Financial advice disputes – recent developments

By Josh Mennen

This article first reviews the legislative changes to the *Corporations Act* 2000 (Cth) in respect to conflicted remuneration. Part II offers an overview of issues faced by financial advice clients seeking to recover their losses from a financial adviser's professional indemnity insurer directly, drawing on the consequences of *Perpetual Trustees Victoria Ltd v Malouf* [2012] NSWSC 1119.

PART I – THE FUTURE OF FINANCIAL ADVICE REFORMS AND CONFLICTED REMUNERATION

Many of the estimated one in five Australian investors who receive financial advice sustained financial losses during and in the aftermath of the global financial crisis. These losses were felt most intensely by consumers of financial advice whose assets, including their superannuation investments, had been overexposed to inappropriately risky investment strategies.

The subsequent barrage of legal complaints by such consumers ('retail clients'), alleging that the financial product advice they received was negligent or in breach of contract, exposed deep failings in the regulatory regime. Particularly alarming was the inherent moral hazard associated with volume and commission remuneration structures that have dominated the financial product advice industry. These structures give Australian Financial Services Licensees ('advisers') strong incentives to irresponsibly overexpose their retail clients' assets by a raft of risky strategies, including through options trading portfolios, margin lending and other gearing strategies.

These improper and, in many cases, unlawful practices, were not limited to minor industry players, but were culturally systemic in some of the largest and most trusted advisers in the Australian corporate landscape. Perhaps the most notorious example is the conduct of the

Commonwealth Financial Planning Limited ('CFPL'), the financial advice arm of the Commonwealth Bank of Australia ('CBA'), whose advisers gave what it has since admitted was "inappropriate advice" to hundreds of retail clients.[1] This included overexposing retirees' superannuation and other assets to high-risk share and property portfolios managed by CBA's own asset management division, Colonial First State Global Asset Management. The resulting wreckage of so many peoples' lives eventually led to the banning of CFPL advisers by ASIC. The investigation by ASIC into one such CFPL adviser only began, it has been reported, after he was promoted to Senior Adviser, even though the bank's whistleblowers had previously raised concerns about him with ASIC.[2] In the well-publicised fallout, and under the strain of a class action on behalf of the disaffected clients, CFPL gave an Enforceable Undertaking in which it undertook to review its risk management framework and address identified deficiencies. CFPL ultimately compensated hundreds of clients, including over 1,000 clients of one of its advisers, Mr Don Nguyen.[3]

Coupled with public outrage in response to the collapses of major financial advice and investment companies such as Storm Financial, Westpoint Group and Trio Capital, these experiences motivated the former federal Labor government to introduce significant reforms to the financial advice sector.[4]

Dubbed 'Future of Financial Advice' ('FOFA'), these reforms took effect from 1 July 2013. They addressed, among other things, the findings of the 2009 Inquiry into financial products and services in Australia by the Parliamentary Joint Committee on Corporations and Financial Services, which had, in line with popular sentiment, observed that:

> 'A significant conflict of interest for financial advisers occurs when they are remunerated by product manufacturers for a client acting on a recommendation to invest in their financial product.'

Central to the reforms was a ban imposed on 'conflicted remuneration' structures including (subject to exceptions), commissions and volume-based payments. When advising retail clients (as opposed to wholesale clients[5]), advisers must no longer accept conflicted remuneration,[6] and product managers like banks and private superannuation funds may not give conflicted remuneration to advisers.[7]

Furthermore, there is a presumption that volume-based benefits (that is, benefits whose provision is dependent on the volume of the financial product sold) constitute conflicted remuneration.[8]

Conflicted remuneration is defined as:[9]

> '...any benefit, whether monetary or non-monetary, given to a licensee or their representative, who provides financial product advice to persons as retail clients that, because of the nature of the benefit or the circumstances in which it is given:
> (a) could reasonably be expected to influence the choice of financial product recommended by the licensee or representative to retail clients; or
> (b) could reasonably be expected to influence the financial product advice given to retail clients by the licensee or representative.'

Fees paid by a retail client to an adviser are not conflicted remuneration.[10] A product manager may pay a benefit to an adviser in circumstances where it has, with a retail client's consent, first procured that benefit as a fee from the retail client on behalf of the adviser.

The FOFA reforms also introduced a prescribed duty requiring financial advisers to act in the best interests of their clients when giving personal advice and a requirement for advisers to obtain client agreement to ongoing advice fees every two years.

