without the scheme property being affected by the liquidation, except to the extent that the RE has unsatisfied liabilities out of which it can be indemnified out of the scheme property. The RE's right of indemnity is statutorily preserved in a liquidation of the RE, but only may be exercised by the liquidator in that case[74].

On a simple view, the RE may have incurred liabilities to three classes of creditor:

(a) secured creditors for whom a direct security interest has been created in specific scheme property;

(b) unsecured creditors for whom debts were properly incurred in its capacity as RE and trustee and for which the RE is indemnified out of scheme property generally - these creditors are subrogated to the RE's right of indemnity and proprietary rights in scheme property; and

(c) other creditors of the RE, who either intended to have recourse only to the RE's personal assets or unfortunate lenders for whom there is no right of indemnity of the RE to be subrogated to.

In an insolvency of the RE, a significant asset of the RE is its right of indemnity out of scheme property that would become available for distribution. If the RE's right of indemnity and any proceeds of its become an asset of the RE personally, an issue to consider therefore is whether unsecured creditors who have access to the RE's right of indemnity (**scheme creditors**) have any greater claim to proceeds of the RE's right of indemnity over other creditors of the RE (**personal creditors**). The answer depends on the nature of the indemnification.

[74] Section 601FH.

If the RE's indemnification is by exoneration out of the scheme property directly to satisfy a liability properly incurred as RE, then only scheme creditors will have the benefit of the indemnification. This necessary to ensure that there is no breach of the administration of the trust and to give effect to the lender's right of subrogation.[75]

If the RE is to be reimbursed so as to recoup payments that the RE made personally, then presumably the particular scheme creditor for whom the payment was made has been paid, and so no longer has a right of subrogation in respect of the RE's reimbursement. In that case, any proceeds out of scheme property by way of reimbursement simply accrue to the RE beneficially as a personal asset, and so should be equally available to both scheme creditors and personal creditors of the RE.

Change of RE

A natural consequence of insolvency, administration or liquidation of the RE will be that the members may wish to replace the RE, which they can do by ordinary resolution (for a listed scheme) or extraordinary resolution (for an unlisted scheme) by following the procedures in section 601FM.

7.2 Administration risk

If an administrator is appointed to a company, a person who holds security over 'the whole, or substantially the whole, of the property' of the company for the purposes of section 441A(1)(b) can enforce its security during the first 10 days of the administration standstill period (namely, appoint a receiver and take possession of the assets).

An issue for a secured lender in respect of the RE (or a custodian who holds scheme property) is that the lender will usually only have security over the scheme property. If the RE or custodian holds substantial property personally, or for other schemes (such as a professional RE/custodian), then it is not possible to have secured substantially the whole of the RE's/custodian's assets.

The RE's right of indemnity is statutorily preserved in an administration of the RE, but only may be exercised by the administrator in that case[76]. In practice however, the significance of this issue as concerns an administration of the RE must be considered in the context of the statutory regime for change of the RE noted earlier in this paper.

Administration risk generally must be accepted when dealing with a professional RE or professional custodian.

7.3 Winding up the scheme

A duty of the RE is to ensure that the scheme constitution makes adequate provision for its winding up[77], and so should provide for how scheme property is to be distributed.

Part 5C.9 sets out various circumstances in which the scheme is to be wound up. These include:

(a) where prescribed by the constitution at a particular time or because an event has occurred (other than an event being a particular company ceasing to be the RE);

(b) an extraordinary resolution of members directing the RE to wind up the scheme;

(c) a wind up by the RE where it considers that the scheme objectives have been accomplished or cannot be accomplished, and members do not call a meeting to vote

[75] *Re Suco Gold Pty Limited* [1983]33 SASR 99 and cases following this.

[76] Section 601FH.

