



**ASIC**

Australian Securities & Investments Commission

## **Corporations and Markets Advisory Committee**

# **Long-tail liabilities: The treatment of unascertained future personal injury claims**

**Submission by the Australian Securities and  
Investments Commission**

**October 2007**

# Introduction

The Australian Securities and Investments Commission (ASIC) welcomes the opportunity to provide this submission to CAMAC's review of long-tail liabilities and the treatment of unascertained future personal injury claims.

ASIC supports the Government's aims of strengthening protection for unascertained future personal injury claimants ('UFCs'), and deterring the misuse of company structures to avoid making compensation.

ASIC also supports the stated aim of the Parliamentary Secretary to the Treasurer's Referred Proposal, which is to strengthen protections for personal injury claimants, particularly where there is a long latency period for an injury, which hinders them from taking any action to protect their rights.

At the same time, ASIC recognises the need for any law reform process to minimise disruption to business certainty.

ASIC is generally supportive of CAMAC's proposed measures for the implementation of these aims, as set out in its paper *Long-tail liabilities: The treatment of unascertained future personal injury claims* (Discussion Paper). ASIC's submission comments on various aspects of the proposals that relate to ASIC's functions and responsibilities, in the interests of assisting the further development of these proposals. This includes comment on the impact of the proposals on the conduct of companies and external administrations, and the practical operation of the proposals in general.

The issue of long-tail liabilities and UFCs also encompasses two particular aspects of public policy, that is:

- whether the cost of compensating UFCs should be borne by companies responsible for the injuries suffered, or by the community through a public fund, or other means; and
- whether increased protection for UFCs should extend beyond personal injury claims to all long-tail liabilities, for example, those resulting from environmental harm.

ASIC does not consider that it is part of its role to comment on these high-level public policy issues, which are properly to be determined by the Government. ASIC's submission does not discuss these matters.

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# Issue 1: Threshold Test

## Relevant Proposals

- 1.1 The model referred to CAMAC by the Parliamentary Secretary to the Treasurer (Referred Proposal) envisages that UFC protections will only be triggered once a threshold test is satisfied (Referred Proposal test, set out at section 3.2 of the Discussion Paper).
- 1.2 The Discussion Paper proposes an alternative threshold test (CAMAC test, set out at section 4.5 of the Discussion Paper).

## ASIC Comment

- 1.3 It is crucial to define a threshold test with sufficient certainty to make it reasonably clear when it will be satisfied. This is particularly so for directors and external administrators, who will be subject to additional obligations once the threshold is met. These parties need to be able to make decisions about how to deal with company funds with confidence.

### Referred Proposal Test

- 1.4 ASIC has some reservations about the Referred Proposal test. In particular, we are concerned that certain aspects of the wording might lead to uncertainty.
- 1.5 Concepts such as an ‘unusually high number of claims’, a ‘strong likelihood’ and ‘numerous’ appear to incorporate a range of different standards of probability and need more precise definition, and might mean different things to companies of different sizes.
- 1.6 We are also concerned that the carve-out might represent an additional significant obstacle to triggering the threshold and impose an unnecessarily high evidentiary burden at this preliminary stage. There is also some risk that including such a carve-out might encourage wilful blindness in companies, in deliberately not investigating the potential for UFC liabilities to arise or not quantifying the likely costs involved.

### CAMAC Test

- 1.7 ASIC supports the alternative test proposed by CAMAC. We feel that it avoids some of the problems of the Referred Proposal test discussed above, as it is more precise and certain and is not undermined by the carve-outs in the Referred Proposal, which, in combination, might have the tendency to promote lengthy legal disputes.
- 1.8 We note that this test would not cover the situation where UFC liabilities of one company were at some point in the past isolated in a

subsidiary, which was then sold off. However, we consider that this kind of scenario relates properly to the issue of anti-avoidance, and should be dealt with through the proposed anti-avoidance provision, as discussed further in section 4.

**1.9** While, as stated, we support this test, we make the following comments:

*Application of Test — Corporate Groups*

**1.10** We consider that this test should apply to corporate groups. That is, the test should be satisfied if:

- at least one personal injury claim against the company or related body corporate, or against another company or related body corporate in a similar industry to the company, has successfully been made or currently exists with a reasonable likelihood of success; and
- the company knows or ought reasonably to know of the exposure of a significant number of persons to the factors that have given rise to the claim; and
- there is a reasonable likelihood that future claims against the company or a related body corporate would arise from that exposure.

**1.11** Companies in corporate groups often have formal or informal arrangements that ensure that their financial viability is interrelated, and it is essential that these structures not be misused to defeat the interests of UFCs.

## Issue 2: Solvent Companies

### Relevant Proposals

- 2.1** The Referred Proposal suggests that, once the threshold standard is met, existing creditor protection provisions in relation to share capital reduction and share buy-backs would be triggered. It proposes an amendment to the *Corporations Act 2001* (the Act) along these lines.
- 2.2** The Discussion Paper sets out various alternative policy options in relation to solvent company UFC obligations, including extending the Referred Proposal model to financial assistance transactions and dividends, and introducing a specific directors' duty in relation to UFCs.

