Companies and Securities Advisory Committee

Report to the Minister for Financial Services and Regulation

on

Liability of Members of Managed Investment Schemes

March 2000

Liability of members of managed investment schemes

Request from the Minister

By letter of 28 June 1999, the Minister for Financial Services and Regulation, The Hon Joe Hockey MP, requested the Advisory Committee's advice on the liability of members of managed investment schemes.

The Minister pointed out that, during the Senate debate on the Managed Investments Bill in June 1998, the Australian Democrats proposed the following amendment to the Bill to limit the liability of scheme members:

> "On winding up of a scheme, a member is liable to contribute to the scheme property only to the extent to which the member has not paid the consideration that the member was liable to pay to acquire the interest in the scheme held by the member immediately before commencement of the winding up."

This compares with s 516 of the Corporations Law which provides that in a corporate liquidation:

> " … if the company is a company limited by shares, a member need not contribute more than the amount (if any) unpaid on the shares in respect of which the member is liable as a present or past member."

CSLRC proposal

In August 1984, the Companies and Securities Law Review Committee (CSLRC) wrote to the then Ministerial Council requesting a legislative amendment to limit the liability of all unitholders in public unit trusts, in a similar manner to what is now found in s 516 of the Corporations Law.

The CSLRC pointed out that the investing public sees the purchase of units in a public unit trust as analogous to the purchase of shares in a limited liability company and generally assumes that the limited liability that attaches to shares in such companies applies equally to units. However, under trust law, each beneficiary may be proportionately liable to indemnify the trustee (and indirectly the creditors through their subrogation rights) for any liabilities which are incurred by that trustee in the exercise of its powers and which could not be met from the assets of the trust, unless that right of indemnity has been expressly excluded by the trust deed.[1]

The CSLRC also recommended that trustees or management companies be obliged to notify third parties that members of unit trusts have limited liability.

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1 *Hardoon v Belilios* [1901] AC 118. The principle of proportionate liability of beneficiaries was applied in *JW Broomhead (Vic) Pty Ltd (in liq) v JW Broomhead Pty Ltd* (1985) 3 ACLC 355, 9 ACLR 593. *McLean v Burns Philp Trustee Company Pty Ltd* (1985) 9 ACLR 926 also confirmed that the potential personal liability of beneficiaries for the debts of a trust could be excluded by a clause which limited the trustee's right of recourse to assets of the trust, except where this would be contrary to public policy. However, the Court held that a clause in the deed of a public unit trust which excluded the trustee's right of indemnity against the beneficiaries was not contrary to public policy.

The Ministerial Council subsequently considered the matter. There was some support for the proposal, based on the analogy between unitholders in a public unit trust and shareholders in a limited liability company. Those opposing the amendment argued that the statutory limited liability protection could come at the expense of innocent third parties. They gave the example of investors in a timesharing development being preferred over private contractors employed by the management company to refurbish the premises. They argued that any unitholder liability should be left to the drafting of particular trust deeds (which might, for instance, specifically ensure that the rights of the trustee, and therefore the subrogated rights of creditors, do not extend beyond the assets of the trust). The legislation could also be amended to oblige promoters to indicate in the prospectus whether unitholders could be liable under the terms of the particular trust deed.

In consequence of this difference of view in the Ministerial Council, the CSLRC proposal was not adopted. Instead, the Ministerial Council decided to defer the matter pending any judicial decision that directly imposed liability on unitholders in a public unit trust. The Ministerial Council did not subsequently consider the matter.

The Harmer Insolvency Report

The Australian Law Reform Commission (ALRC) *Insolvency Report* (1988) considered the matter from a different perspective from the CSLRC, namely whether to exclude the common law right to draft trust deeds to limit the potential liability of beneficiaries.

The argument put forward in those submissions that supported excluding that right was that beneficiaries who had gained financially through a trading trust should have to provide some compensation to creditors if that trust became insolvent. However, most submissions opposed that common law right being excluded. They pointed out that beneficiaries, in that capacity, have little, if any, influence or control over a trustee and thus should not be held personally responsible for debts incurred by the trustee. These beneficiaries were analogous to shareholders in limited liability companies.

The ALRC recommended that the common law rights of a beneficiary to have personal liability excluded under the terms of a trust deed should not be removed.