Despite (in the author's opinion) their much-needed introduction, these reforms have been met with resistance by some sectors of the industry, and most recently by the new federal Coalition government, which takes the position that the '*reforms went too far, creating unnecessary complexity, imposing significant burdens on industry and reducing the availability and increasing the cost of advice to consumers*'[11]. Consequently, we expect to see controversial changes to the FOFA regime in this electoral term.

While it is outside the scope of this article to examine the various proposed FOFA reforms in detail, the proposal to exempt general advice from conflicted remuneration is of major concern. To examine the effect of that proposal, it is necessary to clarify the relevant terms (paraphrasing s766B of the *Corporations Act* 2000 (Cth)), where: >>

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Dr Keith Tronc, Barrister-at-Law and an APLA/ALA member of long standing, who has been invited to speak at seven APLA/ALA National Conferences, is a former teacher, school principal, TAFE teacher, university lecturer, solicitor and Associate Professor of Education. He assists numerous Australian law firms in educational litigation involving personal injuries, discrimination, bullying, sex abuse, breaches of contract, and TPA matters. Dr Tronc appears frequently in court in several States providing independent expert opinion on matters concerning education and the law. Dr Tronc has published four national textbooks and looseleaf services on schools, teachers and legal issues.

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Contact: Dr Keith Tronc, PO Box 6490, Upper Mt Gravatt, Brisbane Q 4122, Ph: 07 3849 2300 Fax: 07 3849 2500

- Personal advice is *financial product advice that is given or directed to a client in circumstances where the adviser has considered one or more of the client's objectives, financial situation and needs, or a reasonable person might expect the adviser to have considered one or more of those matters.*
- General advice is *financial product advice that is not personal advice.*

One of the common complaints by retail clients seeking to claim compensation for losses against their adviser is that they had been told or assumed that the advice they were receiving was appropriate to their '*objectives, financial situation and needs*' (personal advice) whereas the adviser, in its defence, asserts that the retainer was one of general advice which obviated it from ordinary requirements to have ensured the advice strategy was in the client's best interests.

An adviser may establish a general advice retainer simply by confirming in it that it is so.[12]

Ongoing or trailing commissions and volume payments offered under the former regime often proved too tempting to resist for many profit-driven institutions. This fostered a 'boiler room' culture in which sales targets took priority over compliance and service. Given this context, exempting general advice from conflicted remuneration will inevitably encourage advisers to engage in general advice rather than personal advice retainers at greater volume and risk to their retail clients, thereby evading the conflicted remuneration safeguards in pursuit of fatter profits. There can be little doubt as to the result for retail clients, if history is anything to go by.

The counter-argument is, of course, that retail clients have a choice as to the service they buy, and can and should insist on personal advice if they desire those protections. However, unfortunately, in the author's experience, once a level of rapport has been established between advisor and retail client, many investors can all too easily be persuaded to sign forms without examining or properly understanding them, or to otherwise agree to obtain general advice with its siren call of greater flexibility and lower fees, without appreciating the implications. Many retail clients simply do not understand the ramifications of receiving general advice. They will not realise that it is incumbent on advisers to provide robust and careful advice if retained to give personal advice, nor will they know of the consequential impact on their prospects of recovering damages if the advice given is inappropriate and results in them suffering losses.

Hence, it appears that, notwithstanding the rhetoric being advanced in support of the proposed changes, this is a regressive leap that will likely result in inappropriately risky advice being given to and followed by many retail clients who are unable to absorb the resulting losses if and when markets decline, as they will inevitably do.

PART II – THIRD PARTY RECOVERABILITY AGAINST A FINANCIAL ADVISER'S PROFESSIONAL INDEMNITY INSURER

When systemic advice failures have been exposed, it is common for the advising entity to become insolvent.

Retail clients looking to take legal action against an adviser through the courts are confronted by a number of complex considerations, not least of which is whether any insurance is available if the relevant adviser is in liquidation or deregistered; a factor which can influence the identity of the defendant(s) to be pursued, the forum to proceed in, and indeed whether to proceed at all.