### ASIC Comment

- 2.3** ASIC agrees, as a basic principle, that solvent companies should not be able to act in such a way as to jeopardise their ability to compensate UFCs.

#### Capital Returns

- 2.4** ASIC supports the proposal that the Act should be amended to make it clear that solvent companies that meet the threshold standard should take into account the interests of UFCs in various corporate transactions that return capital to shareholders. That is, for the avoidance of doubt, the Act should be amended so that it is clear that UFCs cannot be materially prejudiced in the following circumstances:
- in relation to share capital reductions (ie, an extension of the condition in s256B(1)(b) that share capital reductions only be made by a company where the reduction would not materially prejudice the company's ability to pay its creditors); and
  - in relation to share buy-backs (ie, an extension of the condition in s257A(a) that share buy-backs only be completed by a company where the buy-back would not materially prejudice the company's ability to pay its creditors).

#### *Financial assistance*

- 2.5** ASIC notes that the Discussion Paper does not express a strong view on whether the proposals should extend to financial assistance for acquiring shares, that is, whether the condition in s260A(1)(a)(ii) of the Act, that a company only give financial assistance for acquiring shares where it would not materially prejudice the company's ability to pay its creditors, should extend to UFCs.

- 2.6 ASIC supports this extension, being a logical extrapolation of the principle that a company's funds should not be transferred to shareholders if this would prejudice UFCs.
- 2.7 We note, however, that s260A(1)(a)(ii) operates differently from ss256B(1)(b) and 257A(a), in that shareholders may approve such assistance under s260A(1)(b) of the Act, even where this would be materially prejudicial to creditors. Thus, an extension of this provision would not necessarily provide entire protection for UFCs from prejudicial transactions, especially given that UFCs are unlikely to be members of the relevant company, or even realise at the time that they have a claim against it.
- 2.8 Nevertheless, ASIC still believes this extension is necessary in order to provide some requirement to consider UFCs in these circumstances.

#### *Dividends*

- 2.9 ASIC notes that the Discussion Paper considers various arguments for and against the extension of UFC protection to the payment of dividends, that is, extending the implicit creditor protection in s254T of the Act, without making an explicit recommendation.
- 2.10 ASIC feels that, while there are arguments for extending UFC protections in relation to all transactions that reduce company funds, dividend payments can be distinguished from capital reduction transactions in that they are part of a company's regular capital management activity, and are less discretionary in nature.
- 2.11 We are concerned that requiring companies to take UFCs into account before declaring a dividend might prove to be an unnecessary restraint on this market activity.

#### **Preferred Approach — 'Red Light' Directors' Duties**

- 2.12 While we support the Referred Proposal and CAMAC proposals as discussed above, ASIC feels that CAMAC should consider a broad duty for directors to take UFCs into account as necessary.
- 2.13 ASIC notes CAMAC's conclusion that the law currently permits directors to take into account the interests of UFCs in carrying out their duties (Discussion Paper, section 5.10). However, we consider that, while a permissive provision might not be necessary, the Act should be amended in order to introduce a positive obligation on directors to act in such a way that will not materially prejudice UFCs when carrying out their duties.
- 2.14 This could be done via a 'red light' model, so that the positive obligation is triggered once the threshold test is met. At this point, directors would be required to take UFCs into account in any

transaction the company undertakes, including capital reductions and share buy-backs. This would replace the need to introduce specific obligations into the Act in relation to particular activities discussed above.

- 2.15** ASIC feels that a ‘red light’ director’s duty could be an important way of providing global protection for UFCs in all of a company’s transactions. While the standard of the duty would be high, this duty would only be engaged once the threshold test was satisfied. ASIC prefers this approach because it is cleaner, and does not clutter up the capital reduction, buy-backs and other provisions with rules that will only very rarely be relevant.

#### **Alternative Approach — Court Approval of Transactions**

- 2.16** Another alternative is to incorporate an additional protective measure into the capital reduction and buy-back procedures, so that:
- where a company has UFCs, and meets the threshold test; and
  - the directors of the company consider that a capital reduction or buy-back would not materially prejudice UFCs, and that the company should proceed;
  - a court should first approve such a transaction on such terms as it thinks appropriate.
- 2.17** A court might be better placed to consider the interests of UFCs and how they might be affected by the proposed transaction than directors. In order to obtain court approval, the company would need to put before the court evidence that the interests of UFCs would not be materially prejudiced, and its methodology for reaching this conclusion. This would expose the decision-making process to external scrutiny, and potentially to publicity. These factors would act as a deterrent in circumstances where the decision to enter into the transaction was not reasonably based.
- 2.18** Nevertheless, ASIC recognises that such a step would involve additional cost to companies, and might have the effect of discouraging companies from undertaking these transaction. This is not our preferred option.



## Issue 3: Insolvent Companies

### Relevant Proposals

- 3.1** The Referred Proposal contains a number of options for making provision for UFCs in the course of voluntary administrations, schemes of arrangement and liquidations (Discussion Paper, Chapters 6–8).