Collective Investments Review

The ALRC and the Advisory Committee conducted a joint *Collective Investments Review* from 1991 to 1993. The Review concluded that it would be unsatisfactory for the potential liability of investors in public investment vehicles such as collective investments to depend on the drafting of an individual deed or constituent document. The Review recommended a statutory provision to ensure that investors in collective investment [managed investment] schemes have no personal obligation to indemnify the responsible entity or a scheme creditor where scheme assets are insufficient to cover scheme debts. Investors' liability should be limited to any amount unpaid on their investment in the scheme. Submissions on this matter strongly supported this policy.[2]

Advisory Committee analysis

Consultation

In preparing this Report, the Advisory Committee sought the advice of its expert Legal Committee. It also sought comments from the Investment and Financial Services Association (IFSA) and the Managed Investments Industry Association. Both Associations supported the principle of statutory limited liability.

The Committee thanks Pamela Hanrahan, Senior Lecturer in Law, University of Melbourne and Special Counsel, Arthur Robinson & Hedderwicks, for her very useful comments on an earlier draft of this Report.

The need for law reform

The Advisory Committee considers that the common law creates some uncertainty about when, and how, it is possible to ensure that investors in managed investment schemes are protected against unlimited liability. This legal uncertainty is not in the interests of creditors or members. Creditors do not currently rely on having access to the personal wealth of scheme members. This uncertainty could also increase the costs of fundraising and thereby have a negative impact on the Australian economy.

The Advisory Committee supports the general principle that passive investors should have similar protections against liability, whether they invest in managed investment schemes or in limited liability companies. In many respects, these investors are already treated in a similar manner under the Corporations Law.[3] The question is whether all managed investment schemes should provide limited liability and in what manner.

Types of schemes

There are various types of managed investment schemes under the Corporations Law, namely:

- *registered schemes.* A scheme must be registered if it has more than 20 members, is promoted by a person who is in the business of promoting managed investment schemes or is subject to an ASIC requirement that it be registered[4]

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2 *Collective Investments: Other People's Money* vol 1 (1993) para 11.37.

3 For instance, there are parallel provisions for shareholders and scheme members concerning the conduct of meetings: compare Parts 2G.2 and 2G.3 (shareholder meetings) and Part 2G.4 (meetings of members of registered managed investment schemes).

4 s 601ED.

- *ASIC-exempt schemes.* ASIC may exempt schemes that may otherwise be required to be registered. ASIC has exercised its power both by class order[5] and on a case by case basis[6]

- *other unregistered schemes.* These schemes are those that do not require registration because there are fewer than 20 members, or all interests in the schemes that have been issued are excluded from the fundraising requirements.[7]

What schemes should have limited liability

There are various rationales for giving limited liability to shareholders of companies, which apply equally to members of managed investment schemes.

Facilitating enterprise

Limited liability encourages the economic activity of companies and schemes by separating investment and management functions and shielding investors from any loss in excess of their original contribution. This also decreases the need for shareholders or members to monitor the managers of entities in which they invest, given that limited liability shields them from the consequences of the actions of those managers.

In companies, this separation of functions is achieved by excluding shareholders from the day-to-day running of the company.[8] Similarly, one of the hallmarks of any managed investment scheme is that members do not have day-to-day control over the operation of the scheme.[9] This is an argument for extending limited liability to members of all managed investment schemes, whether registered or not.

The Advisory Committee considers, however, that any statutory provision granting limited liability should only apply to registered and ASIC-exempt schemes.

The definition of managed investment scheme contemplates the possibility of particular members having the right to give directions.[10] Limited liability should not

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5 Examples of schemes exempted from registration by class order include:
- foreign schemes (Policy Statement 136.3)
- strata management rights schemes (Policy Statement 140)
- managed discretionary accounts (Policy Statement 136.34)
- participating property syndicates (Policy Statement 136.34)
- some mortgage schemes (Policy Statement 144)
- various exemptions carried over from the previous law (Policy Statement 136.46).

6 The case by case exemptions from registration include “closed prescribed interest schemes” (Policy Statement 135.3 ff) and instances where there is serious doubt about whether the scheme is a managed investment scheme (as defined in s 9), but ASIC will grant relief to provide commercial certainty.

7 s 601ED.