Where the insured adviser is deregistered, a retail client may seek recourse against its professional indemnity insurer directly, assuming details of the identity of the insurer can be ascertained. This is often a formidable challenge in itself. This direct recourse by the retail client may be facilitated by s601AG of the *Corporations Act* 2000 (Cth), which provides that a third party may recover from the insurer of a deregistered company an amount that was payable to the company under the insurance contract if: (1) the company had a liability to the person; and (2) the insurance contract covered that liability immediately before deregistration.[13]

Additionally, s51 of the *Insurance Contracts Act* 1984 (Cth) gives a third party a right to recover against an insurer in the event that the insured has died or cannot be found (which has been applied to extend to the deregistration of a corporate insured).[14] Despite recommendations over the years to augment s51 to expressly cover cases where the insured is alive and can be found but is unable to meet any judgment from its own resources (such as where an insolvent insured is in liquidation), amendment has not transpired.

Hence, where the adviser is in liquidation but has not yet been deregistered, it is unlikely that either s601AG or s51 would assist, and the options and prospects for recourse, both against the adviser and against the insurer directly, are more limited.

A retail client may seek leave to sue an adviser in liquidation by virtue of s500(2) of the *Corporations Act* 2000 (Cth). Leave may be granted where the claim attracts a responsive insurance policy. However, that option may not always be feasible. The criterion for such leave was identified in *Oceanic Life Ltd v Insurance and Retirement Services* (per Zeeman J)[15] as including:

1. whether there is a substantial question to be tried;
2. whether the action would interfere with the orderly winding up of the insured;
3. whether the action would serve any sufficient purpose; and
4. whether the action would have any adverse effect upon the insured and its shareholders.[16]

It may be difficult, prior to discovery or subpoenas, to adduce evidence in a leave application that the adviser is insured for its liability – in respect of the claim being made and in respect to the costs of defending the proceedings – without access to all relevant insurance policies. As the claimant may not have such access prior to making the s500 application, it may be wise to accompany the application with a notice requiring production of such policies. This may be successful, but success is not guaranteed.

An alternative option exists in New South Wales, the Australian Capital Territory and the Northern Territory

whereby legislation creates a 'charge' on any money payable under a contract of liability insurance in favour of a third party whose claim is covered by the contract, notwithstanding the winding-up of the insured.[17] A third party may, with leave of the court, take action to enforce the charge in the same way and in the same court as if the action were an action to recover damages or compensation from the insured. The relevant charge on insurance monies arises on the happening of the 'event' giving rise to the claim against the insured, and the 'event' is whatever completes the cause of action against the insured.

These provisions are generally consistent with the practical doctrine of 'direct recourse' reflected in the comments of the ALRC[18] that:

> 'The fact that an insurer under a third party liability policy usually takes over the conduct of a claim by a third party against the insured might suggest that a third party should be entitled to bring a claim directly against an insurer in all cases.'

Indeed, there has been no serious argument made that third parties should not have a right of direct recourse so long as the insurer's rights to defend the action, as if it had been brought against the insured in the normal manner, are preserved. That is, giving the insurer the same rights and liabilities as if the action were against the insured,[19] and providing that the insurer's liability is no greater than its liability to the insured.[20]

However, despite the policy rationale, recent cases turning on the application of s6 of the *Law Reform (Miscellaneous Provisions) Act* 1946 (NSW) in the context of leave applications by third parties have significantly curtailed the scope of these statutes.[21]

Among the most recent of these is *Perpetual Trustees Victoria Ltd v Malouf*.[22] There, in the underlying proceedings, Perpetual Trustees Victoria Ltd sued Mr Albert Malouf and his parents, Mr and Mrs Malouf (collectively the defendants), for possession of a property that had been mortgaged to fund an investment loan by Mr Albert Malouf in 2004.

In a cross-claim, Albert Malouf alleged that Mr Goldberg, the solicitor who had advised Mr and Mrs Malouf in respect of the loan documents in 2004, had given negligent advice which caused the loss. Mr Goldberg's practising certificate was cancelled in July 2004. LawCover had, from July 2006, agreed to insure the administrator of Mr Goldberg's practice for professional liability claims first made against it after that date. Albert Malouf sought leave to cross-claim against LawCover under s6. His Honour Davies J refused the leave application.

Albert Malouf's argument was that while Mr Goldberg's negligent advice was given in 2004 (before the relevant insurance policy), the relevant 'event' was in 2006 because that was when the loss was suffered (it being when the relevant loan could no longer be recovered).