[77] Sections 601FC(1)(f) and 601GA(1)(d).

otherwise within 28 days of ASIC and the members being notified of the RE's intentions to wind up;

(d) on application by the RE, a director of the RE, a scheme member or ASIC, by court order directing the RE wind up the scheme where the court considers it just and equitable to do so; or

(e) on application by a creditor, by court order directing the RE wind up the scheme if within the previous 3 months the creditor has had returned an unsatisfied execution or other process issued on a judgment or court order against the RE in favour of the creditor.

Depending on the circumstances of the RE, a consideration in initiating a wind up of a scheme may involve first changing the RE using the statutory novation method in Division 2 of Part 5C.2. As discussed above, this process would allow a lender to take advantage of the exclusion from the novation process those liabilities for which the RE could not have been indemnified out of scheme property had it remained the RE[78].

8. Stapled security issues

8.1 Nature

Stapling is an arrangement under which different securities are admitted to the official list of the ASX and quoted jointly on the basis that the stapled securities cannot be traded separately. Stapling may occur in respect of units issued by one or more trusts, shares issued by one or more companies or different classes of securities issued by the same entity.

A number of listed property trusts are structured so that 'trading' activities (generally speaking, property development activities, as opposed to holding property for passive rental or other income) are instead conducted by a management company. Units in the trust are 'stapled' to shares in the company. Stapled security holders receive untaxed trust income via distributions on their units (due to the 'flow through' tax treatment of trusts) and taxed income via dividends on their shares.

The ASX does not require that entities with stapled securities enter into a formal co-operation agreement in relation to matters such as the joint issue of prospectuses or making joint disclosures to the market. However, ASX requirements in relation to the stapling provisions to be contained in the constituent documents have the effect that the entities would not be able to issue securities or reorganise their capital or interests except in close co-operation with each other. The constitution of each entity must provide that securities of one entity cannot be issued unless there is a matching issue of securities of the other entity.

Otherwise, the treatment of each security (and issuing entity) remains separate. For example:

(a) each entity retains its legal status and own responsibilities to comply with accounting standards and law;

(b) each entity still must separately report financial statements, however ASX also requires the entities to provide the market with joint financial statements[79];

(c) there is no joint or cross-liability to creditors (unless of course one or both entities gives a lender the relevant guarantee to that effect);

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[78] Section 601FS(2)(d).

[79] The Australian Accounting Standards Board (Urgent Issues Group) has issued Consensus View 13 on 'The Presentation of the Financial Report of Entities whose Securities are Stapled'.

(d) if one entity was insolvent and ASX suspended (or removed from quotation) that entity's securities, ASX reserves the right to suspend (or remove from quotation) the other entity's securities - the constitution of each entity may also provide that the insolvency of one entity triggers the stapling of the securities to cease (any such trigger events must be approved by the ASX).

8.2 Conflicts and related party issues

The fact that the securities are jointly traded on the ASX would not usually be relevant to consideration of directors duties. The directors of each entity (such as a company or RE) will have a duty to their own shareholders (under common law and Chapter 2D.1 in the case of a company entity) or their own unitholders (under common law and Part 5C.2 in the case of a scheme) but not to the shareholders or unitholders of another entity within the stapled structure.

If the entities within a stapled structure have common directors, when the directors are carrying out their duties to the individual entity, each director must act in good faith and in the best interests of the members of that particular entity. Common directorships does not necessarily mean that the directors can not vote on any resolution, although they still must act in the best interests of the particular entity (and in the case of a scheme, the best interests of the unitholders, which take priority over the interests of the RE).

ASIC has on occasion granted case by case relief to other entities with stapled securities to allow directors of the RE to act in the best interests of the unitholders, having regard to their interests as stapled security holders.

The related party provisions of Chapter 2E (public companies) and Part 5C.7 (schemes) require shareholder/unitholder approval for a company to give a financial benefit to a related party. If entities within a stapled structure will be related parties, any proposed transaction between the parties should be considered by the directors as to whether it is on arm's length terms.

Generally, legal opinions are obtained to the effect that the relevant finance documents and the transactions contemplated by them do not contravene these Corporations Act provisions. However, ASIC has on occasion granted case by case relief to other entities to allow financial benefits to be provided between wholly owned entities in the stapled structure for as long as the securities are stapled.