8 The division of functions between management and shareholders in corporate decision-making is outlined in Chapter 1 of the Advisory Committee Discussion Paper *Shareholder Participation in the Modern Listed Public Company* (September 1999).

9 Para (a)(iii) of the s 9 definition of “managed investment scheme” provides that “the members do not have day-to-day control over the operation of the scheme (whether or not they have the right to be consulted or to give directions)”.

10 Ibid.

shield those members from the consequences of giving these directions. However, all registered schemes must be operated by a licensed responsible entity, which must be a public company.[11] Any member who is actively involved in controlling the affairs of a managed investment scheme through the giving of directions could be a "shadow director" of the responsible entity[12] and be subject to the personal liabilities of a director, for instance, for any insolvent trading by that responsible entity.[13] Therefore, extending limited liability to members of registered schemes, qua members, would not create an avenue for those who control these schemes to avoid liability for their actions.

Members of ASIC-exempt schemes should also have the protection of limited liability. To exclude these schemes may discourage some schemes from seeking an ASIC exemption. ASIC could take this factor of limited liability into account when considering applications for, or the terms of, any exemption.

The Advisory Committee considers that there should be no change to the existing common law for members of unregistered schemes. These schemes can adopt structures that do not have a public company responsible entity. However, confining any statutory limitation on liability to registered schemes and ASIC-exempt schemes may result in fewer unregistered schemes being floated.

Promoting market efficiency and encouraging investment diversity

Limited liability promotes the liquidity and efficient operation of securities markets, as the wealth of each shareholder or member in a listed entity is irrelevant to the trading price of its securities. This allows the securities to be freely traded, as their price is set by factors other than their owners' wealth.

Limited liability also permits investors to acquire securities in a range of companies or managed investment schemes. This would be impractical for many investors if the principle of unlimited liability applied and they could lose all or most of their personal wealth through failure of one entity in which they invested.

These rationales for conferring limited liability on shareholders of companies apply equally to members of registered and ASIC-exempt managed investment schemes.

Types of member liability

A company limited by shares is formed on the principle that each shareholder is liable during the life, as well as upon the liquidation, of the company only for the amount (if any) unpaid on the shares held by that person.[14] No further pre-liquidation or

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11 s 601FA.

12 The s 9 definition of director includes any "shadow director", namely any person in accordance with whose instructions or wishes the directors are accustomed to act.

13 s 588G.

14 s 9 definition of "company limited by shares". A shareholder could be subject to additional liability under the terms of a separate contractual arrangement, for instance, a personal guarantee for debts of a company. However, this is not an exception to the principle of limited liability, but an example of the right of persons to bind themselves by separate agreement.

post-liquidation liability may be imposed on a shareholder without that person's consent.[15]

Members of managed investment schemes have potentially broader liabilities. Depending on the type of scheme and the terms of its constitution, scheme members could be liable (in addition to the cost of their units) for:

- *pre-liquidation liabilities*, that is, levies or other payments imposed during the life of the scheme in accordance with the scheme constitution[16]

- *post-liquidation liabilities*, that is, debts to scheme creditors that remain outstanding upon the liquidation of the scheme.

The Advisory Committee considers that there should be no interference with any right to impose levies, charges or other forms of pre-liquidation liabilities on scheme members pursuant to a scheme's constitution. Various schemes may depend on imposing periodic levies or charges to achieve their objectives. Any liability for these unpaid amounts should remain, even where the scheme subsequently goes into liquidation. Statutory limited liability for managed investment schemes should only apply to other debts arising in the context of a scheme's liquidation.

Policy options for introducing limited liability

Managed investment schemes may be structured in various ways, including as trusts, full or limited partnerships or contractual arrangements. The constitution of these schemes could take one of four possible approaches to limited liability in the context of their liquidation:

- *limited liability schemes*, which seek to provide that, upon the winding up of the scheme, members will have no obligation to contribute (beyond any capital amount still outstanding on their units)

- *indeterminate liability schemes*, which make no reference to member liability upon the winding up of the scheme

- *specific liability schemes*, which provide that, upon the winding up of the scheme, members will have an obligation to contribute in specified circumstances or pursuant to the exercise of specific powers in the constitution, but not otherwise

- *unlimited liability schemes*, which, either expressly or by the inherent nature of the scheme (for instance, a full partnership), provide that, upon the

15 For instance, all shareholders of a company limited by shares or guarantee must approve that company changing to an unlimited liability company: s 163(2)(c). Also, a shareholder, except by written consent, is not bound by any modification of the company's constitution that purports to increase shareholders' liability to contribute to the share capital or otherwise pay money to the company: s 140(2)(b). Upon liquidation, shareholders need not contribute more than the amount (if any) unpaid on the shares they hold: s 516.