### ASIC Comment

#### Preferred Policy Options

##### *Voluntary administrations*

- 3.2** ASIC supports Option 4, as set out at section 6.6 of the Discussion Paper, requiring administrators to appoint a legal representative for UFCs, who would play no other role than to have standing to apply to the court to challenge a deed of company arrangement (DOCA) prejudicial to UFCs. We consider that this option achieves the best balance between protecting the rights of UFCs and avoiding excessive disruption of the voluntary administration process.

##### *Schemes of arrangement*

- 3.3** ASIC supports the third alternative proposal, as set out at bullet point three of section 7.3 of the Discussion Paper, again requiring the appointment of a legal representative for UFCs, who would play no other role than to have standing to apply to the court to challenge a scheme where prejudicial to UFCs.
- 3.4** We feel that this proposal would fit well with the existing regulatory framework for schemes of arrangement, which are already subject to court supervision.

##### *Liquidations*

- 3.5** ASIC supports the Referred Proposal, with the implementation procedure as set out in section 8.4 of the Discussion Paper, involving a trust fund for UFCs, with all matters to be determined by a court on the basis of expert actuarial evidence.
- 3.6** ASIC feels that this proposal has merit in making provision for UFCs without unreasonably delaying the course of the liquidation and payment to other unsecured creditors.
- 3.7** While we support this policy option, we feel it is important to note the following:
- The proposals will result in some delays and reduction of returns for ordinary unsecured creditors.

- The reduction in returns for ordinary unsecured creditors will be greater than the return to UFCs because of the expense of the process. Trustee fees, legal costs, and fees for actuarial advice will all erode the amount available to pay both unsecured creditors and UFCs.
- UFCs will only receive minimum compensation through this process:
  - Reports by liquidators lodged with ASIC under s533 indicate that, for the period 1 July 2004 to 30 June 2007, the amount payable to unsecured creditors was 10 cents in the dollar or less in approximately 96% of these liquidations. In the same period, approximately 63% of unsecured creditors received nothing.<sup>1</sup>
  - ASIC conducted a review of 275 reports from administrations that commenced between 1 July 2006 and 15 March 2007. Based on the reports in this sample, administrators estimated that creditors would receive between zero and 10 cents in the dollar in 38% of these administrations.
  - We would expect an insolvency involving UFCs to return significantly less than other insolvencies because of the additional class of creditors, and the expense of the UFC process.

**3.8** ASIC suggests that, given the problems outlined above, CAMAC might wish to consider proposing a threshold amount of net assets remaining in the insolvent company, below which the UFC process will not be worthwhile. For example, if the possible return to UFCs is calculated to be less than one cent in the dollar, the process might only end up transferring the limited assets of the company to the external administrator, trustee, lawyers, and actuaries.

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<sup>1</sup> These figures do not reflect all liquidations and generally reflect the position for small to medium-sized enterprises only.

## Issue 4: Anti-avoidance

### Relevant Proposals

- 4.1 The Referred Proposal includes an anti-avoidance provision, whereby a person would be prohibited from entering into agreements detrimental to UFCs where certain conditions are met (Discussion Paper 9.2).
- 4.2 The Referred Proposal also suggests giving a special priority for amounts awarded as compensation under the new provision, so that these would rank behind employee entitlements, but before other unsecured creditors (Discussion Paper 9.2.4)

### ASIC Comment

- 4.3 The proposed provision would be difficult to enforce, as it would be hard to obtain the evidence necessary to prove the intention elements of the offence. This would be especially so where the relevant event is remote in time from the crystallisation of the offence. In addition, evidence of a different intention might be used as a defence.
- 4.4 Nevertheless, ASIC feels that an anti-avoidance provision might have a deterrent effect, particularly with a criminal sanction attached. It is also important that the Referred Proposal envisages that persons knowingly involved in the contravention of the provision would also be liable to prosecution, including non-corporate parties such as lawyers.
- 4.5 As discussed in section 1 at para 1.8, above, we feel that it is important that the provision should cover situations where a company no longer operates in the industry in question, having been sold in an attempt to quarantine and avoid UFC liability.

### Priority

- 4.6 ASIC has some reservations about the Referred Proposal's suggestion of a special priority for compensation awarded to UFCs above other creditors, so that they would rank only behind employees.
- 4.7 An effect of this would be that all existing creditors, including those existing personal injuries claimants with an unexecuted judgment debt against the company, would rank behind future personal injury claimants. This seems an unjustified intrusion into the *pari passu* principle.
- 4.8 That, in turn, creates a potential disincentive to foreign investors in Australian domiciled companies, as foreign investors will be aware that the special priority afforded to potential personal injury claimants would demote the investor's ranking in a distribution in the event of

insolvency. There is also the potential for the complication of multiple jurisdiction insolvencies.<sup>2</sup>

- 4.9** ASIC feels that a better outcome is to rely on the trust fund model for payments to UFCs, discussed in relation to Issue 3, above.

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<sup>2</sup> See *Re HIH* [2006] EWCA Civ 732. Assets could not be repatriated to Australia for distribution because of a different order of priority from that under the English statutory scheme.