The court dismissed Albert Malouf's leave application to cross-claim against LawCover. His Honour's reasoning was that the 'event' giving rise to the claim for compensation was a breach of the retainer. This breach had occurred in 2004 when the legal service complained of was provided and when the loans were given. That was so notwithstanding the fact that the defendants did not expressly plead a breach of retainer, but rather that an allegation was deemed to have been implied by the 'negligent acts alleged which [were] inconsistent with the terms of the retainer'.[23]

Malouf followed on from the NSW Court of Appeal's decision in *The Owners –Strata Plan No. 50530 v Walter Construction Group Limited*.[24] *Strata Plan No. 50530* settled what had been an inconsistency in the law, and held that a 'charge' under s6 did not arise when the 'event' happened before the inception of the relevant policy being claimed upon.

As to the time of the 'event', in claims involving the breach of professional duty, *Malouf* diverged from previous reasoning in *Sciacca v Ace Insurance Ltd*.[25] *Sciacca* also involved a petition for leave under s6 in the context of a claim in negligence against the insurer of a professional service provider under a 'claims made' policy. There, His Honour Schmidt J found that the s6 'event' occurred when actual loss flowing from the breach is ascertainable. He stated:[26]

> '...at common law a plaintiff can only recover compensation for actual loss or damage incurred, not potential or likely damage. Loss and damage is not the inevitable result of every act of negligence. When a cause of action for negligence causing economic loss accrues, this requires consideration of both the negligent act or

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omission in question and when the resulting loss or damage actually materialised.'

The approach in *Malouf* is a difficult precedent if it is to be applied in the context of retail clients considering legal action against their adviser's insurer under s6 (or the corresponding ACT or NT statutes) because even where no breach of retainer is expressly pleaded, an allegation of negligence against the adviser may be construed as an allegation of breach of retainer.

In financial advice cases, in particular, the initial breach of retainer generally occurs at the time the adviser places a retail client's assets into an inappropriate investment, and that often occurs years before any economic losses' flowing from that breach are ascertainable.

As such, the effect of *Malouf* appears to be that the relevant 'charge' under s6 will not be enlivened even when there was an insurance policy in place when the claim is made where the essential nature of the claim was breach of contract, the breach of which occurred prior to the policy being in place.

Interestingly, His Honour Giles J observed in *Strata Plan No. 50530* that s6 '...was enacted prior to the present prominence of claims made and claims made and notified policies of insurance...',[27] and that it is an unsatisfactory provision deserving of wide-ranging legislative reconsideration and with regard to the availability of direct enforcement against an insurer.[28]

Without a remedy under s6, a remaining possibility may be to seek to ascertain the details of, and if appropriate, claim on the professional indemnity policy held by the adviser as at the date of the inappropriate investment being made. However, that raises a new set of challenges to grapple with in respect to the substantive insurance claim. For example, it will usually be necessary to overcome the policy requirement that the claim be made whilst the policy is extant, which may be accomplished under s54 of the *Insurance Contracts Act* 1984. That section provides that where an insurer may refuse to pay a claim by reason of some act or omission (that is, the failure to claim on the policy in time), the insurer may not refuse to pay the claim by reason only of that act or omission. Instead, the insurer's liability in respect of the claim is reduced by the amount that fairly represents the extent to which its interests were prejudiced as a result of that act or omission. Additionally, while it is not within the scope of this article to examine the relevant limitation statutes that apply to claims against financial advisers and their insurers, this ever critical consideration is of greater urgency and concern when considering suing in respect of an older policy. ■