16 The right of a responsible entity to impose levies on scheme members pursuant to the terms of the scheme constitution is commonplace in agricultural and various real estate schemes.

winding up of the scheme, members shall have unlimited liability for all the scheme debts not covered by the liquidation of scheme assets.

The Advisory Committee has considered a number of possible alternative statutory approaches for registered and ASIC-exempt schemes (eligible schemes).

- *Disclosure obligation only.* Under this option, there would be no statutory provision concerning limited liability for eligible schemes. Instead, the Corporations Law would oblige the responsible entity to inform members by an express statement in the constitution, and in any fundraising document, of the extent to which the scheme into which they are entering gives members limited liability and how that is achieved. For instance, for eligible schemes that operate through a trust structure, the terms of the trust deed may expressly deny the trustee any right of indemnity against the trust beneficiaries. The effectiveness of any limited liability provision in a scheme constitution would depend on the drafting of that provision and any relevant common law principles. Third parties would have to rely on their own interpretation of any relevant clause to determine their likelihood of recovery against members. Also, it would be difficult to determine whether or how to impose a disclosure obligation when interests in managed investment schemes are transferred.

- *Limited liability if expressly adopted.* Under this option, the Corporations Law would contain a provision conferring limited liability on members of an eligible scheme on the winding up of that scheme, in the same manner as shareholders of a company, if the scheme constitution expressly adopted that provision. This option may be difficult to apply to specific liability schemes, given that such schemes could at best only partially adopt limited liability (that is, limited liability in any circumstances not covered by specific liability).

- *Limited liability, except to the extent of any contrary scheme provision.* Under this option, the Corporations Law would confer limited liability on members of an eligible scheme on the winding up of the scheme, in the same manner as shareholders of a company, except to the extent that the inherent nature of the scheme (for instance, an ordinary partnership) or any scheme provision imposes any form of liability on members of the scheme beyond their initial contribution.

The Advisory Committee supports the third policy option. It gives the greatest level of protection to passive investors in eligible schemes by ensuring that they have limited liability unless a scheme inherently precludes limited liability or specifically chooses to exclude that protection, in whole or part. This statutory protection should apply to all eligible schemes, whether or not listed on the ASX. There are many unlisted managed investment schemes involving public participation.

Consequential policy matters

Several consequential policy issues arise for eligible schemes in implementing the principle of limited liability.

Identifying limited liability schemes

A company limited by shares must have "Limited" or "Ltd" at the end of its name.[17] This informs both investors and creditors that shareholders in those companies have limited liability during the life, as well as upon the liquidation, of those companies.

The Advisory Committee considers that schemes that limit the liability of their members in whole or in part on liquidation should be noted through some appropriate identifier to be stipulated by the Corporations Law. The aim would be to put creditors on notice, without attempting to provide detailed information or advice on the extent of limited liability. This would be in addition to the information that outsiders, particularly creditors, will be able to obtain through Australian Business Numbers (ABNs), which all business entities, including schemes, will be required to have from 1 July 2000.

The Committee also considers that any fundraising document for a managed investment scheme should indicate prominently the nature of any pre-liquidation or post-liquidation liabilities of its members.

Increasing liability

The constitution of any registered managed investment scheme may be amended by special resolution of its members.[18]

The Advisory Committee considers that the members of any eligible scheme should be permitted, by special resolution, to amend the constitution to increase the liability of future members and those existing members who consent in writing.[19]

Decreasing liability

The Advisory Committee has considered whether an eligible scheme that has specific liability or unlimited liability provisions should be permitted to reduce or eliminate that liability for existing and future members. The Committee supports schemes having this right, subject to approval by scheme members and protection of existing creditors. This could be achieved through the following procedure:

- a special resolution by scheme members to alter the scheme constitution to reduce or eliminate liability
- a statement signed by the directors of the responsible entity setting out the reasons for their opinion that the reduction or elimination of liability would not materially prejudice the scheme's creditors, and

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17 ss 148, 149.