ASX Listing Rules only consider admission of an entity in its sole capacity, and so do not allow for stapled securities. ASX has published a Guidance Note on how it will regulate the listing of entities that will have stapled securities. Therefore, ASX waivers may need to be obtained as to satisfaction of admission criteria for the entities with stapled securities collectively (rather than individually).

ASIC modifications/exemptions also may be sought to avoid uncertainties as to possible conflicts of duties or related party transactions as discussed above. ASIC relief may be applied for:

(a) **duties of RE** - section 601FC requires the RE to act in the best interests of the unitholders of the scheme. If there are common directorships and control, it may be more efficient for the management of the stapled group if the RE can act in the best interests of holders of the stapled securities (rather than just the unitholders). ASIC has granted similar relief to stapled entities;

(b) **duties of officers of RE** - ASIC may grant relief to enable the officers of the RE to act in the best interests of the holders of stapled securities (not just the unitholders);

(c) **related party transactions** - as discussed above, ASIC may grant relief from Chapter 2E and Chapter 5C.7 to allow financial benefits being given between wholly owned entities within the stapled group for as long as the securities are stapled;

(d) **requirements of scheme constitution** - Class Order 98/52 amends section 601GA (the requirements for the constitution). ASIC has granted case by case relief to make it clear that CO 98/52 applies to stapled securities. This may allow the RE to determine the allocation of the issue price of a stapled security between a share and a unit in the scheme.

9. IFRS Impact

9.1 Background

On 15 July 2004, the Australian Accounting Standards Board (AASB) introduced new or revised accounting standards designed to implement the International Financial Reporting Standards (**IFRS**). These standards will apply to all registered managed investment schemes and other reporting entities (under the Corporations Act) from the commencement of their first financial year after 1 January 2005. For schemes with a 30 June financial year end, the new standards will apply for the financial year 1 July 2005 to 30 June 2006. For those with a 31 December financial year end, the standards already apply for the period 1 January 2005 to 31 December 2005.

The adoption (rather than harmonisation) of new accounting and reporting standards generally impacts reported results, form and content of financial reports, recognition and measurement of assets/liabilities position, distribution policies, performance-linked key measures, ratios and resultant tax treatment of some arrangements and instruments.

9.2 Scheme impacts

Two financial reporting standards that are creating the most discussion for managed investment schemes are AASB 132 (which requires that the redemption price multiplied by the number of units on issue, or 'unitholder equity', be categorised as a liability) and AASB 139 (which will change the way most schemes value their underlying assets).

For the purposes of this paper, it can be said that the extent of impact on the operation of any particular scheme will depend on the specific drafting of provisions in the scheme constitution and the RE's operational approach.

From a lender's perspective, there will be a review of new reporting information in light of existing credit assessment and requirements. Lenders generally obtain warranties as to financial statements over the transition period to IFRS. Other usual considerations in connection with any lending to schemes include the impact on:

(a) continued performance and compliance with reporting, gearing and other financial covenants and ratios;

(b) the accounting and tax effect of more structured transactions;

(c) the introduction into loan facility agreements of 'review event' triggers covering adopting and transition to IFRS, and the extent of rights given to the lender in those circumstances.

10. Ending comment

The variety of investment arrangements that may qualify as schemes, or be exempted or relieved from being schemes, means that lenders need to consider the regulatory impact on such arrangements and consequential lending risks. A significant area of risk (for lenders and all parties to a scheme) remains properly identifying an unregistered scheme as being one that requires registration. The consequential fall-out happens from that point.

When dealing with the RE of a registered scheme, the basic considerations of dealing with a trustee and a separate custodian in a regulated environment generally seem to be well understood by most lenders and their lawyers. Some of the vagaries of inherited trust law, particular requirements under Chapter 5C and associated issues of access to the scheme property occasionally throw up difficulties for which there are more than one view.