Notes: **1** Commonwealth Bank of Australia, 'Response to Fairfax Media regarding Commonwealth Financial Planning and Don Nguyen', media release, 1 June 2013: https://www.commbank.com.au/about-us/news/on-the-record/2013/response-to-fairfax-media-regarding-commonwealth-financial-planning-and-don-nguyen.html. **2** Noting that there is evidence that some of CFPL's negligent advisers were initially promoted when whistleblowers first raised concerns with ASIC: See Adele Ferguson and Chris Vedelago, 'Profit above all else: how CBA lost savings and hid its tracks', AAP, 1 June 2013: http://aap.newscentre.com.au/cpsunat/130601/library/private_&_public_partnerships/31198976.html *'The clincher had been the decision to promote the fast-talking Nguyen in October 2008 to senior planner, a month after he had been suspended over allegations of charging improper fees and paying cash backhanders to branch staff to divert client referrals.'* Also available here: http://www.smh.com.au/business/profit-above-all-else-how-cba-lost-savings-and-hid-its-tracks-20130531-2nhde.html. **3** Adele Ferguson and Chris Vedelago, 'Targets, bonuses, trips – inside the CBA boiler room', 22 June 2013: http://www.smh.com.au/business/banking-and-finance/targets-bonuses-trips–inside-the-cba-boiler-room-20130621-2oo9w.html#ixzz2pZ0CsmjL. **4** *Corporations Amendment (Future of Financial Advice) Act* 2012 (Cth); *Corporations Amendment (Further Future of Financial Advice Measures) Act* 2012 (Cth). **5** See s761G *Corporations Act* 2000 (Cth) for definitions of 'retail client' and 'wholesale client'. **6** *Corporations Act* 2000 (Cth), s963H. **7** *Ibid*, s963K. **8** *Ibid*, s963L. **9** *Ibid*, s963A. **10** *Ibid*, ss963B(1)(d)(ii) and 963C(e)(ii) *Corporations Act* 2000 (Cth); ASIC, Regulatory Guide 246, reg246.61, 'Conflicted remuneration'. **11** 'Delivering affordable and accessible financial advice', Media release of Senator the Hon Arthur Sinodinos, 20 December 2013: http://axs.ministers.treasury.gov.au/media-release/011-2013/. **12** The National Insurance Brokers Association suggest the following wording be used when giving general advice: 'This advice does not take into [account] any of your objectives, financial situation or needs. For this reason, before you act on this advice, you should consider the appropriateness of the advice taking into account your own objectives, financial situation and needs. Before you make a decision about whether to acquire the policy, you should obtain and read the product disclosure statement.' **13** See also s562 *Corporations Act* 2000 (Cth) and s117 *Bankruptcy Act* 1966 (Cth), which give third parties with a claim against an insolvent insured priority over other creditors in relation to money paid to the liquidator or trustee in bankruptcy by the insurer in respect of a claim brought by the third party against the insured. **14** *Norsworthy & Encel* v SGIC [1999] SASC 496 at [62]. **15** *Oceanic Life Ltd v Insurance and Retirement Services (in liq)* (1993) BC9300099 (per Zeeman J) at [3] **16** See also *Katingal Pty Ltd v Amor* (1999) 162 ALR 287. **17** Section 6, *Law Reform (Miscellaneous Provisions) Act* 1946 (NSW); ss206 and 207, *Civil Law (Wrongs Act*) 2002 (ACT); ss26 and 27, *Law Reform (Miscellaneous Provisions) Act* (NT). **18** Australian Law Reform Commission, *Insurance Contracts* (ALRC Report 20), tabled December 1982, last modified 19 July 2012, at 340. **19** Andjelkovic v AFG Insurances Ltd (1980) 47 FLR 348 at 355-6. **20** Section 51(1), *Insurance Contracts Act* 1984; *Gorczynski v Wandft Osmo Pty Ltd* [2010] NSWCA 163 at [82], [83]. **21** While not the focus of this article, it should be noted that the NSW Court of Appeal decision of *Energize Fitness Pty Ltd v Vero Insurance Ltd* [2012] NSWCA 213 is one such case. That case prescribes a tougher test for claimants in persuading a court to grant leave. That is, not only that there is an arguable case that certain facts exist, but also that those facts provide grounds for legal relief (at [58]). Also of high importance is the decision of the NSW Court of Appeal in *Chubb Insurance Co of Australia Ltd v Moore* [2013] NSWCA 299 which held that if s6 applies, defence costs may be taken from the insurance monies. However, that finding is contrary to the subsequent decision of the New Zealand Supreme Court of *BFSL 2007 Ltd (in liq) v Steigrad* [2013] NZSC 156. That decision considered *Chubb Insurance* but held that if the s6 equivalent applies (s9(1) of the *Law Reform Act* 1936), defence costs cannot be taken from the insurance monies. **22** *Perpetual Trustees Victoria Ltd v Malouf* [2012] NSWSC 1119. **23** *Ibid*, at [51]. **24** *The Owners – Strata Plan No. 50530 v Walter Construction Group Limited (In Liquidation) and Ors* [2007] NSWCA 124. **25** *Sciacca v Ace Insurance Ltd* [2011] NSWSC 798. Although for reasons unknown to the author, and not obviously apparent, *Malouf* did not refer to *Sciacca*. **26** At [30], citing Wardley Australia Ltd v Western Australia (1992) 175 CLR 514 at [14] – [16]. **27** *Sciacca v Ace Insurance Ltd* [2011] NSWSC 798 at [2]. **28** *Ibid*, at [7].

Josh Mennen *is a senior associate at Maurice Blackburn, Sydney.*
PHONE *(02) 8267 0976* **EMAIL** *Jmennen@mauriceblackburn.com.au.*