18 s 601GC(1)(a). The responsible entity may also amend the constitution where the change would not adversely affect members' rights: s 601GC(1)(b).

19 cf s 140(2)(b).

- approval by ASIC, taking into account the position of creditors.

The Advisory Committee does not support additional requirements such as the consent of all creditors or leave of the court. These could considerably increase the cost and time in reducing liability and, in effect, give a veto to any creditor. However, the Committee considers that the directors of the responsible entity should be personally liable in the event that creditors are prejudiced by the reduction or elimination of liability.

Protection of creditors when members withdraw from a scheme

The increasing tendency for managed investment schemes to borrow funds against scheme assets points to the growing importance of creditor protection.

The Advisory Committee considers that the creditors of managed investment schemes should be protected through a provision similar to that found for reduction of capital or buy-backs by companies. Any right of members to withdraw from a scheme under a withdrawal offer should be made subject to a requirement that it "does not materially prejudice" the ability of the responsible entity to pay the existing scheme creditors from the remaining scheme assets for any debts for which scheme creditors have rights against scheme assets.[20] That requirement should apply to any withdrawal offers made after the amending legislation has come into force.

Creditors of managed investment schemes, like creditors of a company that is buying back shares, should have the right, where appropriate, to seek an injunction to prevent a withdrawal offer.[21] Likewise, the directors of a responsible entity should be personally liable if the scheme is or becomes insolvent in permitting withdrawals by investors.[22] However, creditors should not be entitled to pursue former members for return of funds paid to them in withdrawing from the scheme.

The Advisory Committee considers that this creditor protection provision should apply to all schemes that permit members to withdraw, whether or not the proposals for introducing statutory limited liability proceed.

Taxation implications

Attached is a letter of advice from Treasury of 2 December 1999 dealing with the possible tax implications of introducing statutory limited liability.

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[20] cf s 256B(1)(b), s 257A(a). In a trust arrangement, a creditor's right of recovery against scheme assets is through subrogation to the responsible entity's right of indemnity from the scheme assets. The responsible entity's indemnity right is regulated by s 601GA(2).

[21] cf s 256E referring to s 1324.

[22] cf s 256E, referring to ss 588G and 1317H.

Recommendation 1. Limited liability of members

The Corporations Law should provide that:

- members of all registered managed investment schemes and ASIC-exempt schemes (eligible schemes) have limited liability for scheme debts that remain outstanding on the winding up of the scheme, in the same manner as shareholders of a company limited by shares, except to the extent that the inherent nature of the scheme or any scheme provision imposes any form of liability on members of the scheme beyond their initial contribution

- eligible schemes that limit the liability of their members in whole or in part on liquidation should be noted through some appropriate identifier to be stipulated by the Corporations Law

- any fundraising document for an eligible scheme that imposes any form of liability on members during the life or on the liquidation of a scheme must prominently note and explain the level of liability

- members of an eligible scheme may by special resolution amend its constitution to increase the liability of future members. Each existing member should only be bound by that amendment with that person's consent

- an eligible scheme may reduce or eliminate the liability of its members by the following procedure:

    - a special resolution by scheme members to alter the scheme constitution to reduce or eliminate liability
    - a statement signed by the directors of the responsible entity setting out the reasons for their opinion that the reduction or elimination of liability would not materially prejudice the scheme's creditors, and
    - approval by ASIC, taking into account the position of creditors

- the directors of the responsible entity of an eligible scheme should be personally liable in the event that creditors are prejudiced by any reduction or elimination of liability.

Recommendation 2. Withdrawal from a scheme: creditor protection

The Corporations Law should be amended to provide that any right of members to withdraw from a managed investment scheme under a Part 5C.6 withdrawal offer is subject to a requirement that it "does not materially prejudice" the ability of the responsible entity to pay the existing scheme creditors from the remaining scheme assets for any debts for which scheme creditors have rights against scheme assets. That requirement should apply to any withdrawal offers made after the amending legislation has come into force.

Creditors of managed investment schemes should have the right to seek an injunction to stop a Part 5C.6 withdrawal offer. Also, the directors of a responsible entity should be personally liable if the scheme is or becomes insolvent in permitting withdrawals by investors.